

Looking Back and Moving Forward

Howard Yata

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The year 2004 was somewhat of a breakout year among corporate and foundation and endowment sponsors. Numerous corporate plans were either over or well funded in the years leading up to 2000. However, the "perfect storm" of three consecutive negative stock market years combined with near record low interest rates left many corporate plans in painfully under-funded positions that required cash contributions for the first time in many years. Even with the double-digit equity returns of 2003, corporate financial executives were scrambling to finance these cash contributions and explain to senior management what went wrong.

Last year many public funds grappled with state legislatures over the need to increase contribution rates to cover the shortfalls resulting from the equity market downturn. So called costless' benefit increases granted during the 1990s were determined to have an implied cost in that no surplus funds were available to buffer periods of poor asset returns. Actuarial assumptions received greater scrutiny by trustees who recognized the difficulty of requesting additional contributions when most states were themselves experiencing increasing deficits from lower tax revenues. The equity market downturn illustrated the need to maximize diversification. As a result, many funds explored expanding asset classes and investment strategies in order to better weather the next downturn.

Foundations and endowments also found themselves in uncomfortable predicaments. Commitments made during the high return times of the 1990s had to be honored, but with lowered asset levels, many discovered they could make few, if any, new commitments. This caused foundation and endowment boards to ask if they should exceed their spending policies, or if there was a better way to manage their investments.

During 2004 most clients were asking if the traditional methods of investment management were still relevant. Is mean variance optimization still appropriate? Are stocks and bonds still the best way to achieve long-term return with appropriate levels of risk? What other forms of investment can be considered that might have different characteristics?

We found many clients who had previously ignored, or were too scared to consider derivative based strategies, began to at least listen to the potential opportunities available.

The fact that many corporate sponsors used hedging of some sort in their daily business activities (hedging energy prices for instance) made the possibility of their use in the pension fund more palatable.

Even in the face of the lowest long term interest rates in years, the concept of duration matching or cash flow matching (at least to some extent) started to appeal to some corporate defined-benefit plan sponsors who wished to more closely tie their asset value changes to liability changes. Lowered expected returns on stocks and bonds caused some plan sponsors to consider alternative asset classes in order to justify their return assumptions for FASB and funding purposes.

With respect to asset allocation, most plan sponsors, and consultants as well, concluded that asset-liability management requires more than simple mean-variance optimization solutions. Consultants, however, have been considering that liability modeling and hence cash flow analysis, might have a greater impact on asset allocation going forward. We observed cases where plan sponsors with specific circumstances undertook to match some parts of their liability stream with specific fixed-income investment programs.

The acceptance of market neutral investment strategies or other absolute return strategies paired with derivative based market exposure began to take hold. Plan sponsors that had become disenchanted with the ability of active large capitalization equity managers to add significant value over the indexes began to experiment with these strategies. It is too early to tell yet whether they have been successful, but 2005 will reveal how they fared.

Foundations and endowments, following the lead of well known university endowment investment programs, began considering absolute return strategies. Those concerned about the possible effects of inflation going forward have considered real return investment strategies. Such strategies involved highly diversified portfolios of assets, including real estate, inflations-linked bonds, derivatives and commodities.

Wilshire Consulting expects to see continued interest by public funds in non-traditional investment strategies and asset classes.

However, we do not expect to see a departure from the roughly 65%/35% equity/bond mix of the average pension fund, but we do expect to see a change in the way that mix is implemented. We do expect to see greater use of portable alpha strategies as well as increased allocations to real assets and international equities and bonds.

Howard Yata is a managing director and member of the Board of Directors of Wilshire Associates Incorporated.

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