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THE FUSS ABOUT POLICY PORTFOLIOS:

ADRIFT IN INSTITUTIONAL WONDERLAND

"'Curiouser and curiouser!' cried Alice".
Lewis Carroll

Tempest in a Teapot….or Not?

Our good friend Peter Bernstein put the institutional investment community in a tizzy earlier this year by pronouncing that policy portfolios (ie. the practice of managing investment funds with fixed policy asset mix benchmark weights) should be abandoned. The phone lines burned. The industry media wrote articles. It became the #1 topic of lunchtime conversations. Hands were wrung. Peter, oh Peter, why would you say such a thing? Have you become, heaven forbid, one of those… evil market timers?

After a summer of keeping the institutional investors waiting with bated breath, Peter gave them his answer. Policy portfolios have become a substitute for thinking, he said. The time has come to go back to investment basics. Every investment fund has a liability counterpart. That is where our benchmark thinking should take us. Only in asset-liability space can we think constructively about risk, and how much of it the balance sheet stakeholders can, want to, or should undertake.

In short, the reason why policy portfolios should be abandoned is because they have become a dysfunctional barrier between investment professionals, the fiduciaries accountable for setting risk policy in pension and foundation balance sheets, and the beneficiaries/stakeholders in those balance sheets.

How does someone (specifically, this writer) who has had this viewpoint, and has been strenuously arguing for it for years, react to these developments? Let us tell you. The first reaction was envy ("…how come they listen to him more than to me?"). The second reaction was to heap scorn on an institutional investment community so far adrift that, when confronted with the patently obvious, it is seen as a radical new insight ("….an industry adrift on a sea of irrelevance"). The third reaction was to be thankful to Peter for getting everyone's attention, and to sit down at the keyboard and write this *Letter.*

Below we retrace some of the history behind why liabilities matter in setting investment policy. We also demonstrate that when this fundamental idea is put into practice, the investment paradigm does indeed shift away from the policy portfolio-based investment paradigm that continues in vogue today. A much more powerful paradigm that integrates asset risk and return with liability risk and return takes its place. These conclusions are supported by new results from *CEM* (*Cost Effectiveness Measurement Inc.*). We conclude this *Letter* with the view that the barriers to the much-needed paradigm shift (ie. from an assets-only to asset-liability framework) actually occurring are not so much technological, as they are institutional. That makes them much more difficult to knock down.

Duality in Finance: A Brief History

The idea that an investment fund is the asset yin to some liability yang is not new. Indeed, the fundamental idea of duality in finance can be traced all the way back to the invention of double-entry bookkeeping during the European Renaissance. Since then, every credit has had its counterbalancing debit. When accumulating credits and debits are transformed into a balance sheet, they become assets on one side, and liabilities on the other. This necessary duality in turn has become the foundation of modern financial management and reporting.

Financial intermediaries forget this necessary asset-liability duality at their peril. One of the first stories we heard when joining Sun Life in 1969 was how management in the 1920s got caught up in the equity bull market of those times. The resulting mismatch between equities on the asset-side of the balance sheet and the insurance policies on the liability-side pushed the company into technical bankruptcy when the bottom fell out of the stock market in the 1930s. A government bail-out saved the company (and many other insurance companies doing the same thing). The lessons of the 1930s affect insurance company balance sheet management and regulation to this day.

It appears that every class of financial intermediary has to learn the financial duality lesson in its own way in its own time. The material mismatch risks embedded in the balance sheets of the Savings & Loans industry did not catch up with it until the 1980s and 1990s. In the hedge fund sector, Long Term Capital Management thought it was managing its mismatch risk, but had so much leverage that when financial markets misbehaved for only one fatal month in 1998, the LTCM balance sheet blew up. The combination of falling stock prices and interest rates since 2000 has now turned the spotlight on the risk management practices of pension and endowment funds. The record for the three-year period ending 2002 shows that these practices too have been sadly inadequate to the task.

Financial Duality in Pension and Endowment Funds: Building the Conceptual Framework

Why so sadly inadequate to the task? It certainly wasn't the absence of a balance sheet-oriented conceptual framework within which to manage pension and endowment funds. If we take the passage of *ERISA* on Labor Day 1974 as the catalyst for the need to create such a framework, it appeared almost instantaneously. By July of 1976, Jack Treynor and co-authors Pat Regan and Bill Priest came out with a startlingly clear and clairvoyant little book titled "The Reality of Pension Funding Under *ERISA*". In it, the authors set out the key issues around funding and managing corporate DB balance sheets that they argued, should be attached to the balance sheets detailing the other corporate assets and liabilities, and managed in that context.

Marty Leibowitz took over in the 1980s with a series of lucid articles that focused on the technology of immunizing the balance sheets of financial intermediaries with long duration liabilities such as DB pension plans. We also made our initial public argument in favor of balance sheet management rather than assets-only management in the 1980s, with the publication of the book "Pension Funds and the Bottom Line" in 1985.

Our award-wining 1987 FAJ article "In Defence of a 60-40 Asset Mix" was intended to counterbalance Leibowitz's articles that argued for 100% immunization. Our counterpoint was that some pension plan balance sheet mismatch risk was acceptable as long as the fiduciaries understood what the extent of that balance sheet risk exposure was, and as long as they held a reasonable expectation of an adequate payoff from undertaking the mismatch risk.

The 1990s saw the development of a balance sheet-oriented performance measurement framework for pension and endowment funds. Its focus was and is: how's the balance sheet doing? Specifically, net of risk and expenses, is the investment process adding any value in a balance sheet context? Through prior *Letter*s, we have been reporting results in this context gleaned from the *CEM* (*Cost Effectiveness Measurement Inc.*) databases for over 10 years now. Indeed, some new results follow below. The point here is that the ongoing assets-only focus of the institutional investment community can't be blamed on the absence of an integrated asset-liability investment paradigm. It has been around for decades.

New Insights from the *CEM* Database

Our friends at *CEM* have just sent us some new information on the performance of pension and endowment funds for various time periods ending with 2002. Here are some of the more interesting findings:

- The median five-year total mismatch risk (ie., the volatility of the balance sheet surplus return) for the US funds in the *CEM* database was a dangerously high 20% (there are 89 funds with an aggregate value of $900B with five year continuous histories). This 20% volatility reading is over twice the historical mismatch risk associated with the standard 60-40 asset mix relative to a liability portfolio of typical duration and inflation sensitivity.

- When mismatch risk due to asset mix policy and mismatch risk due to active management are measured separately, the medians came in at 20% and 2.5% respectively. In other words, asset mix policy contributed 8 times more risk to the median balance sheet than active management did during the last five years. Indeed, total balance sheet risk and asset mix policy risk both came out to the same 20%. Thus the marginal risk of active management was zero over this period, despite its separate clocking at 2.5%. How can this be? Because policy risk and active risk were uncorrelated over the five-year period.

- A major reason why policy risk blew up to an outsized 20% over the 1998-2002 period is because usually, stock returns and interest rate movements are negatively correlated (ie., generally, stocks do better when rates are falling than when they are rising). This relationship reversed itself over the measurement period, with stock prices and interest rates both rising and (mainly) falling in tandem. This meant that during this period, as fund assets were falling because of falling stock prices, fund liabilities were rising at the same time because of falling interest rates.

- Despite being the major balance sheet risk contributor, passively implemented asset mix policy portfolios underperformed fund-specific 100% liability-matching strategies by a median -19% per annum over the 2000-2002 period. Put differently, while the median policy portfolio had a three-year return of -5.6%, the liability-related three-year hurdle rate exploded to +13.5% as interest rates fell precipitously. So cumulatively, the asset mix policies chosen by these 89 funds reduced their end-of-1999 funded ratios (ie., asset/liability ratios) by a shocking median 47 percentage points over this three-year period ending 2002. On an aggregate balance sheet of $900B, that works out to a three-year 'loss' in the many hundreds of billions of dollars for the 89 funds.

- The median active management contribution was a positive 0.9% per annum over this same period before expenses, but only 0.5% per annum after expenses, or say, a cumulative 1.5% over the three-year period. That works out to $14B 'profit' on assets of $900B.

The short of these findings is this. While the active investment managers were making a few billion dollars in profits for these 89 funds over the course of the last three years, the policy portfolio decisions of these 89 funds were at the same time costing their sponsors many hundreds of billions of dollars in balance sheet losses. Clearly, there is something wrong with this picture.

Enter Organizational Dysfunction

So what is wrong with this picture? Simply put, the answer is organizational dysfunction. With a few notable exceptions, no-one is accountable for dynamically managing balance sheet risk in pension and endowment funds. So the most important risk doesn't get managed at all (no, doing static asset-liability studies using historical data that always give the 60-40 answer don't count!). Had the asset mix policy risk been dynamically managed over the 1998-2002 measurement period, that risk would have never been allowed to balloon to the 20% volatility level indicated by the *CEM* database. Any fund managing to a 10% maximum risk budget would have been forced to reduce equity exposure as the risk needle went through 10% on its way to 20%.

Why is no-one in the pension and endowment fund worlds accountable for watching the balance sheet risk needles and acting when required? There is no conspiracy here. It arises from a whole lot of well-meaning people doing the best they can within the confines of their own silos. There are HR silos where people worry about pension benefits (its equivalent in the endowment world is the granting silo). Then there are Treasury/Investment silos where people worry about asset management. Outside of the organization, there are the external actuarial, accounting, consulting, and investment silos, each with their own principles, practices, and conventions.

Hovering uncomfortably on top of all these internal and external silos are the funds' governing fiduciaries (sometimes called trustees, sometimes board, pension, or investment committee members). While these bodies are in theory accountable for balance sheet risk policy, in practice, they are typically not equipped to make decisions that can withstand the test of adequate knowledge and due diligence necessary to make such decisions.

Why is this usually the case? Because they have not been given the tools and the information needed to discharge their responsibilities. And why is this? Again, there is no conspiracy here. It is simply because there is typically no single executive to whom the governing fiduciaries can (or are willing to) look to, to come up with a functional integrative asset-liability investment paradigm, and a feasible business plan to implement it effectively. So instead everyone looks to outside 'experts' for advice and comfort.

Decisions By Default

As a consequence, instead of being guided by effective, integrative, dynamic balance sheet risk management processes, pension and endowment funds continue to operate largely by a series of simple heuristics and rules of thumb supplied by outside 'experts'. That is why the vast majority of funds continue manage around the no-brainer 'policy portfolios' that Peter Bernstein decries. Is there a better way? As we have shown in prior *Letter*s, absolutely! Will the pension and endowment fund management 'industry' move to this better way? Not until the funds develop stronger, more effective internal governance processes that insist on balance sheet risk being managed in a 'best practices' manner. In short, change for the better will not be coming any time soon.

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