De-Risking Pensions Swarm to Low Vol Strategies

By Tim Sturrock April 10, 2015

Corporate pensions that are reducing risk have jumped on the low volatility bandwagon, consultants say. These products have been gaining prominence in recent months due to **stock market concerns**, and now that demand is extending to corporate pension investors.

Low-volatility strategies appeal to some corporate plans in part because they share similar risk reduction goals as liability driven investment (LDI) glide-paths, which match liabilities with fixed income instruments, said **Brian McDonnell**, managing director at **Cambridge Associates**, speaking on the sidelines of the **Pension Bridge** conference in San Francisco. On the whole, the low-volatility universe as measured by **eVestment** has notched 16 quarters of consecutive growth with a total inflows of $11.8 billion in 2013 and $9.1 billion in 2014.

At the same time, the low-interest rate environment has also battered corporate pension funding statuses, prompting pensions on LDI glide-paths to explore options in their return-seeking buckets, said McDonnell, who spoke on a panel that discussed LDI.

Alternatives such as hedge funds are other options.

“All the plans that we work with are very much focused on thinking about all levers in the current rate environment,” he said, adding that choices depend on a plan’s acceptable funding status drawdown.

But, low volatility equities strategies must beat beta-adjusted benchmarks, not just offer low volatility, in order to justify their fees, he said.

“As long they are quite divorced from beta and correlation with the equities markets, that’s the real key that most sponsors, who are trying to reduce surplus risk, should be focused on. Low volatility strategy can be one element of that,” he says.

Lower funding statuses for pensions have slowed down many LDI plans and that has kept money out their fixed income buckets making low volatility strategies an attractive option as pensions manage their equity risk, says **Dave Wilson**, head of solutions for **Nuveen Asset Management**.

In 2013, the average funded status of pensions in the S&P 1500 soared to 95% causing pensions on LDI glide paths to make purchases of fixed income instruments as planned, according to **Mercer**. But the following years have told a very different story. Persistently low interest rates have lowered the average funded status to 80%.

As speculation continues that the six-year bull equity market has run its course, interest in low volatility will only grow as pensions seek to protect gains, Wilson says.

“We expect volatility to rise, and let’s notforget that we will have a recession in the next three or four years … the market is starting to realize that,” he says, adding he’s seeing a jump in requests for proposals (RFP) that seek low volatility products.

“A lot of corporate plans who embark on LDI also have large equity portfolios and they are asking ‘how do I protect these portfolios?’” he says, adding that Nuveen has also developed its own low volatility product.

“It’s part of the evolution of risk management for corporate plans,” he says.

Managers have effectively marketed low volatility strategies and that has driven some demand from corporate pensions and other institutions, but firms must be clear about risks, says **Eugene Podkaminer**, a senior v.p. for capital markets research at **Callan Associates**.

Low-volatility can certainly have a place in a portfolio, but investors need to understand that low-volatility equities often has stock market correlation and a value tilt, he says.

“It’s important to be intellectually honest and robust and rigorous in the way that these strategies are presented to intermediaries like consultants and the end investor,” he says.

Research on strategies must include more than just back tests, he says.

“Ultimately we’re talking about what happens in the future … I want to understand how a manager positions a portfolio going forward instead of looking out the rearview mirror,” he says.