

# How Investment Policies Can Impact Returns

**Edward Patchett, CFA**

*Senior Vice President & Managing Director*

**Independent Fiduciary Services®**

Washington, DC

# Why This Session?

- Current state of plan funding
- Prospect for low returns in many asset classes
- Plan Trustees and investment management industry seem to be at a “secular turn” in the way they think about investing

# Discussion Points

- Investment Policy Statement (IPS) and Guidelines
- How Policies and Guidelines Can Limit Returns
- Examples With a “Hypothetical” Fund
- “Emerging” Strategies
- What Trustees Can Do

# Fund Policies and Guidelines

## Typical Plan “Investment Governance Framework”

	Perspective	Applies To	Implemented By	Monitoring
Investment Policy Statement	Strategic Level	Total Plan Assets	Trustees (based on investment consultant advice)	Trustees (and investment consultant)
Investment Manager Guidelines	Operational Level	Each Manager Account	Managers (based on investment consultant advice)	Managers (and investment consultant)

# Investment Policy Statement (“IPS”)

- Serves as a key, overarching fund “Governance” document
  - Establishes plan investment objectives
  - Delineates the roles and responsibilities of the Trustees, investment consultant and investment managers
  - Establishes target asset allocation (with maximum and minimum ranges)
  - Identifies rebalancing procedures
  - Proxy voting responsibilities
  
- Normally, key function of IPS is also to establish
  - Permitted and prohibited *asset classes*
  - Permitted and prohibited types of *securities*
  - Permitted and prohibited types of *investment strategies*

# Investment Policy Statement (“IPS”)

- Collectively, a board of trustees will limit their fund’s (and their own) “risk” by prohibiting certain investments
- Examples may include the following
  - No “small cap” equities
  - No non-investment grade bonds
  - No “foreign” securities
  - No “emerging markets”
  - No options, futures or other “derivatives”
  - No “short selling”
  - No “leverage”
  - No “private placements”
  - Etc...

# Investment Manager Guidelines

- Boards of Trustees often establish customized investment guidelines for separate account managers intended to reflect the manager's mandate and agreed levels of discretion
- Common manager guidelines include the following
  - Minimum number of securities in the portfolio (e.g., “..manager must hold at least 30 stocks.”)
  - Maximum invested in any one security (e.g., “...no more than 10% of the account at market in any one company.”)
  - Market “sector” diversification requirements – either “absolute” or “relative” to the manager's performance benchmark (e.g., “...must invest in at least four sectors” or “no more than three times the index sector weight.”)
  - Performance objectives (e.g., “exceed the benchmark by 100 b.p. on a net of fees basis on a rolling 3 to 5-year basis”)
- Manager benchmark selection can create “implied” guideline restrictions and lead to unintended consequences

# How Policies Can Limit Returns

- While policies and guidelines are appropriate in many instances to manage risk ... too many restrictions can limit a fund's investment opportunity set and mute investment returns
- Decisions to prohibit asset classes, certain securities or strategies should be based on a thoughtful risk/return analysis
- However, these decisions are sometimes a result of
  - Lack of understanding (“we don’t understand, so its prohibited”)
  - Convenience (“cookie cutter” approach by consultant, counsel, other advisors)
  - History (“we’ve always done it this way”)



# Hypothetical Fund Example

## Hypothetical Local Pension Fund

- Assets at June 30, 2001: \$200 million
- Fund contributions = benefit payments and administrative costs (no net cash outflow from the fund)
- Fund asset allocation is as follows (“Baseline Scenario”):
  - US Stocks: 60% (all benchmarked to the S&P 500 Index)
  - Bonds: 40% (all benchmarked to LB Aggregate)
- Expressed and implied “Policy” restrictions
  - No small cap
  - No non-US stocks
  - No high yield bonds

# Hypothetical Fund Example

“Baseline” Scenario (60/40 mix)

*Fund Growth Over 5 Years*



**Annualized Return:** 3.78%

**Annualized "Risk":** 7.74%

*NOTE: Reflects linked monthly returns consisting of 60% S&P 500 Index and 40% LB Aggregate Bond Index. Annualized "Risk" reflects the annualized standard deviation of monthly returns*

# Hypothetical Fund Example

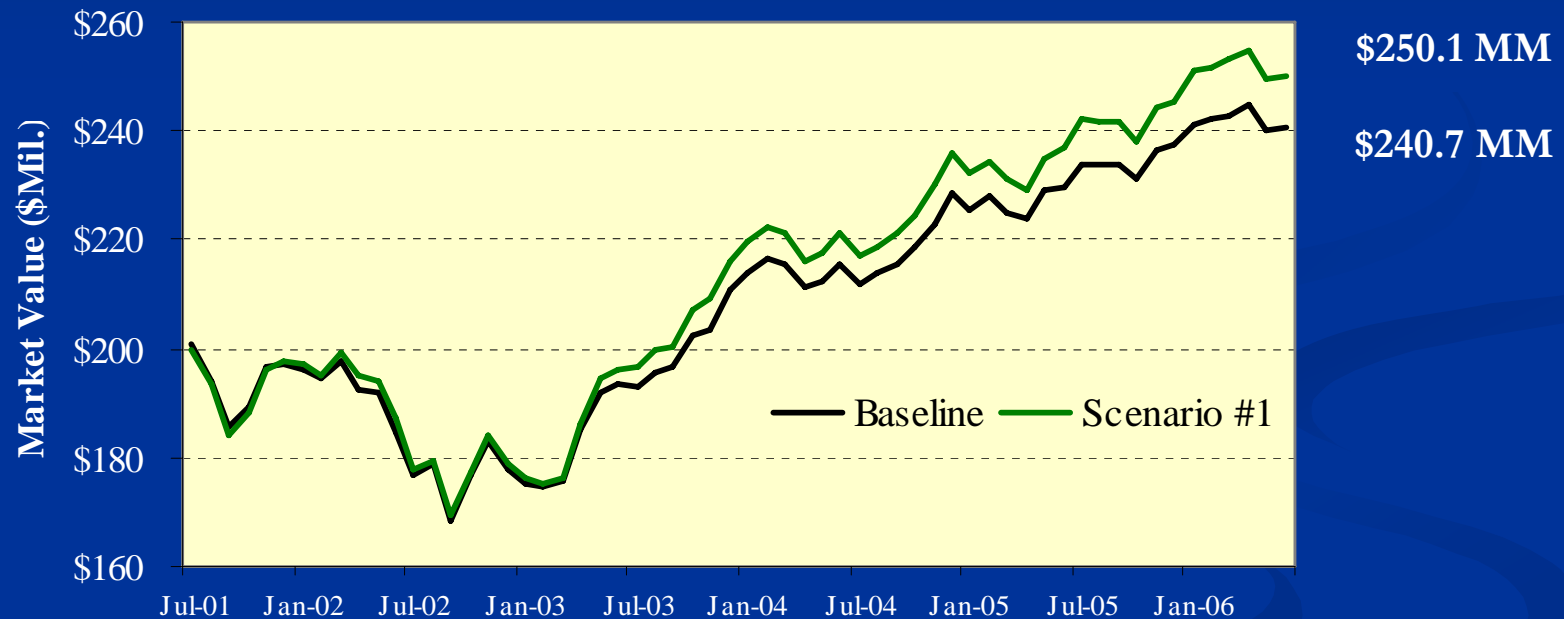
## Compare the Following Alternatives to the Baseline

- Scenario #1
  - US small cap allocation is 20% of overall US equity allocation
- Scenario #2
  - High yield bonds are 20% of overall bond allocation
- Scenario #3
  - Non-US equities are 10% of overall asset allocation (50% US stocks)
- Scenario #4
  - Emerging market equities are 5% of overall asset allocation (55% US stocks)
- Scenario #5
  - Add all of the above

# Hypothetical Fund Example

## Scenario #1: Add US Small Cap Equities

### *Fund Growth Over 5 Years*



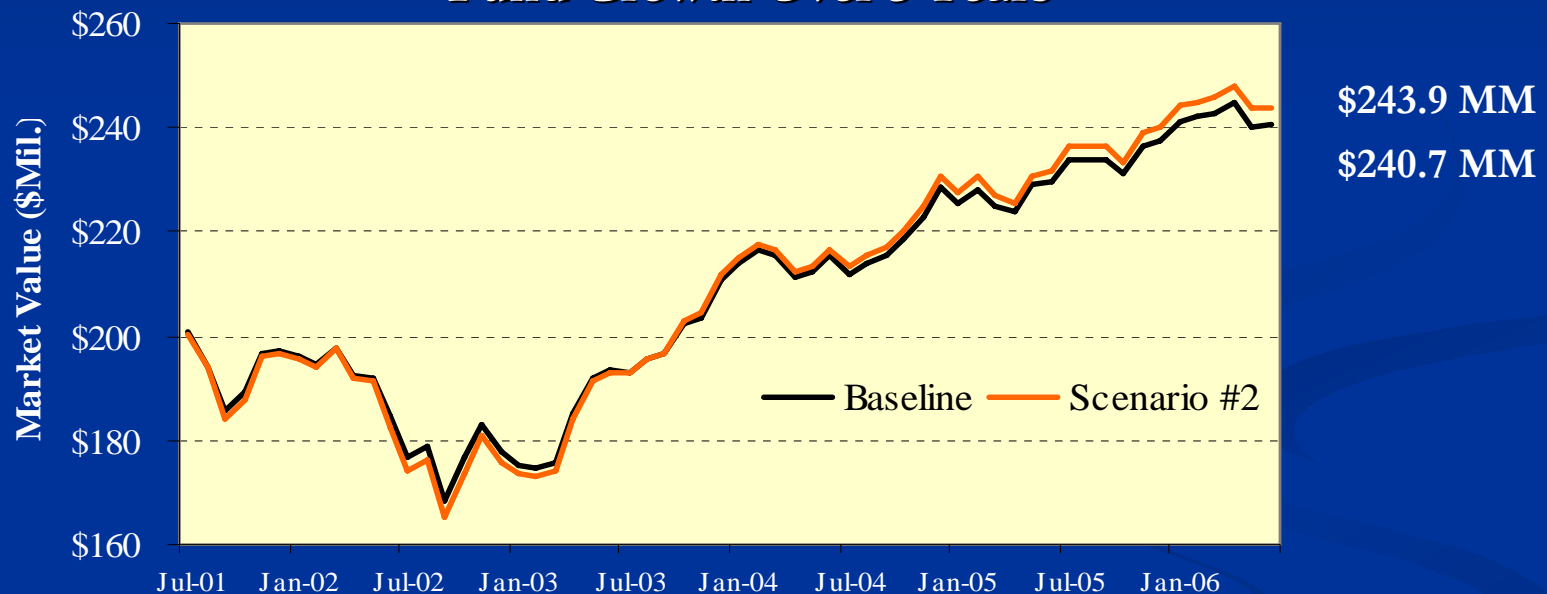
**Annualized Return:** 4.57%  
**Annualized "Risk":** 8.08%

*NOTE: Scenario #1 reflects linked monthly returns consisting of 48% S&P 500 Index, 12% Russell 2000 Index and 40% LB Aggregate Bond Index through June 2006. Annualized "Risk" reflects the annualized standard deviation of monthly returns*

# Hypothetical Fund Example

## Scenario #2: Add High Yield Bonds

*Fund Growth Over 5 Years*



**Annualized Return:** 4.05%

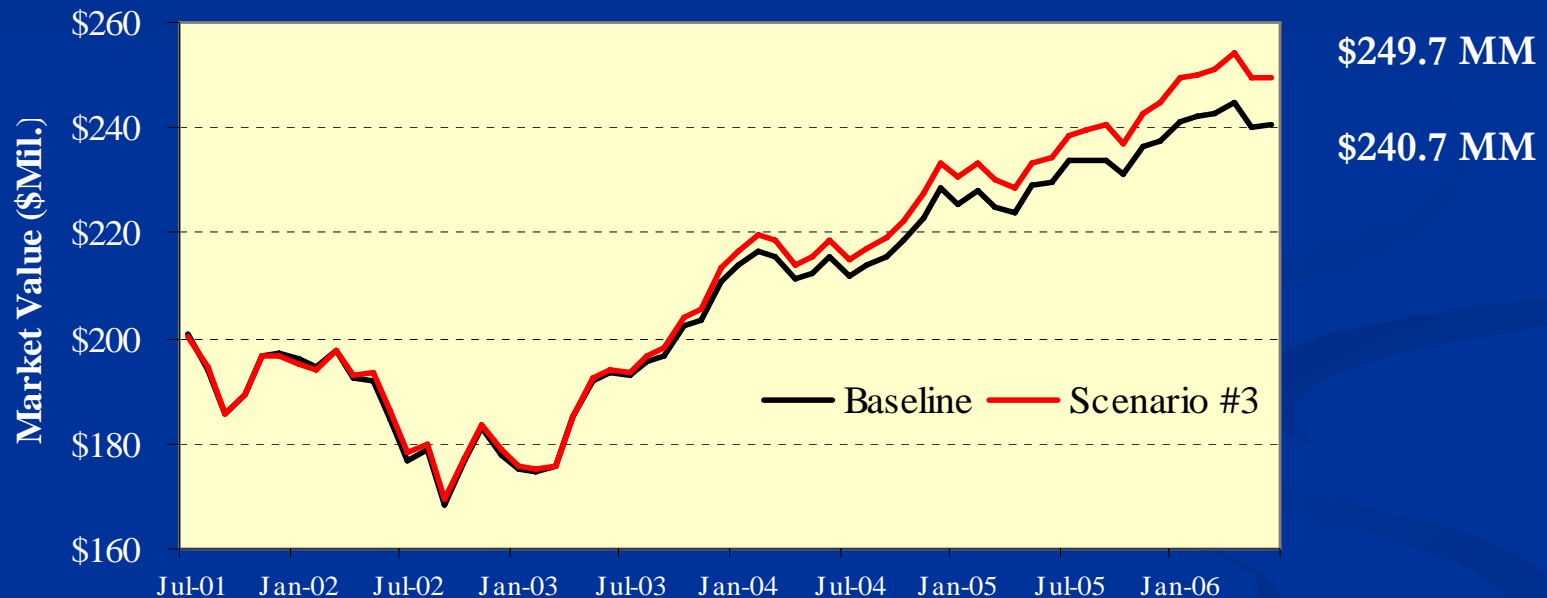
**Annualized "Risk":** 8.20%

*NOTE: Scenario #2 reflects linked monthly returns consisting of 60% S&P 500 Index, 32% LB Aggregate Bond Index and 8% LB High Yield Index through June 2006. Annualized "Risk" reflects the annualized standard deviation of monthly returns*

# Hypothetical Fund Example

## Scenario #3: Add Non-US Equities

### *Fund Growth Over 5 Years*



**Annualized Return:** 4.54%

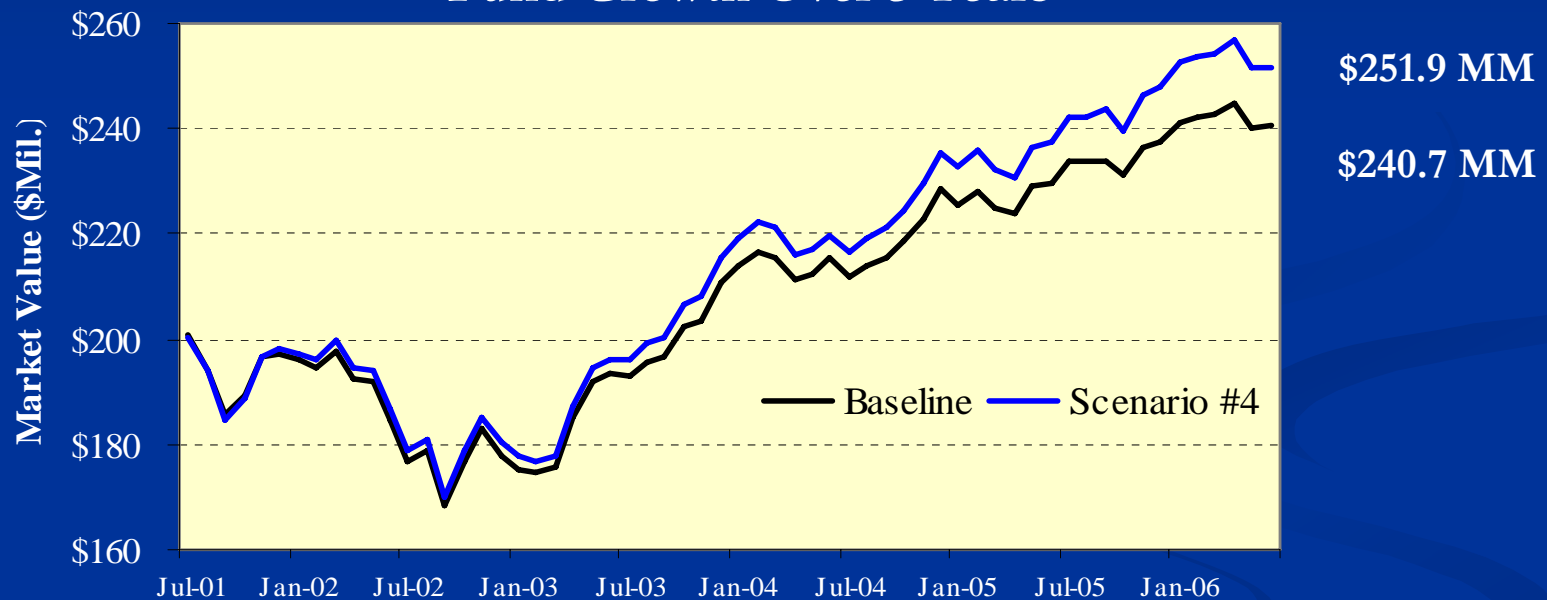
**Annualized "Risk":** 7.68%

*NOTE: Scenario #3 reflects linked monthly returns consisting of 50% S&P 500 Index, 10% MSCI EAFE Index and 40% LB Aggregate Bond Index through June 2006. Annualized "Risk" reflects the annualized standard deviation of monthly returns*

# Hypothetical Fund Example

## Scenario #4: Add Emerging Market Equities

*Fund Growth Over 5 Years*



**Annualized Return:** 4.72%

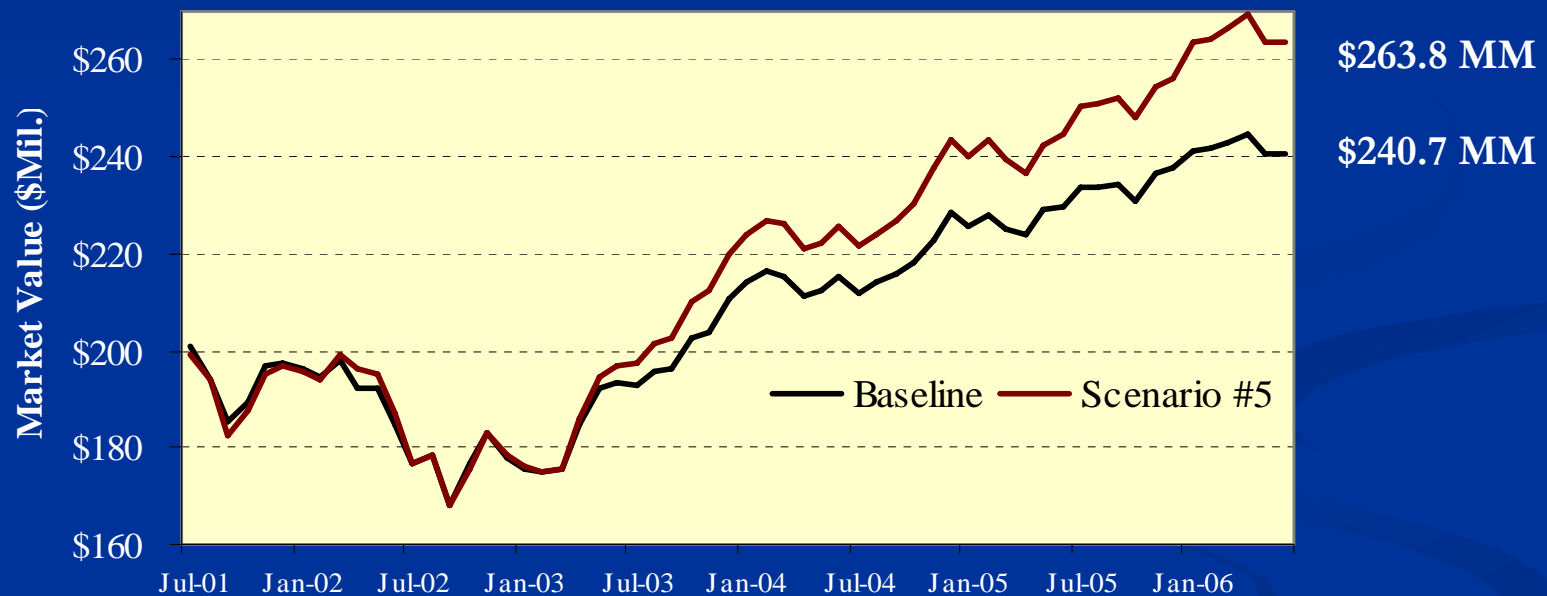
**Annualized "Risk":** 7.90%

*NOTE: Scenario #4 reflects linked monthly returns consisting of 55% S&P 500 Index, 5% MSCI Emerging Markets (free) Index and 40% LB Aggregate Bond Index through June 2006. Annualized "Risk" reflects the annualized standard deviation of monthly returns.*

# Hypothetical Fund Example

## Scenario #5: Add All Asset Classes

*Fund Growth Over 5 Years*



**Annualized Return:** 5.70%

**Annualized "Risk":** 8.55%

*NOTE: Scenario #5 reflects linked monthly returns consisting of 40% S&P 500 Index, 10% Russell 2000 Index, 8% MSCI EAFE, 2% MSCI Emerging Markets (free) Index, 32% LB Aggregate Bond Index and 8% LB High Yield Index through June 2006. Annualized "Risk" reflects the annualized standard deviation of monthly returns.*

# Hypothetical Fund Example

## Scenario Summary For the 5 Years Ended June 30, 2006

Example	Description	Return	Risk	Market Value	Gain vs. Base
Base Scenario	60% / 40% Mix	3.78%	7.74%	\$240.7	--
Scenario #1	Add Small Cap	4.57%	8.08%	\$250.1	\$9.4
Scenario #2	Add High Yield	4.05%	8.20%	\$243.9	\$3.2
Scenario #3	Add Non-US Equity	4.54%	7.68%	\$249.7	\$9.0
Scenario #4	Add Emerg Market	4.72%	7.90%	\$251.9	\$11.2
Scenario #5	Add All	5.70%	8.55%	\$263.8	\$23.1

- At the strategic level, “policy” asset allocation restrictions can have a meaningful impact on fund returns

# Emerging Strategies

- In the search for “alpha”, many investment managers are seeking broader investment mandates and/or fewer investment restrictions
  - Premise – allow skillful managers the ability to fully implement their investment ideas
- Markets continually evolve – new securities and different approaches to portfolio construction can enhance returns and/or reduce risk
- New and unique strategies can have a place within a reasonably diversified fund asset allocation
  - No “silver bullet”

# Emerging Strategies

## Equity-Based Examples

- “All Cap” or “Any Cap” equity mandates (“style-less” investing)
  - Eliminate the style and size constraints from a manager’s mandate
  - Benchmark performance to a broad market index
- “Best Ideas” Portfolios
  - Allow manager to hold larger positions in fewer securities (better reflection of manager’s conviction)
- Long-short Mandates
  - Eliminate the “long-only” constraint (e.g., allow the manager to invest 130% long / 30% short)
  - Expands opportunity set and allows manager to fully express views
- Global Mandate
  - Eliminate the requirement to invest only in US securities
  - Manager can seek best investment opportunities globally

# Emerging Strategies

## Fixed Income-Based Examples

- “Core-Plus”
  - Allow manager discretion to opportunistically invest in sectors outside a given benchmark
  - Plus sectors typically include high yield, non-dollar and emerging markets
  
- “Absolute Return” Fixed Income
  - Mandate is to generate positive “absolute returns” using fixed income securities and related instruments
  - Portfolio is not constructed relative to a benchmark like Lehman Aggregate
  - Sectors can include traditional “core”, the “plus” sectors noted above and bank loans, commodities and local currency emerging market debt

# Emerging Strategies

## Other Examples

- Global Tactical Asset Allocation (“GTAA”)
  - Opportunistic trading among asset classes (stocks and bonds) and currencies on a global basis
  - Can be used as an overlay to existing asset allocation, relative to a global benchmark or on an absolute return basis
- Portable Alpha
  - Achieve “beta” exposure through futures or exchange traded funds (ETFs) and overlay or “port” the “alpha” from another source onto the portfolio
- Hedge Funds
  - Manager may have broad investment discretion across many asset classes and could employ complex strategies
  - Absolute return focus

# Emerging Strategies

- Implementation may require modification or elimination of certain policy and/or guideline constraints and approaches
- Examples could include the following
  - Use of derivatives
    - Futures might be used within an equity-based strategy to gain market exposure (e.g., a cash market substitute) or to hedge portfolio risk
    - Credit default swaps (“CDS”) might be used within a fixed income-based strategy to take credit exposure or as “insurance” against a negative credit event
  - Short selling
    - Stock may be sold short to hedge risk and/or add incremental return by expanding manager opportunity set
  - Private placements
    - 144a securities
    - Certain securities / investment vehicles are not “registered”
  - Currency hedging
  - Leverage
- Investors cannot establish own guidelines for commingled / pooled funds

# What Can Trustees Do?

- Examine strategic policy level restrictions in your IPS
  - Perform asset allocation / asset-liability analysis
  - What limitations (if any) could impact fund returns going forward?
  - Do asset class prohibitions still make sense?
- Review all investment manager guidelines
  - How have the benchmark and the manager's capabilities evolved?
  - Involve managers in the discussion
  - If a manager has demonstrated "skill" in the past (real alpha), perhaps expand manager's investment "opportunity set" through more discretion
- Put your investment consultant to work – advice and recommendations regarding these matters should be a fundamental responsibility of the consultant
- Ongoing trustee education