How Cash Efficiency in Indices, Derivatives and Managed Accounts may be Important to an Institutional Investor's Well Being

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Background and Managed Account Mechanics

Accessing third party investments (hedge funds) via Managed Accounts is becoming increasingly accepted by the pension fund community and many other institutional investors. What are the mechanics? Rather than investing in a fund offering sponsored by the hedge fund, the pension plan contracts with the hedge fund who then trades in an account owned by the plan or a surrogate. These trades are typically pari-passu with the fund offering of the hedge fund. The ownership of these investable assets and the trades remain with the Pension Plan or a surrogate.

The basic objective of this business model is transparency and risk reduction. Pension plans can also avail themselves of the many other attributes of managed accounts, from alpha identification, manager knowledge, liquidity, investment flexibility, improved fees and fee transparency, improved oversight /control and ***cash efficiency.*** The benefits available from a full managed account model are very significant.

Alpha Identification

Since the early days of "Risk Premia," endowments and pension fund investors have tried to attribute alternative investment managers' returns to a market subsector or phenomenon. Large investors have engaged quantitative shops like Sigma to decompose hedge fund returns, provide a better understanding of the risks in their investments and examine strategy divergence if applicable.

Astute investors realized:

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1) In many cases, there was a market phenomenon (or premia) that accounted for much of a manager's returns;
2) One might be able to purchase the market phenomenon in the form of an index;
3) One could access a hedge fund manager's returns with a managed account for a very small cash outlay while reducing risk, reducing fees and getting total transparency and liquidity. The cash efficiency available in the managed account created a conundrum still facing institutional investors. This opportunity set, combined with risk premia, has encouraged a massive re-thinking of risk and return.

How valuable is Cash Efficiency?

Typically, a 3rd party Global Macro manager that uses futures or derivatives might only require 10% of the capital for a managed account, relative to 100% for a fund investment. That means a traditional fund investment of $100 million would require a wire to a Caymans account (or some other distant entity) of $100 million compared to a managed account allocation of $10 million…quite a difference. While futures and derivatives are the most capital efficient way to access a market or strategy, there are significant benefits to having a managed account for strategies that utilize equities or debt, particularly if the strategy is meant to be market neutral/market independent.

The cash efficiency available from managed accounts plus low cost access to derivatives such as the S&P 500 Index (costing 5 basis points or less and zero cash outlay) is an investment game changer. The use of managed accounts and derivatives is the lifeblood of excess returns, and in a less than favourable environment, it could be the singular savior.

Why invest cash in trying to generate returns from equities when you can invest in equity indices without cash and get the same or better economic effect at lower cost?
That isn't a trivial question. It's the essence of the question every pension plan, endowment, family office and investor should have asked and answered.

As a result, a much higher bar can be set before allocating to private equity or attempting to stock pick.

In the case of pension funds, if a plan is underfunded, or even if they want to stay fully funded, they should attempt to use cash efficiently. They should look to indices, and overlay cashless, complementary risk, and they really should use managed accounts for hedge fund investments. Any underfunded plan that buys private equity may consign themselves to a continued underfunded status as that path can't utilize managed accounts and chews up cash. Any plan that doesn't use managed accounts when allocating to a hedge fund is undervaluing the opportunity cost of cash and may be overestimating and overpaying for the unique skill the hedge fund possesses.

Prevailing pension plan investment orthodoxy is to match assets with liabilities. In an era where the future economic value of asset ownership is available without deployment of the asset, one must question this orthodoxy of matching assets and liabilities. A risk-based approach looks at the world differently.

Moving to a Risk-Based Approach

Historically, a pension plan's core investment approach has been via an asset mix strategy. In recent years, the major Canadian pension funds have moved to a risk-based approach, rather than an asset allocation methodology. These and other large investors seek to deploy return seeking exposures while at the same time, reducing overall risk.

Many of the pension plans who conserve cash via a risk-based approach are allocating that cash to private equity and infrastructure. As we know, private equity is illiquid, is often highly correlated to public equity and has a fee structure that is usually higher than most hedge funds. The viability of that premium will be a topic of continuing discussion long into the future.

Conclusion

It has been a great run. From March of 2009 through July of 2018, the S&P 500 has quadrupled. From its pre-crash high in 2007-8, the index has more than doubled. Abnormally low interest rates and bond yields have been a significant driver of those returns. What will be the relationship between bonds and equities going forward? Is there a bond/equity scenario that could really hurt pension plan funding? It might be time to think differently. Cash-efficient allocations via managed accounts enable investors to diversify risk, improve returns, reduce fees and gain liquidity.

About Sigma Analysis: A firm of market professionals, mathematicians and data scientists. Sigma delivers investment solutions to Pension plans via custom built cash efficient, liquid and cost-efficient vehicles.