Unbundling risks and using crocodile strategies

Bjarne Graven Larsen, who recently stepped down as chief investment officer of **Ontario Teachers' Pension Plan**, talks about the most meaningful discussion to have prior to constructing the portfolio, getting rid of uncompensated risks and his plans for what to do next.

By: **Caroline Liinanki** Photo: **Thomas Tolstrup**

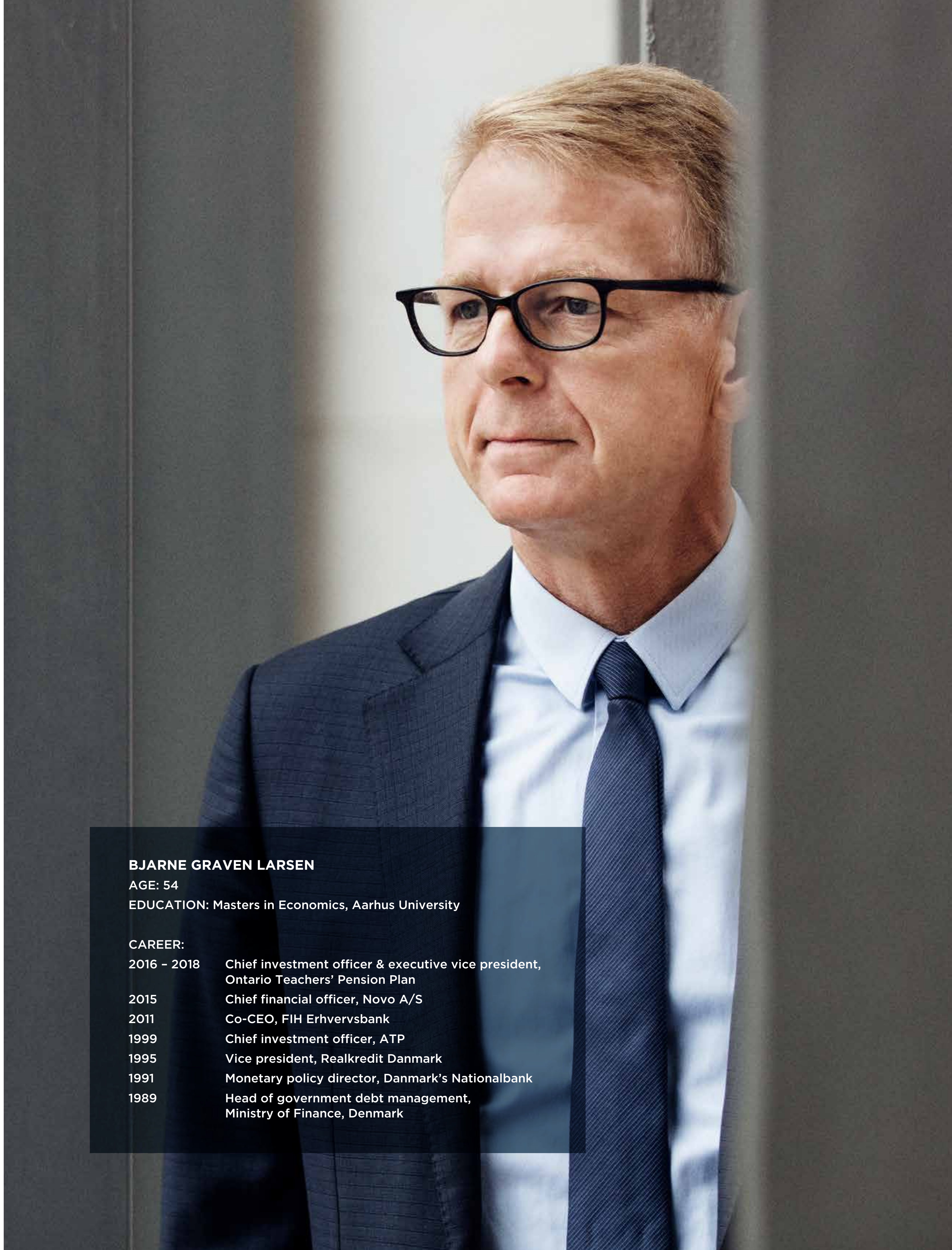
After two and a half years of holding one of the top chief investment officer jobs in the asset owner world, Bjarne Graven Larsen returned to Denmark this summer. His time at the Ontario Teachers' Pension Plan and the new experiences brought back in the luggage have, however, probably reaffirmed rather than altered his beliefs of how to think about portfolio construction and successfully manage an institutional portfolio.

Asked about his time in Canada in charge of the pension fund's CAD 193.9 billion (EUR 130 billion) portfolio and an investment department of about 350 members of staff, he has only praise for his former employer.

"It has really been terrific and the pension plan looks as great from the inside as the outside. I would be long Ontario Teachers' if you could buy it in the market," comments Bjarne Graven Larsen, who is known to many in the industry for his more than a decade spent as chief investment officer of Denmark's largest pension fund ATP and one of the key figures behind its all-weather and risk-based approach to investing.

That he ended up in Canada was, in fact, something of a coincidence considering that he wasn't looking for a new job at the time, having recently started as chief financial officer of Novo, the holding company and majority shareholder of the Novo Group. "I got a call from a search company in London about a very interesting opportunity internationally. I said that I had just started a very attractive job and that I wasn't interested but asked them to just tell me which job it was," Bjarne Graven Larsen explains.

However, after finding out the details about the job in



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question, he began reconsidering. "I had always admired Teachers'. At ATP, when we looked at the top pension plans globally that we could learn from, Ontario Teachers' was always at the very top of that list," he says. For Bjarne Graven Larsen, it was also an opportunity to fulfil a long-standing dream of working abroad, which before hadn't been possible due to an ill family member.

At the Canadian pension fund, he was tasked with building on the existing strategy in order to ensure that the pension fund would continue to be as successful in the future as in the past. That included making even better use of its strengths, expanding its global partnerships as well as making sure that the top-down allocation also was world class.

"There were actually a lot of things you didn't want to change, so one of the challenges was making adjustments without ruining or changing all of the successful parts. What the pension plan didn't want to change was the high allocation to illiquids and having strong internal teams globally focused on sourcing deals and creating alpha. The same was true for the capital market division, which did a lot of quant strategies and where we doubled the risk budget," he says.

From all of the places that he has worked so far, Bjarne Graven Larsen notes that there are some common lessons and takeaways, which form the basis for his approach to portfolio construction. "One of the most meaningful discussions that most people do not have is to - before you start with the allocation - ask yourself how to think about risk, how to measure risk and what kind of risks that would really hurt you," he says. "Not enough people do that. They start with recommendations about how to invest instead of taking the individual company and figuring out what the objective is, what risk looks like for you and which risks you really want to avoid. When you know that, that's when you can really start with the portfolio construction."

He notes that people initially tend to get a bit annoyed and uncomfortable when you start questioning what the objective is but insists that having that discussion is hugely important. Especially since that helps define which risks to avoid and which risks that don't come with any reward.

"In all of the jobs I've had, I've found that there are a lot of unwarranted and uncompensated risks," he says. "Getting rid of those won't hurt your return but it will lower your risk. Furthermore, if you really define risk, then it helps you define what kind of drawdowns and market scenarios you can't take."

At ATP, he notes that starting to hedge the liabilities removed one uncompensated risk. "At Teachers', the portfolio construction team spent a lot of time on currency. But what they did, which I think was very appropriate, was a thorough analysis of the optimal currency exposure. That led to a reduction of currency risk, which was really an uncompensated risk that was taken away. When you remove uncompensated risk, you actually free up some risk budget because now you have less risk but the same return. And then you can start spending that risk budget elsewhere," he says.

However, he notes that it is only when you really have all of that figured out that you can move on to the asset allocation. "Then you can start with how much exposure you want to the compensated risk: how much in equites, fixed income, style premia and then you can start looking for areas where you can harvest alpha. People often jump too soon to areas where they think they can harvest alpha. I do believe in trading alpha if you can attract skill and smart people but if you start your investment allocation on that basis, there's a danger that you don't get rid of the uncompensated risks," he says.

Another core part of his philosophy is about being in charge of one's destiny. "You do that by controlling the risks and making sure you don't take risks that you will regret in bad times," he says." And to do that, you sometimes need to accept that you might underperform a bit in good times. If you give away a bit of the upside to protect against bad scenarios, you have to stomach the fact that you can have three or four years of great returns because markets are up but not as great returns as your competitors. And that's really difficult for many people."

Not becoming a victim of this herding mentality is also what he views as one of the biggest challenges for boards and management. "It really takes a lot courage, transparency, discussion and alignment to agree that it's ok to have a different return profile from your peers. In my view, that's one of the most important discussions to have in a board room," he comments.

Asked whether he believes that a well-diversified portfolio need to look different now compared to in the past considering the low expected yields from both equities and fixed income, he does not appear to be in the camp of those arguing that this time is different.

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"During all the years I've worked within investments, people have been saying that they don't know where to look for returns. When I started at ATP in 1999, all of the conferences I attended had the search for yield as the main topic. There's always a tendency for people to think that they won't get returns from anything. But you will always get returns from something - you just don't know from what," he says, which again is an argument for diversification.

Bjarne Graven Larsen's time in Canada was cut short after his sons wanted to return to Denmark for university and school. Since the family from the start had decided to stick together, Bjarne Graven Larsen resigned from his job. "I would have preferred to stay on but on the other hand, you only have one family. So in the end, it wasn't that difficult of a decision because family comes first."

Having returned to Copenhagen in July, he is now contemplating what to do next. At the beginning of September, he was appointed as a board member of Kirk Kapital, the holding and investment company managing the assets for one branch of the Lego family. "I'm very honoured by that. It's a great organisation and as a Dane, there's always something about being a part of the Lego success," he comments.

He is, however, not interested in pursuing a career as a professional board member or a consultant but looking for something more operational. "I'm trying to figure out how I can use my 29 years of experience. I feel that there are some lessons learnt over the years that I would like to bring to the table in one way or another. I think the whole factor and alternative risk premia approach will grow going forward and getting exposure to that will be important for a lot of investors. That might be part of what I'm going to do but I'm still in the investigative phase," he says.

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Alternative risk premia is also the topic that comes up in relation to new innovation within investments. "I think it's now very solid that there are some alternative risk premia that you can pick up, whether that's momentum, carry or value. It's not a free lunch and you have to be careful but I think a lot of investors in Europe are under-allocated to that part of the investment universe. That's probably the building block that I feel is having the brightest future," he says.

He explains that the way he would construct a portfolio is, after having answered the questions on how to measure risk and having dealt with the uncompensated risks, to start putting together the building blocks. The first would be a market risk premium block with exposure to equities and rates as well as the appropriate inflation exposure. "Then, I would construct a block of alternative risk premia across asset classes, which should be market neutral," he continues. "Then, I would do real alpha. That could be in private equity because you have a really great team or it could be in long-only equities because you have a fundamental equity team and believe in that. It could be in real estate or within the factor space."

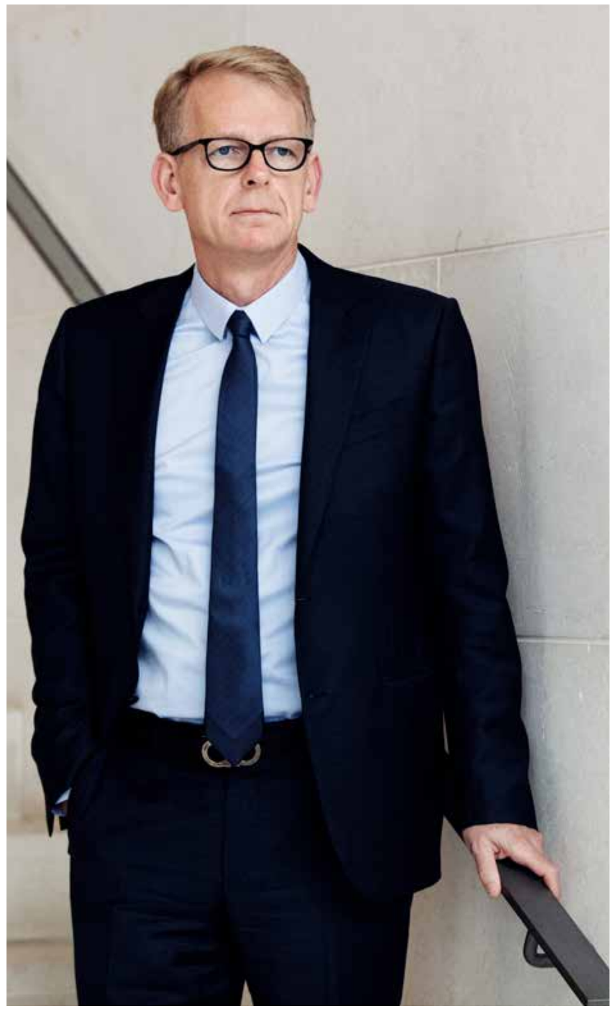
With the building blocks in place, it is then time to move on to how to allocate. "Maybe an external manager can implement all the equity premiums in his equity mandate to a very low price," he says. "Or maybe you want to use all your equity risk in private equity, where you can do alpha at the same time. That was actually what we did at Teachers'. We reduced the passive listed equity portfolio but we didn't reduce risk. Instead, we increased actively-managed listed equities and, even more so, the allocation to private equity. Since the team was so skilled and had outperformed the markets with a huge margin for 25 years, we said that this is one of the areas where we believe we truly can harvest alpha and get exposure to equity markets."

Furthermore, he says that unbundling the risks and breaking it up into building blocks in this way and deciding how big exposure you want to each risk factor provides a lot of freedom in picking a manager. At the same time, he notes that getting pure exposures isn't always possible.

"You have to accept that some things only come bundled, so you have to unbundle stuff in your risk system. But the good thing about unbundling, at least on paper, is that you ask yourself how much you're willing to pay for pure market exposure. I think the pension plans that are thinking in this way will be able to lower the fees they pay going forward. And a lot of asset managers that are delivering a bundled product but charge too high fees for the passive part or the market risk premium will have a more difficult time," he comments.

With many predicting tougher times ahead also for asset owners, Bjarne Graven Larsen points to a few things that he believes will characterise successful investors in the years ahead. "I think the investors that will be successful going forward will be the ones that on the one hand will be able to continue to invest in illiquid assets or wherever they can harvest alpha, because they have strong teams and can beat the market," he says.

He continues: "At the same time, you need to make sure that you have a risk management policy and, probably more



importantly, a liquidity and leverage management policy that will allow you to, for example, protect yourself against inflation risk without having to sell out from your illiquid assets. How can you keep your private equity allocation and at the same time get more exposure to inflation? Well, you probably need to use derivatives. And if you do, you need to make sure that you have cash for margin calls and variation margin calls and that means that you really have to think about liquidity management and risk management in a version 2.0."

He notes that while he sees using derivatives and actual balance sheet leverage as two sides of the same coin, you need to be able to do both in order to be successful. "Ontario Teachers' was AAA-rated by Moody's and while I was there, we started a medium-term note program, so a trust controlled by Teachers' started issuing bonds. So you don't just use leverage synthetically but you actually issue bonds as well. Very few European pension plans do that but it's quite common in Canada. By doing that, you get longer term financing, so you reduce some of your liquidity risk," he says.

He believes that having this strong focus on liquidity management and funding is of great advantage in a time of crisis. "Then you could be in a situation where you could actually benefit from the crisis and buy a lot of stuff at distressed prices. So making yourself able to do what I like to call crocodile strategies: you hold liquidity, make sure you

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have enough and then, like a crocodile, you just wait and wait. You don't need to eat every month, you can just let all the small fish pass by and then suddenly a wildebeest comes – and then it's time to eat," he says.

After leaving ATP in 2011, Bjarne Graven Larsen spent a few years as co-CEO of the Danish bank FIH Erhvervsbank. The bank, which had focused on financing for small- and mid-sized enterprises but later expanded into real estate and leveraged buyouts, came into trouble when the Icelandic crisis worsened due to its ownership by the Icelandic bank Kaupthing that went into bankruptcy. In order to save the Danish bank, ATP stepped in and acquired a 50 per cent stake and Sweden's Folksam, Denmark's PFA and the private investor Christian Dyvig bought the remaining share.

"It wasn't really the plan that I should take over as CEO but when the banking crisis became worse, the other part of the consortium asked me if I needed a change in my responsibilities. I thought about it and decided it was time to try something new," he says.

For many, making that shift may have appeared as a peculiar career move. "That's because people think a lot about prestige," Bjarne Graven Larsen responds. "It was a bigger and more prestigious job to be the chief investment officer of ATP but after 11 years, I found that it was difficult to continue to be a thought-leader and come up with new thinking. I almost felt like an old grumpy man that either said to the younger talent that we had already tried it or it wasn't going to work - or I would agree to try it even though I didn't believe in it. Eleven years in the same role at one institution is a long time. I still loved being there but I had started to think about what I should do next."

And getting his hands dirty by taking part in the clean up after the financial crisis and trying to rescue a bank was certainly something different. "It was very hands-on and more operational. Investing in credit as a pension plan is very different from seeing all the individual credits on the bank's balance sheet and dealing with that. I felt that was an opportunity for me to learn something new - and I like learning new things," he says.

That is also one of the reasons why he sees benefits in keeping part of the portfolio outsourced to external managers. "Even for those that could do 100 per cent internally, I think it's wise to keep some external management. At the time I worked at ATP, it was split 80-20 between internal and external and it was the same at Teachers'. For a really large successful investment organisation, you can probably manage around 80 per cent internally but you probably shouldn't go much lower than 20 per cent external because you need to engage with smart people out there that want to help you and want to educate you" he says.

Personally, he says that having those discussions with external partners about everything from portfolio construction to macro scenarios have added a lot of value over the years.

"So it was easy for me to embrace the philosophy at Teachers' of building these global partnerships because that's one thing about investments that I like a lot," Bjarne Graven Larsen says. "And I think the asset management industry has a lot to learn there. A lot of the asset managers have figured out that nobody will pay them for advice, so in some ways they've stopped giving it. Back when I started, there were still ALM teams and advisory teams at some of the big investment banks and asset managers. They didn't charge for that but just did it to build a long-term relationship and then hoped that over time you would do some business with them."

He continues: "Today, a lot of asset managers have a product they want to sell but I think we need to go back to that old relationship kind of thought process where asset managers actually help investors to figure out how to solve the big problems that they're dealing with. When you meet asset managers, they always want to tell their story and sell their product. I always try to say to the new people that I meet that if it's ok with you, I will tell you about our investment strategy and what I'm struggling with and maybe you can help me. So I think it's up to investors as well to demand that and to make a presentation of your thinking and your struggles."

He agrees that this change probably is related to the increased shorttermness of the financial industry as a whole. "It's difficult to see a direct link between building long-term relationships and gaining additional business but being patient and building those relationships is something that I believe in very much," he says.