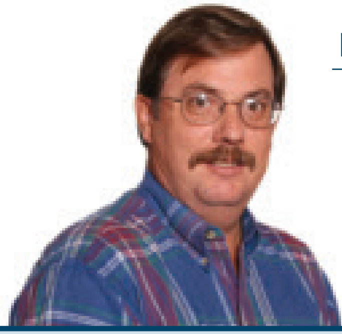

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IS THE GAME AN ALPHA BET?

The quest for alpha continues. . .but what are the benefits?

The search for alpha has become the silver bullet for today's pension investment management morass. Plan sponsors need to make sure that benefits are adequately secured while still ensuring the plan remains affordable so that it continues for future members. Low expected returns for both stocks and bonds and the minimum funding strategies increasingly adopted by plan sponsors (in response to an unequal risk/reward game) compel funds to seek out whatever added returns they can.

Plan sponsors are encouraged to manage their pension plan(s) as a corporate subsidiary and to integrate plan management with that of the overall business. It is thus imperative for the plan to have clear financial objectives for the trend and variability of its earnings (expense), its cash flow needs, and the architecture of its balance sheet.

Many major public sector pension plans have such clear objectives because each one is a stand-alone entity, essentially a business by itself. Many corporate plans do not have such clear objectives because they have long been considered ancillary to the business.

FACING TRADE-OFFS

Unfortunately, they are no longer ancillary. The exhaustion of surpluses, huge changes in workforce demographics and the prospect of low capital market returns are forcing sponsors to face trade-offs in finding the cash their pension plans now demand—trade-offs that can affect the very core of the business.

Clear financial objectives will permit plan sponsors to determine the degree to which plan assets need to match liabilities and how this matching can best be achieved. Those advocating much greater matching are failing to recognize the current reality: a 100% matched portfolio will make the plan unaffordable, both today and in the long term. There must, therefore, be an unmatched portion of the fund holding financially risky assets. We also need to investigate ways to make the matched portion provide greater financial risk control than the traditional bond benchmarks provide.

ACHIEVING OPTIMAL RETURNS

Managing the financially risky portion of the portfolio becomes a balance between generating returns and doing so in the optimal pattern. Traditionally, generating the returns has been largely dependent on the public equity markets, with implementation geared to ensuring that the extra return desired from active managers did not change the riskiness of the portfolio. But were plan sponsors satisfied that their managers beat the equity markets by 3% when the markets were down 20%?

Today's financially risky portfolio should contain three clear elements. Plan sponsors may still desire a certain amount of explicit public market risk (beta), but they will need to layer various sources of uncorrelated or negatively correlated pure return (alpha) on top if this element is to provide sufficient return. The other two elements represent forms of modified market risk.

The first form is represented by "alternative" investments. These are vehicles that do not invest in the same securities as the public equity markets (e.g. infrastructure, commodities) or that invest in securities in a way that significantly reduces market risk (e.g. hedge funds).

The second form uses the existing public equity manager, but generally would involve high conviction portfolios with extremely high tracking error. The focus would be on the pattern in which absolute returns are delivered relative to the market.

This creates a four-legged framework. The optimal allocation of money among them forms the risk management solution to the challenges posed by the initial set of objectives. The solution lies in first understanding the fit between the pension plan and the sponsoring business, and then in allocating assets to avoid or minimize undue strain on the corporate budget and balance sheet.

The game is about far more than added return. ■