

## Risk first – the thinking behind fiduciary managers Cardano

Interview by Alex Beveridge

Investment consultants and fiduciary managers Cardano have made a name for themselves with a risk based approach to investing, which protected clients during the crisis. Theo Kocken (TK), group CEO, and Kerrin Rosenberg (KR), UK CEO, explain their investment process.

**What is the process you go through when you manage a scheme's asset, in setting the strategic objectives and then working through to those objectives?**

**KR:** The first bit is always fact-finding. We are going to find out a lot about the particulars of the scheme, and the sponsor, and the funding plan. We get all that information together, and the first task is to get a coherent investment objective. We will always like to express the investment objective in a very clear, measurable way. We find out how much of the assets are trying to outperform the liabilities by, and what the risk budget is. Also, what the tolerance is for volatility or deviation?

And there is a lot of modelling that goes into that process and, it is a fairly well trodden path, but it also helps crystallise what success and failure look like.

Then step two is lots and lots of training for the trustees and the clients. Then we set up parameters in the contract. Only after we have done the training do we ask the clients to try and agree how much freedom they are willing to give us.

**So, trustees don't always want to outsource everything?**

**KR:** They may want to retain control of certain decisions and outsource other decisions. This initial process of training and clarification, establishing the mandate, will also define what our freedom is and where we perhaps have an advisory role.

**Your success or failure is not based on how much money you have made?**

**Absolutely not.** It is about how we run the funding ratio, and how the funding ratio is stabilised and gradually improved. It is not about if you run the assets against the benchmark very well. Of course, if you do not outperform against the liabilities, if you really underperform a benchmark, you will probably not outperform the liabilities anyway - but that is key for what we do in Holland and what we do in the UK as well. The pension system should follow the liabilities and gradually outperform against the liabilities.

And that is very important, because since we have been doing this for clients, liabilities are on average up 20%. So, producing a 15% return is not very useful in this environment.

**So, your focus is firstly on the risk?**

**KR:** Yes, you could say risk is in our genes. We think about constructing portfolios which are very robust, and consider all kinds of scenarios. We are, more or less, all

weather, instead of adopting a good weather approach – where we do not think this is the expected economic route in the next ten years or next years.

And this is what we do on expectation because we follow the expectation. But we take all these scenarios and we look at the consequences for the fund and we avoid consequences which are too dramatic.

It is a very robust solution, which means in very good scenarios and years of high returns in the markets, we might do less than the rest of the market. But, at least then the funding ratio is improving anyway. In very bad situations, that is where we have of course gained our name. Over the last two crises our clients did extremely well, and people said we were lucky. Now, it is not that we saw the crisis coming, but that we were robust in our solutions.

**You don't rely on economic forecasts?**

**TK:** Scenarios are more important than forecasts.

**KR:** Yes and no is the answer to that question. So first of all, with the investment approach that we use, we are trying to take lots of small risks – not one or two, where if you get it right you a hero, and if you mess it up there are disastrous consequences. But equally, we are also then trying to balance the portfolio, because we do not know whether we are going to land up with a high inflation environment over the next five years. Or, might we dip back into a recession? These



Picture: Jim Dyson

are tail risks and they are very pronounced. So, we want to have some of the portfolio that's going to do well in different types of circumstances.

Having said all that, we do very much try and form an understanding of the world in which we live. Another big mistake in the past has been having very long term horizons, where – you assume over a century equities must produce a higher return relative to bonds. And you almost end up ignoring the world that you live in.

You end up with the same view on markets in 1999, 2003 and 2008 - which are three very different circumstances. When you should do something different.

#### How does that play into your asset allocation decisions?

**TK:** In the middle of it is always a view, because that is what you need to take, to make your asset allocation.

**KR:** First of all for most UK pension funds, and I think probably also Dutch pension funds, historically there was equities and bonds and no liability hedging – certainly in the UK. And for some people when they come into a fiduciary relationship, they think the manager is simply going to buy and sell equities.

#### Explain your approach

**TK:** We have got a very different investment approach. If you are perfect in your timing, you will do amazingly well, but given nobody is perfect, you can also mess the whole thing up. We just do not have confidence that can be done well. So we are not going to try and

do that. That is part of what people learn going through this process, by setting up an all weather, very diversified portfolio with lots of smaller risks. It does not matter if one or two of the things do not work out, because you are not putting so much risk in one place.

That is also relevant for liability hedging, because at the moment there is a common perception amongst UK pension funds they should have hedged ten years ago. And then five years ago they thought they should have hedged ten years ago. And then of course two years ago they thought they should have done it five years ago, because now yields are even lower. So they just keep waiting. It has been a very costly mistake.

Now we will form a view on things - I mean at the moment the 50 year real yield is about nine or ten bases points. It is close to zero. That is a very low level, but no matter how much of a view you form, it is very hard to get interest rates and inflation right. What makes us think, or anyone think, that they have a better idea?

#### But you do take a view in the end

**KR:** Even when we have a view we will constrain the size of that view, so we will always be at least 80% hedged for a solvency management client - even if we have a strong view. And 80% hedged is more than double the average of the industry, which is certainly less than 40% for the UK.

#### What is the process from there?

**KR:** The bit that is bespoke is the objectives, the guidelines and the communication. Then we have investment professionals, who

typically do not interact a lot with clients, working on liability hedging and liability hedge construction. We have traders in Rotterdam who then implement that. And we have people working on asset allocation, and fund manager selection.

Our view is already formed, we are not waiting for a client to form our view on how we would like to see a portfolio. Obviously we need to tailor it to their cash flows, their particular liabilities and any constraints the client wants to impose. Some clients for example want to put a maximum on illiquid investments.

#### What is your approach to liquidity?

**TK:** With pension funds, many of them are maturing now and in the next 10 to 20 years. Depending on the client of course, but we are very long term, so we can take a lot of illiquid stuff on the balance sheet.

Many of our clients in The Netherlands are already in a phase that means they need to consider how the next ten years will play out. How much they have to unwind. Sometimes it's 40% or 50% of all the value of their liabilities which has to be paid out. If you want to keep your liquid stuff proportional to your portfolio, you have to take into account that you have to unwind a lot of it during what we call the dip in relation phase.

So in that respect you have to be very careful. And I think the whole pension industry has to be careful about what will happen with the outflow of money in the next 10 to 20 years, and what the consequences are for liquid investments – though that does not mean that we do not have a liquid investment.

**KR:** When we make an investment we will look at illiquid investments but they need to produce a high expected return to entice you to lock up capital.

So if there is something that wants a ten year commitment then, in our opinion, that has got to be at least a 20% IRR investment.

Over the the last couple of years most of the private equity style investments have been, in our opinion, quite unattractive because they are just a leverage game, and the leverage game is not there anymore.

There are some investments we have made, for example an investment in an oil-related industry that is private equity owned in total. We set up a set up an investment in bank loans which we structured with the fundmanager who we liked as a private equity vehicle – we did this in February 2009.

#### How did your investment in bank loans work out in the end?

**KR:** The manager was called Blue Mountain, and we structured a bank loan investment with them as a private equity vehicle because we thought the opportunity of bank loans was to buy and hold to maturity for five or six years. We wanted the fund manager only to receive a performance fee once they had passed the money back to the investors, just as a private equity fund works. But actually the market corrected quite quickly and within 12 months the performance was fantastic, and most of the bank loans were now less attractive going forward, so we agreed with the fund manager to wind the fund up early. We thought it was a five year investment and it turned out to be a one year investment.

#### So, you are able to be very dynamic if you see an opportunity?

**TK:** That is not a typical investment, I mean you would be wrong to think everything we do looks like that. But it is an example of how, if you look at the price of something and the implied default probabilities, you therefore work out what you think the returns could be and what the risks are – when that changes dramatically you should do something in your portfolio to adjust.

#### You do not have a fixed allocation for illiquid assets then?

**KR:** I think a lot of people make these asset location decisions, that they must have 10% in private equity or whatever. We never work that way. From our perspective each investment has to be looked at individually against all the other investments that are available at that point in time. So when you are allocating the capital and risk, you are always asking yourself the question, “Why should I come out of cash and make this in-



**TK:** Another example was people having an allocation to equity and an allocation to corporate bonds in 2007, when corporate bonds spreads widened. People said, “Well this is our allocation and we will continue with it.”

#### What was your allocation at the start of the crisis?

**TK:** I think with equities, the allocation went down to a few percent only in that period, for our clients. Well, that makes a huge

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vestment today relative to the other opportunities?” If there are not any other good opportunities, you should rather sit on cash

#### Is there not a danger you could become a little bit skewed to just one view? By having relatively fixed splits you would force yourself to diversify.

**KR:** Yes, but it also does not guarantee diversification, because what a lot of pension funds did was they had a lot of their cash, bonds and equities all exposed to financial institutions. So you look at it from an asset allocation perspective, even the property was exposed to financial institutions.

difference, because you know something is completely wrong.

Either the credit market will have to come up or the equity market will come down. You reverse your allocation to credit and equity. You should not say, “this is our policy” when you know that the threat is coming.

**KR:** Actually now it is very similar, you find bond and equity markets implying two completely different views. Bond deals are pricing in poor economic growth and yet the stock market is up 10% last month. We worry a lot about the tail risks and what happens if something really awful happens in the world, what do we have in the portfolio that will protect us?

**What do you look for in an asset manager?**

**KR:** The first thing to say is, we are trying to construct a portfolio and allocate the risk, and we therefore want to try and understand what type of risk exposure we want.

If we want exposure to do something that is a liquid efficient market, then we will probably go with passive or we will go with the derivative. So we are not going to try and add value by picking US equity managers.

I am not saying it cannot be done, I just think that 99% of what they produce is an internal market.

Of course what we are trying to do is create exposures to interesting things. If you want an exposure to an investment that lets you do well in times of financial stress, then you have got to think quite cleverly, and that is where we will look for a particular style for the fund manager. It probably will be called a hedge fund. We will look for a particular trading style, a particular risk management approach.

But we are starting very much from the top down. Then, with the actual identification of the manager, we will look for a number of things.

We like our fund managers very much aligned, so we like to find funds where the individuals have their own wealth invested. We need to understand their edge, their risk management, and, because of our expertise, we spend a lot of time understanding how they use derivatives to manage risks.

We also like fund managers who will take risk off the table when they get less confident and we manage their exposures and spend a lot of time on that.

We also have a key independent operational veto as well.

So in addition to all the investment divisions, our operations team will go in, and they will veto any investments where there is any unacceptable risk of fraud or poor internal governance or poor risk management.

They have done that a number of times, and actually have vetoed five or six investment decisions over the last few years.

**How do you manage your managers?**

**KR:** We have a list of all these managers and we have the strategic view on scenarios.

All these scenarios are put against these managers, and then we look at what we expect and we test it.

For us, that is much more important than any ex-post analysis of the manager's performance.

*You find bond and equity markets implying two completely different views*

**Why have you chosen to manage and execute the derivatives yourselves?**

**TK:** That was the core of our business when we started in the Netherlands. There, the asset management was already allocated and managed by the pension delivery organisations.

Derivative overlay was not done by any of them, so that was the market. Last year we did over €70bn of derivative transactions. They are running the money, and we are running the risk profiles. And with solvency management we have integrated the two; we do both the asset managements on a very

risk based approach and we do derivatives on a risk based approach. In the UK we are probably using less derivatives, because we are already risk-oriented in our asset management portfolio. If you only have strategy and you give it to somebody else to implement, like an investment bank, then you have a mismatch again.

**The crisis was a major test for your process.****How did you deal with counterparty risk?**

**TK:** It was good for us because the best test ever is a very big crisis, and this was unique in 70 years and the first since the derivative market existed. Our counterparties are investment banks and for every client we spread the transactions over several counterparties. We make sure that the counterparties are right in the sense that they have at least some viability of survival. We did not have Lehman's, for example. But we did have transactions with AIG from the early 2000 period. And what we did when AIG downgraded was we, moved some of the transactions to other banks. But the biggest defence is the collateral management. So on a daily basis, we get all the collateral in the form of very high grade bonds, triple A – and even within triple A we have our own requirement; only the best government bonds in Europe. And even that is over collateralised with a margin. We did not lose one penny during the crisis.

**How nerve-racking was the crisis?**

**TK:** Some phases you could see coming. With AIG we did not do any transactions for many years before the crisis. But when you see Goldman Sachs almost stumbling, then everything is insecure. At least we had all the collateral. For example, of our outstanding contracts 20% of the value of the underlying notional was in the money. So out of €70 bn of contracts, €13bn was in the money.