BVK leads the way on diversification

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Ask asset managers hunting for mandates in Germany's pensions industry what the greatest prize is and it is very likely that they will cite the Bayerische Versorgungskammer (BVK), a Munich-based pension fund.

This is not because BVK awards profitable mandates. Like other big institutional investors around Europe, the scheme has the ability to negotiate lower fees due to the huge volumes it needs to invest.

No, the simple reason why asset managers – particularly the numerous foreign houses that have arrived in Germany just in the last few years – would be pleased getting into business with BVK is the scheme's enormous clout in the market. With more than €40bn in assets, BVK is Germany's largest and best-known pension fund, so if a manager wins business from it, it will definitely get noticed.

BVK itself is an amalgamation of 12 so-called Versorgungswerke, or schemes that serve free standing professionals like doctors, architects, chartered accountants and pharmacists. These schemes differ from Pensionskassen or other occupational pension funds in that they provide a first-pillar pension to these groups. Between them they have near 1.4m contributing employees and 290,000 current beneficiaries in Bavaria. By far the largest of the group in matters of assets is the one for doctors, which has €13bn in assets and around 80,000 insured.

BVK's clout is not merely a function of its size. Arguably, much of it has to do with its chief investment officer Daniel Just. Since the beginning of the century, Just has transformed BVK from a local German pension fund with a plain vanilla investment strategy orientated towards bonds into an increasingly sophisticated international investor.

Speaking at BVK's headquarters in Munich, Just recalls: "As the century began, we had around 95% of assets in fixed income and only a small portion in equities. We also had direct investments in real estate around Bavaria. So the portfolio had good potential for diversification."

He adds: "This of course was to our benefit, as the equity crash of 2001-2002 did not harm us as much as other institutional investors who had higher exposure to equities."

BVK's average equity exposure – that is, taken from the 12 schemes – has now risen to 12.2% of assets, with a good deal of that in foreign shares. At the same time, fixed income exposure has sunk to 75%. After profiting from the bull run on equity markets since 2003, Just says BVK has reduced its equity exposure slightly this year amid signs that the run is ending. The correction in equity markets during mid-summer, caused by the sub-prime mortgage crisis in the US, seems to confirm this view.

Just's diversification efforts in past years have not been limited to investing more in shares and reducing the bond portfolio. To the delight of asset managers and consultants in Germany, BVK began investing in hedge funds (currently 5% of assets), international property funds (currently 3%) and just recently committed €350m to private equity. According to Just, the exposure to private equity should reach 2% of assets in the next years and the scheme is aiming for a return of at least 8% per annum.

As part of the diversification effort, Just has turned to investment consultants and so far, the decision has born fruit. For example, when the BVK began investing in hedge funds in late 2004, it hired German consultant Alpha Portfolio Advisors to help find the right ones. Since then, the scheme reports that its hedge funds have outperformed its target return a minimum of 5% per annum.

BVK also hired Mercer Investment Consulting to assist it with the internationalisation of its investments – including the incorporation of high yield and emerging market bonds as well as Asian equities – and the implementation of a risk budgeting tool. For its foray into private equity, the scheme is working with Fleischhauer, Hoyer & Partner, a Munich consultant, though it remains to be seen how that project will go.

Finally, BVK watchers say Just has optimised the investment process by introducing regular asset-liability studies, German master KAGs and a global custodian. Master KAGs enable permit investors like BVK to centralise back-office administration of funds – for example reporting and risk monitoring. Claimed benefits are greater transparency and reduced cost.

"I think he deserves great credit for convincing the bosses of the 12 schemes to abandon the traditional fixed-income driven investment strategy and embrace diversification. He made clear to them that by doing this, they could improve returns and still save money," said an executive at a Frankfurt-based asset manager. Added a consultant in Frankfurt: "Mr Just has also demonstrated management smarts by assembling a team of respected capital market experts led by André Heimrich [BVK's asset management head]."

Despite these impressive achievements, BVK's net return for 2006, at 4.7%, was not among the highest in Germany and was below the averages for Austria and Switzerland (7.3% and 6.9%, respectively). That said, it should be noted that German accounting rules (HGB) compel German schemes like BVK to build reserves, which in turn depresses their returns. Indeed, Just remarked during the interview that the BVK's market return "was much higher" and that the 4.7% figure was "all that we show". He adds that all 12 schemes comprising the BVK are fully-funded, with ratios ranging from 105% to 110% of liabilities.

BVK's return is, moreover, above the 4% that it guarantees on pension savings and well above the 2.25% rate that some other schemes, notably Pensionskassen (insurance-type schemes) guarantee. A final consideration is that Versorgungswerke like the BVK, as well as Pensionskassen, are closely supervised by the regulator to ensure that they meet their guarantees.

While, unlike the Pensionskassen, BVK is not regulated by Germany's BaFin, Bavaria's finance ministry mimics BaFin's approach.

Hence, the stress tests on equity, bond and property holdings that the BVK must pass hinder its ability to assume more risk in exchange for higher returns.

On the other hand, since interest rates in Europe have moved above 4% recently, investing has become easier for schemes like Versorgungswerke and Pensionskassen that provide guarantees. Just stresses though that the BVK cannot rest on its laurels but must continue the diversification effort to generate higher returns.

"Our goal is not to achieve the 4% guarantee but actually 5% as the biometric risks add another 0.3% and there is the adjustment of benefits for inflation to consider. We must become less dependent on the interest rate cycle, which is why our diversification efforts are so important," says the CIO.

BVK's experience with hedge funds is a good example of how much progress the scheme has made on this front. With a current exposure of 5%, it is well ahead of other German schemes and insurers, which have an average of 0.5% in the asset class. BVK's current hedge fund portfolio includes funds of funds that invest in 450 single funds worldwide as well as three single hedge funds.

According to Heimrich, BVK's hedge funds have had a beneficial diversification effect and brought in good returns.

"Based on this experience, we are thinking about a further increase in our hedge fund allocation," he said during the interview. BVK will retain the German consultant Alpha for the effort, with Hubert Dichtl, managing partner at Alpha, its first point of contact.

Regarding real estate, Just says BVK has diversified its portfolio in two ways. First, it has spread its direct property investments – which account for 4% of assets – around Germany.

Second, it is invested in three, hopefully uncorrelated, international property funds, in Europe, the US and Asia. German real estate investment trusts (G-REITs), legalised for the first time this year, are not relevant for the BVK currently, as the scheme is pleased with the performance of its direct investments. For 2006, that performance was 5.5%.

Regarding private equity, Just acknowledges that the BVK is somewhat behind its German peers in investing in the asset class.

"The simple reason is that we had numerous other diversification projects like hedge funds to complete first. One cannot do everything at once." In the effort, BVK has selected seven fund-of-fund managers who invest in Europe and the US and focus on the following aspects: buyouts of small- to midsize companies, venture capital and mezzanine, though the buyouts take precedence. Remarks Heimrich: "We could have incorporated buyouts of large firms into the strategy, but we feel that that would have been too risky." The difficulty that US private equity firm Cerebus had in financing its €5.4bn takeover of the carmaker Chrysler is certainly evidence of such risks.

What's unique about BVK's investment is that the scheme decided against a traditional Spezialfonds (German institutional fund) and in favour of a Luxembourg fonds commun de placement (FCP).

Explains Heimrich: "If we had gone with a Spezialfonds, we might not have had such an excellent choice of managers. This is because many are not willing to comply with the more stringent transparency and reporting requirements related to the German fund. In this sense, the Luxembourg FCP is clearly more attractive."

Heimrich's remarks are evidence that the FCP poses a formidable competitive threat to Germany's €600bn-odd Spezialfonds industry. To deal with that threat, the government in Berlin has removed all remaining restrictions on investment in Spezialfonds. As of yet, however, the move hasn't done much to stop the trend toward FCPs, probably because the reform did not address the reporting and transparency issues related to Spezialfonds. Consider that along with the BVK, AEWL, a €7.1bn Versorgungswerk for doctors in the region of Westfalen-Lippe, has also utilised an FCP for a €600m investment in private equity, hedge funds and structured products. To find the right managers, AEWL is being advised by Feri Institutional Advisors.

Observes Just: "It's common knowledge that the government should further liberalise the investment industry to better compete. However, there is little the government can do to stop German institutional investors from going abroad to diversify their portfolios. That's to be expected and the good news for Berlin is that more and more international investors are coming to Germany."

Even so, Just acknowledged that there was a downside to BVK's investment in private equity – namely the fund-of-fund approach. "By charging two sets of fees, these managers will certainly earn handsomely but then again we expect a commensurate performance," he says.

"It would cost a great deal more to hire the 10-15 staff to find the right managers for hedge funds and private equity. We think, therefore, that a fund-of-fund approach is the best way to start." Just adds that eventually, the BVK may itself begin selecting private equity funds, but this will depend on how the current approach goes.

Industry sources who know the BVK well tell IPE that further diversification of BVK's portfolio – for example in the fixed income area – is a distinct possibility. But Just insists that beyond the hedge fund and private equity projects, the scheme currently has nothing further to announce. As eager as they may be to do business with the scheme, asset managers and consultants in Germany will just have to sit tight and wait for the BVK's next big move.

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