Breaking with tradition: AP1´s abolition of alternative buckets

A State-led pension fund AP1 is overhauling its approach to alternative investment allocation, HedgeNordic caught up with Martin Källström, who heads the team behind the fund's alternative investments mandate. He explained the idea behind the allocation strategy's evolution and made some critical points about what it means for AP1's alternative manager selection going forward.

"AP1 has been investing in hedge funds since 2012, and the allocation has been proximately five percent of the fund's assets," Källström reminds us. "So far, the purpose of this allocation was to help diversify our risk and to generate protective returns during market drawdowns. While we had a dominant tilt towards systematic strategies, such as CTAs, we have always had an exposure to a wide range of strategies. All the funds we have invested in have a point in common: their lack of correlation with the rest of the portfolio."

Diving into the actual transformation, Källström explains why his fund intends to replace some of the hedge fund exposure by a quantitative overlay on the fund's assets. "Firstly, we have decided to in-source part of what we used to allocate to hedge funds, in particular, to some of the trend following and alternative risk premia strategies. Just to be clear, it doesn't mean that we believe we can generate better returns than CTAs. We apply an in-house quantitative process that should be seen as a pure overlay to our overall portfolio. It is very efficient from a cost of capital perspective, as it requires no actual capital allocation. We will also save on the management fees we pay today. It is a way for us to allocate more risk exposure to diversifying strategies to a lower cost."

> "We have decided to in-source part of what we used to allocate to hedge funds, in particular, to some of the trend following and alternative risk premia strategies."

Given this reallocation, some managers will see the investment in their fund decrease, particularly in the trend following segment, but it doesn't mean that Källström and his team were disappointed with the strategies as such. "To the contrary," he says, "we are looking to increase the impact of these types of strategies on our overall portfolio, but in a way that is more efficient for a diversified fund like ours. This will also allow us to refocus our hedge fund portfolio, as we can deploy the capital to gain exposure in new areas."

"A traditional method for asset allocation that several institutions tend to employ is to define well delineated, and sometimes narrow buckets," Källström continues. "With such a system in place, some investment opportunities that don't fit in any given bucket will often be overlooked. We have also experienced this problem in the past. This is why we have now constructed a mandate that is very broad, but with a very specific objective: to generate idiosyncratic returns for the fund."

> "AP1 is taking an entirely new approach to evaluating the cost of capital, not only for the systematic strategies but also for the rest of the hedge fund portfolio."

A few constraints remain of course, due to the legal requirements bestowed upon the AP funds, in particular when it comes to liquidity. “Within the rules, we aim to have as broad a mandate as possible.” To make it even more flexible, AP1 is taking an entirely new approach to evaluating the cost of capital, not only for the systematic strategies but also for the rest of the hedge fund portfolio. Källström explains the transition: “Until now, we basically took money from another asset class to allocate to hedge funds, and typically that meant we sold part of our equity portfolio. Our goal is to generate uncorrelated returns, and the cost of that capital is the equity returns that we miss while allocated to hedge funds.” To remedy that issue, many institutions set a minimum return, or risk target for hedge fund strategies, which keeps their hedge fund bucket from accessing low-volatility strategies. Risk-adjusted performance may be high and decorrelated, but in absolute terms, the return may still not compensate the internal cost of capital, which is often set to match the expected return on equities.

To increase the flexibility of its hedge fund mandate, AP1 will now be taking an internal loan to finance the hedge fund allocation with a much lower cost of capital. “We can sell equities for example,” explains Källström, “while retaining the exposure to the equity market through swaps or futures synthetically. With such a method, the funding cost is not higher than LIBOR. The mandate thus needs to, over time, generate returns that are in excess of LIBOR.”

Meanwhile, Källström is not particularly concerned about the idea of taking on a moderate amount of leverage. “We believe that this method will not lead to a materially higher level of risk for the fund. To a certain extent, it may add to our tail risk as correlations can spike in times of crisis. We could suffer increased losses during these times, due to this phenomenon. But given our very long time horizon, we are not exposed to margin calls or even redemptions.” The pension fund is unlikely to be in a position to realise losses under challenging times due to external factors and, given the uncorrelated nature of the hedge fund mandate, overall returns are expected to be higher over time.

“We believe this to be a very efficient financing for an exposure such as this one. We create an internal loan construction, so that we are able to choose the asset class where the synthetic exposure presents the most attractive cost.” Källström describes the way AP1 views its portfolio construction. The fund is composed of three traditional asset classes: equities (public and private), fixed income and real assets (such as real estate, infrastructure and farmland). And on top come what Källström calls the overlays: tactical asset allocation, currency risk management, alternative risk premia, and idiosyncratic alternative investments. This is where the revolution lies.

Another soft criterion for the new mandate is that the manager should show expertise in an area that cannot easily be replicated in traditional markets, or using alternative risk premia. “The strategy has to exhibit alpha return streams that we can’t obtain ourselves, even if we have expertise in the same asset class. It could also be an asset class we can’t directly tap into, at least not at the moment. For example, we are looking into insurance-related strategies and parts of the credit market, such as aircraft leasing, or the royalty market.”

The transition period has just started and will be completed within the time needed to exit some positions and complete the necessary due diligence process for new ones. “We have already worked extensively on selecting the managers that we will continue working with and those we will not. We have also conducted extensive due diligence processes on a shortlist we have identified.We are now about to start adding new managers to our portfolio,” comments Källström.

While Källström does not disclose exactly which strategies his team has set eyes on, he gives a general idea of what these new investments will look like. “Given our constraints, we can’t invest in any drawdown funds (private equity-like structures). For implementation purposes, we are setting up managed accounts when it is possible, but we will now invest increasingly in commingled funds. We are focused on getting the most efficient implementation of our investments and that is a multidimensional challenge."

> "We are looking into insurance-related strategies and parts of the credit market, such as aircraft leasing, or the royalty market."

"More specifically," Källström continues, "the strategies we are currently looking at are artificial intelligence-focused managers, structured credit and other credit, strategies in the event space and some equity long/short (but it will not become a dominant part). We will keep some of the CTAs we have that are not into trend following, as well as some global macro as a tactical investment, but it won't be as important as it has been to date. Many of them are niche strategies, and they have identified an edge in the market. We also believe that there is often an inverted relationship between size and alpha opportunity, except for quant strategies, which often benefit from size. By definition, some managers have developed an edge in capacity constrained markets, and their advantage will disappear if they grow too large."

The new mandate does not come with a minimum size, and may even be open for seeding new strategies. "Our ability to seed new strategies has increased, but it doesn't mean that we won't require a lot from the manager. It is hard to say exactly what the hurdles will be. We will decide that on a case-by-case basis. But if we partner up at an early stage, we will look for a great opportunity regarding the setup as well. We will bring a lot to the manager and expect a lot in return." In general, of course, the matter of cost is not to be ignored. "We require cost-efficient structures and look at true alignment from all managers, not only through the fees but also concerning transparency and sound governance. We integrate ESG and sustainable investment practices in everything we do, and that is also part of the mandate."

It may seem like a radical shift, but today's strategic move is more an evolution than a revolution, according to Källström. "We have learned a lot over the past five years, and it is only natural that we strive to improve on a continuous basis. While we keep our fundamental investment beliefs firmly anchored, we constantly seek to perfect our approach in every asset class we work with. As such, this upcoming shift in hedge fund allocation can be seen as dramatic from one perspective, but it is also an evolutionary step."