TURNING BELIEF INTO ACTION

Helping boards evaluate alternative investments.

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A large number of institutional investors appear to share the same series of beliefs about investment. From this starting point, low returns are expected from both traditional equities and bonds and that reducing risk or increasing return (while holding the other constant) would be a good thing. At the same time, thanks to Markowitz's 1952 portfolio theory, it is also well known that asset allocation decisions should be based on their expected marginal contribution to risk and return at the total plan level. Institutional investors also believe that a broader opportunity set is desirable and that fiduciary obligations must be taken very seriously. Yet, from an industry-wide perspective, there is still an inexplicable clustering around the 60/40 asset mix dominated by equities and bonds. Does this mean there is a disconnect between the actions and beliefs of institutional investors? And, if so, why the delay in translating beliefs into actions?

Most people seem to believe in the merits of alternatives and of a broader opportunity set. In my opinion though, they do not always evaluate alternatives within the proper frame of reference. Some people seem to underestimate the risk in a typical asset mix and, therefore, they make the mistake of confusing familiarity with low risk. Proper contextual framing will help overcome inertia, undue emphasis on maverick risk, false comfort in the status quo and insufficient consideration of the consequences of under-achieving goals. It will also help to maintain a better focus on a combination of objective analysis and future relevance.

Experience shows that a successful decision-making environment has a board that governs by policy; acknowledgement that the primary long-term objective is to satisfy the liabilities; objective controls that has a risk budget based upon surplus at risk; a culture where decision-making and the residency of the required skill set are aligned; and an emphasis on objective measures of risk and net value added. While most people and organizations are more comfortable with the status quo, an effective decision-making environment can help to offset this natural bias. Indeed, there may be more to be feared from maintaining the status quo than from expanding the opportunity set. One pension plan I am familiar with deliberately set out to seek more diversified return sources and to construct a more diversified alpha opportunity set to complement the rest of their traditional asset mix. They have enjoyed the benefits of diversification into several alternative investments, including commodities (January 2002), high yield bonds (June 2001), and a customized fund of hedge funds (May 2001) with low correlations to their traditional assets. These decisions have helped them beat their benchmark by an average of 260 basis points per year for the five years ended Sep. 30, 2005—and with lower risk. Their experience with alternatives has not only been return enhancing (tastes great), it has also been risk reducing (less filling).

Implementing alternative strategies is certainly not without challenges and pitfalls—including the significant resources required, although outsourcing can mitigate this. Perhaps it is necessary to consider the full scope of fiduciary duty, which includes applying the skills agents possess or ought to possess as the rationale for an obligation to challenge the status quo. While both caution and expertise are essential, fiduciaries need to keep the following in mind: that their investment objective is to satisfy the liabilities; that the fundamental law of active management is important; that they have a fiduciary duty; and, finally, Markowitz's Portfolio Theory, which teaches that the most important attribute of any investment is its marginal contribution to the total portfolio's risk and return.

Ultimately, prudent, risk-controlled investing is never easy and one cannot overstate the importance of an implementation strategy that decreases risk. Nothing trumps the importance of only dealing with ethical partners, and maximizing the alignment of interests. However, as Einstein reminded us, we may need to employ more tools to escape from our current situation than we employed while getting here. ■