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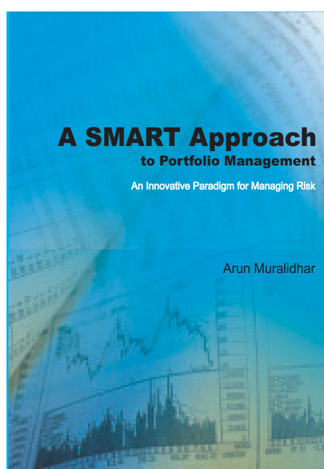
Achieving Solvency Nirvana

Static approaches in dynamic markets are likely to fail.

The market volatility of 2008 and 2010 has caused many funds to reach for new concepts such as "Risk Parity," "Risk-Based Allocations," "Tail Risk Hedges," and "Pension De-Risking," with managers glad to supply such products. Many CIOs are looking to implement risk measurement systems in the hope that risks might be managed through these systems. This frantic search to deviate from the failed portfolio approaches of the last decade is understandable, as pension funds have lower solvency, endowments have tighter budgets, and the economic environment is not conducive to increased contributions to top up previous losses. However, all these approaches, along with the expensive and time-consuming risk systems being implemented, will not solve the fundamental problem in institutional investing. They repeat the mistake made earlier—namely, that static approaches to portfolio management in dynamic markets are likely to fail, with the only questions being when and how badly.



It is my opinion that setting up an adequately staffed, compensated, and empowered investment office is preferable to paying external managers high fees for suboptimal products. The objective of any fund should be to ensure that the return of assets must be greater than that of liabilities, but more important and largely ignored, is that the correlation of the two portfolios should be high. Otherwise the risk to the sponsoring company, public institution, or university will be high. Risk is not tracking error to a strategic asset allocation (SAA), but the drawdown of solvency of the portfolio (a term I call "Yield to Fire"). Given current funding levels and interest rates, with moderate equity return estimates, the only way to achieve "solvency nirvana" is to be dynamic in all aspects of managing the portfolio and to manage both the beta and the alpha of the portfolio, especially of illiquids.

The process starts with defining an Investable Liability Portfolio (a liquid portfolio of swaps to track the daily growth in liabilities). This is the benchmark to match up against in managing portfolios. Thereafter, any SAA must be based on liquid instruments and only with indices with liquid futures contracts. Choosing a benchmark index for an asset class that does not have a futures contract engenders unnecessary cost and risk that gets charged to the CIO, with no benefit to either them or the fund, and does not allow the CIO to be nimble. Similarly, illiquid assets need to be benchmarked to liquid beta equivalents (e.g., private equity is leveraged Russell 2000 beta and similarly for hedge funds) to manage this beta.

CIOs and Boards have to realize that all decisions in managing a portfolio, from implementing an SAA to doing nothing and letting a portfolio drift within rebalancing bands, is market timing. This is not a bad thing, but has acquired a distasteful reputation by uninformed analysts. Managing a portfolio, whether a pension fund or endowment, is no different from managing a portfolio of equities at an asset management company. Hence, the same processes can be applied. Successful CIOs will be those who ask and answer four questions daily at all levels of their portfolio, namely:

(a) What Should I Do (e.g., hedge liabilities, tilt into an asset class, allocate more to a manager, or do absolutely nothing)?

(b) How Much Should I Do (e.g., 1%, 2%)?

(c) When Should I Do It (e.g., based on the evolution of the economic and market factors that drive asset and manager performance as opposed to end of quarter decision-making)?

(d) Why (a good economic rationale)?

A rules-based approach is simple and effective, and can help CIOs evaluate the efficacy of meeting their solvency return and risk objectives, while at the same time removing emotion in decisionmaking. This has worked for the CIOs who implemented it, and brings the same discipline to managing their own funds that CIOs expect from their asset managers.

Asset owners also must address risk-adjusted performance calculations (as the information ratio is simply wrong and easily gamed), evaluating whether managers are skillful. They also must assess how compensation in this industry needs to be changed to pay fees only for risk and skill-adjusted performance. It is my hope that CIOs adopt these processes and evaluation and compensation metrics quickly, as every pillar of retirement gradually is being eroded and adopting static, risky approaches to portfolio management will ensure only one thing—retirement and social insecurity. ai

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