# IN THE PRESS

**Since setting up an advisory team in 2002, Liability Solutions has conducted 14 assignments covering in excess of $5 billion of assets up to end July 2006.**

## Why it pays to split the pot, or how

### Equity Insurance Group chose Union Bancaire Privée for hedge funds, and JP Morgan for long-only, for its £500m mandate in May. Solomon Teague investigated how the deal was done

Following the recruitment of Andrew Gibson by Equity Insurance Group (EIG) as finance director in October last year, the company has been working on ways to better utilise the company's risk budget, to improve performance without a substantial increase in volatility.

The group was invested almost entirely in fixed-income assets, Gibson (pictured below) says, but he felt a reorganisation of its assets, in line with similar changes he had made at previous employer, Highway Insurance, could result in similar improvements to performance.

In May this year, says Andrew Gibson, EIG awarded Union Bancaire Privée (UBP) a mandate to manage approximately half of its £500m portfolio, awarding JP Morgan the other half, the second mandate taking effect in June.

Gibson was no stranger to hedge funds, having been at Highway Insurance when the UK firm allocated a portion of its insurance assets to hedge funds, with the help of London's Liability Solutions, under head of advisory Phil Irvine.

(Irvine also assisted Equity Insurance Group as the consultant for the selection.)

Gibson says EIG's mandate was "very conservative," much as Highway Insurance's plans had been, and aimed to improve EIG's Sharpe ratio without taking on more risk.

UBP and JP Morgan had competed as two of a number of asset managers vying to win one of two mandates awarded by the insurer. Gibson says he saw 15 managers in total, whittling this down to the final duo.

Target returns and volatility levels were set for hopeful institutions to present plans outlining how they would achieve the desired performance. The two winning institutions provided very different ideas for how they planned to manage their mandates.

#### LONG AND SHORT OF IT

One key difference was UBP's assertion that it would utilise hedge funds as part of its portfolio, in contrast to the JP Morgan portfolio, which will not be exposed to hedge funds.

UBP has been managing money on an absolute-returns basis since 1969, traditionally managing money for wealthy industrialists, typically self-made individuals with little regard for performance expressed relative to a benchmark.

It already managed a number of bespoke investment programmes for institutional clients.

These tended to be conservative investors, with low-risk budgets and an appetite for absolute returns.

EIG's mandate was typical of the requirements of many institutions: it specified the need for consistent, conservative and positive returns, second only to the need for minimal volatility. UBP responded to the challenge with an absolute-return asset allocation targeting Libor plus a spread.

The mandate is founded on strict risk control and a very professional approach, says Michael Perotti, chief investment officer of UBP's London branch, and as an insurance company, it was attracted to a portfolio with a risk profile similar to that of a traditional fixed-income mandate.

"These clients tend to compare us with more than one benchmark and rightly so," says Perotti. "Of course, they benchmark us against an absolute-return benchmark of Libor-plus, but they also keep an eye on how the UK short- or medium-term fixed-income markets are performing as this is the opportunity cost of implementing an absolute-return mandate like ours.

"Investors are tolerant of short-term under-performance relative to this "opportunity cost" benchmark but more prolonged periods of underachievement would cause dissatisfaction."

EIG has long believed in the important place hedge funds can play in the delivery of this goal.

The exact nature of the portfolio depends on the specifics of the mandate but typically will involve three or four asset classes, of which one will be hedge funds. The hedge fund allocation typically includes around 35 underlying managers, broadly diversified by strategy.

Conservative portfolios with tightly managed risk parameters, UBP's mandates are designed to be adaptable to market conditions.

Hedge fund allocations are fluid and underlying managers can also change according to their performance or the market's outlook.

"We are looking to deliver positive returns from the hedge funds and we expect them to act as a dampener on volatility," Perottti says. "Opportunistically, we want to deliver returns to clients. If we believe, as we did last year, that a significant amount of the returns in the hedge fund industry would be from directional, then within pre-agreed risk tolerances we will tilt our portfolio allocations to benefit. We won't keep clients exclusively in non-equity investments for the sake of low correlation to traditional markets."

The foundation of the portfolio remains fixed-income assets. Other investments include equities and small doses of non-investment-grade bonds, these two classes together constituting a 'special-situations' class.

"Within the portfolios, we are relatively quick and responsive to market conditions to increase or reduce market exposure as and when we see appropriate," says Perotti.

For example, in a rising interest rate environment, the cash allocation might rise. "If we believed there was value on the medium to longer side of the curve, then we would be quick to increase allocations. At first glance, it might look like the asset allocation has not changed much, but effectively, the portfolio has been very actively managed within the various asset tranches."

It is equally opportunistic in special situations, (equities and high yield) where it moves in and out of opportunities quickly as they arise.

UBP sees one of its key strengths as its cross-asset class know-how and its ability to integrate assets into a single portfolio.

"We are trying to create a robust portfolio that is well-diversified and can deliver competitive returns in varying market conditions without those returns being too dependent on any one market factor."

#### SET RESPONSIBILITIES

Each asset class is the responsibility of the relevant portfolio management team, but the teams work closely together and make co-ordinated investment decisions across the classes.

"Typically, decisions are made in one asset class conscious of what is going on in another. This integrated approach allows, for example, decisions to be taken as a fixed-income manager within a multi-asset portfolio, such as reducing the amount allocated to that asset class, which you might not have the conviction to take with a stand-alone fixed

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income portfolio." To ensure no conflicts of interests arise between the managers of the various assets used in UBP's bespoke absolute-return portfolios, managers are remunerated independently of the level of capital managed within their own asset class, but according to the performance of the portfolio as a whole.

The financial incentive for managers to talk up their own asset class to maximise their own allocation is therefore removed, allowing the team members to view the portfolio holistically.

The key, says Perotti, is flexibility. It is important to have an idea of the market outlook and to prepare for it but it is more important not to be fixated on those expectations.

If the portfolio is run on a day-by-day basis with tight risk management and stop-losses, you can afford to be wrong in expectations of future economic conditions, as long as the target is clear and positions can be cut quickly. UBP is quick to cut positions and has a small overall tolerance for losses in its absolute portfolios, Perotti adds.

"There is no doubt there are certain extreme market conditions where liquidity dries up and where there will be a certain amount of downside volatility in all asset class besides cash," he notes.

## THE ADVISOR'S TALE

Because the typical term-life of an insurance policy is 18 months to two years the industry has tended to gravitate towards portfolios consisting of short-dated bonds to match this liability, says Phil Irvine, head of advisory at London's Liability Solutions.

Regulatory requirements force insurance companies to keep capital in reserve for any mismatch of their liabilities. More diversified portfolios offer a more favourable risk/return profile.

However, the search for improved efficiency in portfolios has not been limited to insurance. Irvine says he has seen the same pattern in many of the institutional mandates Liability Solutions has seen including pension funds, private banking and structured products.

"You can't get a lower volatility than cash. But as you blend into other asset classes you get more payback," he notes. EIG's Andrew Gibson did not want to significantly increase volatility in the portfolio so the challenge was to increase returns with a minimal increase in volatility. "Historically you might have been able to get that increased return by moving along the yield curve or moving down the credit spectrum but those easy gains don't exist anymore," Irvine says.

Phil Irvine, Liability Solutions

Irvine had been enlisted by Gibson, in his previous role at Highway Insurance, where the two had worked on the insurance portfolio in this way, hedge funds constituting one of the assets used. Irvine says they were "one of the first insurers to think about hedge funds as a diversifying asset class."

Highway's success with this over the period since it changed its asset allocation strategy has been "quite dramatic," Irvine says. Even a small improvement in returns can mean a significant improvement to the bottom-line, he says, which in Highway's case has approximately doubled over three years.

## VOLATILE TIMES

The lack of liquidity in June has made volatility unavoidable in the portfolio but Perotti does not view recent months' equity market conditions as comparable with more prolonged corrections such as in 1994.

"This was evidenced in 1994 where there was nowhere to hide. Such periods will result in downside volatility even in a conservative, absolute-return mandate.

"But with enough flexibility to re-allocate across the asset classes, you must actively position the portfolio conservatively and preserve capital. But, despite this, we must remember that an absolute-return approach does not equate to guarantee returns."

"That said, its segregated, institutional track record, dating back to October 2003, has outperformed its clients' benchmarks and delivered only three negative months."

Research is an important part of the process, Perotti notes. Picking the right instruments is vital as the market can disconnect from fundamentals. He regards one of the greatest strengths of UBP as its willingness to challenge accepted norms and presumptions in the market, freeing it from fear of investing in a different way to its peers.

## ROBUST DISCUSSION

Neither is it afraid to challenge the client setting the mandate. "We believe we impress institutions such as EIG by a willingness to challenge pre-conceived asset-management approaches, where we believe such an approach is not in our clients' interests," Perotti says.

Although the client ultimately has the final word on investment criteria, setting those parameters involves a dialogue.

Perotti notes UBP's clients understand they have expertise in asset allocation and usually appreciate all the advice they can get, even if contrary to their opinions.

The ability and willingness to forcefully express its judgement in investment matters is an important part of the mandate itself. UBP values its entrepreneurial approach, which runs throughout the fabric of the bank, and blends a priority on initiative and freedom from bureaucracy within a culture of risk control through all strata of the group.

He believes this played a part, alongside its investment plans themselves, in attracting EIG to UBP.

"At this point, the absolute-return concept has had most success with people who have to be relatively conservative, effectively the insurance industry," says Perotti.

"The billion dollars of assets we have in absolute-return mandates from UK institutions have been conservative mandates.

"That is not to say that going forward we wouldn't be interested in running mandates for people with a less-conservative outlook, who want an absolute-return mandate with higher volatility. We would achieve this with a different mix of asset classes, not with a different underlying philosophy."

To an extent, the concept of absolute returns implies a conservative disposition as it relates to investors wishing to strip market risk from their portfolios. Regulatory constraints play a major role in the setting of risk parameters and investment guidelines for many of UBP's institutional clients, EIM included.

Risk-management criteria, position limits and target returns must all fall within guidelines set by Lloyds and the FSA. These specify the proportion of funds which can be allocated to unregulated collective investment schemes, as well as the maximum allocation to one unregulated collective investment scheme.

"Obviously, if there are regulatory restrictions, there is no debate, but we usually sit down with the client and discuss the restrictions and formal risk budget and investment framework.

"What we want is to have the flexibility to be able to deliver returns, while giving the client the peace of mind that they won't wake up one day to find their portfolio allocations have significantly diverged from their expectations."

With the guidelines set, a degree of flexibility is retained for UBP to allocate between assets as it sees appropriate in order to maximise returns. Position sizes are limited to prevent any investment in any asset class, including cash, dominating the portfolio. Perotti says there are now more realistic expectations of the equity markets and an understanding of the benefits of diversifying into hedge funds, making them more willing to embrace absolute returns, he says.

In the late 1990s, it was hard to raise money in absolute-returns programmes, he notes: if the equity market is delivering strong double-digit returns, it is hard to explain the benefits of making investments not correlated to this performance.

"Everybody was benchmarking against the equity markets, especially Nasdaq. If you weren't fully invested in the equity markets (in the late 1990s), you were perceived as taking more risk by being invested in lower-class assets," Perotti says.

"The correction in equity markets made people focus more on absolute returns. The fact that the potential equity markets returns are not likely to be similar to the heady returns of the late 1990s, but will probably be something a little more realistic, makes people more conscious and more willing to embrace the absolute-returns approach," Perotti adds.

Despite three years of strong markets before the EIG deal, UBP remembers lessons learned when the late 1990s bull run ended.

"At the end of 2005, we had seen three years of strong equity markets," notes Perotti. "That's quite a long time in the markets; to generalise, if people were going to forget the pain of 2000-2003, they would have by now, although with interest rates we are seeing in absolute-return strategies, that is not the case."

Perotti says the equity markets are entering a phase of fair valuations and more sustainable performance, with expectations of compounded annual returns near 20% are unrealistic. He blames recent distrurbances on technicals: interest rates are rising, he notes, while, perhaps crucially, the recent change in Fed governor has made market participants jittery.

"From time to time, the market disconnects from fundamentals so you have to take risk off the table even though fundamentally you might like the investments in question."



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