LEO DE BEVER
Chief investment officer, Victoria Funds Management Corporation (formerly with MFC Global Investment Management)

MANAGING RISK AND REALITY

Don't use short-term thinking when implementing long-term strategies.

Pension obligations usually stretch 50 to 60 years into the future. As such the pension management goal is efficient long-term accumulation of invested pension contributions into enough capital to meet pensions, while limiting the risk of falling short of target. Unfortunately, thinking clearly about long-term risk and return is a challenge.

Most pension obligations could be matched with some kind of bond, but that increases cost. To make pensions more affordable, most plans instead invest part of their assets in stocks, which have a higher return but are more volatile. Asset-liability management theory can justify this only by allowing the net of volatile annual gains and losses to accumulate over time.

However, pension sponsors usually ignore all that, and assume that any excess of assets over liabilities at any time is "surplus" to funding needs and available for contribution reductions or benefit improvements. That most pension plans ended up in deficit after the 90s—the best decade of bond and stock returns in 100 years—painfully demonstrates that the short-term focus of pension governance is a far greater threat to pension security than poor investment results.

Even with strengthening markets, the asset/liability gap that emerged in 2000-2002 continues. Some plan sponsors assume that a rise in interest rates from unusually low levels and a return to double-digit equity returns will right the ship. They will likely be disappointed. Bond returns are not far from long-term historical levels of 2% above inflation, and there are good reasons to suspect that equity returns will trend below the historical average of 6% plus inflation.

Many plan managers do accept lower prospective returns in listed assets and have started seeking higher returns through absolute return alpha strategies, and investments in unlisted alternative assets. Superior returns in alternatives can reflect an illiquidity premium that pension plans can exploit because they have more cash and patience than competitive sources of capital. For example, long-term holdings in timberland have generated real returns of about 7% plus inflation in the U.S. and even higher returns in New Zealand and Brazil. Infrastructure assets, such as investments in utilities, toll roads and airports, are also good long-term pension assets, but they have become expensive as the supply of capital has vastly outstripped supply of good assets.

Absolute return strategies can exploit market inefficiencies that persist for some time. But inefficiencies can be arbitraged away, and in aggregate absolute alpha returns typically net to zero. Before investing in alternative assets, determine the source of extra returns, estimate their longevity, assess whether the extra income compensates for extra risk, and make sure you have access to the expertise to deal with operational issues.

The effectiveness of investment management in implementing long-term return/risk investment strategies needs to be evaluated over a long horizon—ideally more than four years. Plan management is often judged as if it were a chess game with well-defined rules on how the pieces can move on a well-specified playing field, so the best strategy always wins. Managing pensions is more like quantum chess, where the pieces and squares on the board only exist with a certain probability. The best investment strategy only has the highest probability of winning at any point, and consistently good performance only reveals itself when given enough time.

Finally, make sure that after setting a strategy for the best long-term, risk-adjusted asset-liability performance, one does not fall into the trap of rewarding managers based on short-term asset return benchmarks that are easy to measure. Instead, develop measures that are meaningful for acheiving lasting pension security. Incentives are powerful motivators, so be careful what you motivate people to do. It is better to reward for approximately doing the right thing than for doing precisely the wrong thing. ▮