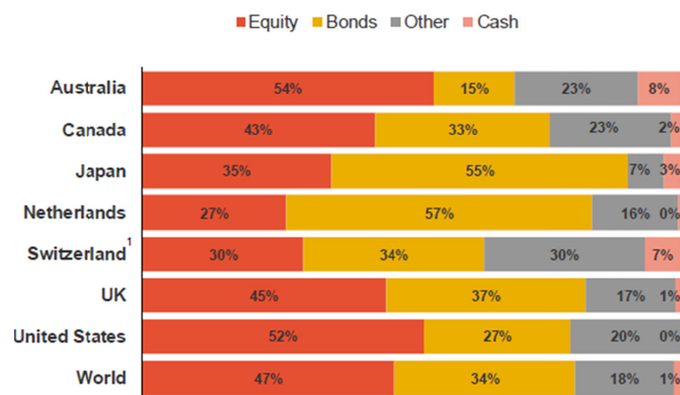
February 15, 2013

Dear clients and colleagues,

Pension assets represent about 40% of global assets under management. A recent Towers Watson study showed that 13 major pension markets boast nearly $30 trillion in pension assets which account for 78% of their total GDPs. It is important to feel the pension pulse. This week we'd like to share our observations on asset allocation trends.

At the end of 2012, the average asset allocation of the seven largest pension markets (see the chart below) was 47% equities, 34% bonds, 1% cash and 18% other assets.

Global Pension Asset Allocation 2012



Source: Towers Watson

In the past decade, two most notable trends in pension asset allocation have been the rise of international equities and the rise of alternative assets.

- The allocation to international equities has increased from 35% of total equities in 1998 to 53% in 2012. Among major pension markets US remains the most dependent market on domestic equities while Canada the least.
- The allocation to alternative assets has increased from 5% of total assets in 1995 to 19% in 2012.

While there is a clear consensus that international exposure will continue to increase, many started to question the role of alternative assets as a diversification strategy.

A few articles on the Wall Street Journal last week highlighted some facts. After two years of record outflows from commodity indexes, the trend is accelerating this year. Pension funds are retreating from commodities after finding they did little to protect their portfolios against inflation risk and the unpredictable returns of

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stocks. California Public Employees' Retirement System (CalPERS), the largest pension fund in the US, was the pioneer pension fund that pushed the higher allocation to commodities. But in October 2012, it pulled out 55% of its holdings in commodities indexes leaving the exposure to 0.6% of total fund, after losing about 8% annually over five years. CalPERS also suffered huge losses in real estate during the same period.

Data from Towers Watson have quantified the above trend. Compared with a year ago, allocation to equities increased while allocation to bonds, cash and other investments fell. This is promising for publicly listed, small cap equities.

Global small cap as an asset class is gaining traction among long-term investors. The benefits of global small cap have been well documented. Here are a few highlights.

- Sustainable alpha: Small caps are under-researched. Information inefficiency provides an opportunity for consistent value-added.
- Outperformance: Small caps outperform large caps over longer periods (>five years), although over short-term periods outperformance can be inconsistent.
- Diversification benefits: Small caps tend to be more influenced by local/regional factors, compared with large caps.
- Active management: There is a greater chance that active managers outperform small cap indices.
- Specialist small cap managers are better suited to cover the space vs. large and mid-cap managers, because the latter will find small cap investing quite restrictive if their assets grow to modest levels.

Have a nice weekend.

The Global Alpha Team

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