Post Conference Report

Pension Fund Risk Management Conference

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Managing risk and improving returns in pension plans

With changes in regulation and accounting, shifts in investment paradigms and alterations in demographics, pension plan sponsors are addressing all sorts of issues of best practice.

By Margaret Morris

The room was packed at the P&I Pension Fund Risk Management conference held in New York in December, as over 160 plan sponsors and consultants sought to consider the changing requirements for operating successful defined benefit pension plans. Issues as diverse as static versus dynamic benchmarks, managing funding ratios, alpha transport, investing in alternatives and liability driven investing preoccupied the presenters and attendees alike.

The purpose of the conference, as introduced by moderator Fern Jones, was to consider the role of risk in its broadest sense as it is associated with managing pension plans. Plan sponsors and participants know all about pension risk – the risk that the plan won't have enough money to pay its retirees. But there are many aspects to pension risk, and it isn't just the plan sponsor and participants that are thinking about pension risk today. Take for instance the CFO, faced with the new FASB rules that require pension plan funding status to be recognized on the balance sheet from the beginning of 2007.

The goalposts are moving. Actuarial valuations are suggesting that participants will live longer. Investment returns are not living up to expectations. Managing pension assets without considering liabilities has left many plans exposed to unacceptable levels of duration risk. And where do plan sponsors find the alpha needed to meet target return levels? In this new pension universe, plan sponsors and consultants came together with some of the world's most innovative investment managers and brokers to debate solutions.

First at the podium was Alan Brown, head of investments and executive director of Schroders plc with his sweeping presentation entitled, A Holistic View of Pension Fund Risk. He focused on the concept of dynamic policymaking in order to implement best practice across all pension-related risks. His approach questioned all of the assumptions that plan sponsors and consultants have long taken for granted, and rested on the need to focus on the risk preferences of the plan and its trustees. By choosing to put risk, risk budgets and funding ratios in the fore, he argued, pension plans can more easily align their investment policy and liabilities, creating a strategic policy that reflects real world objectives. Only in this way are the interests of the pension fund, its sponsor and its investment managers working together.

The audience was most interested in Brown's use of Schroders' own pension fund as an example of how to implement his new version of best practice in pension risk management. Reorganized in early 2006, the $900 million fund, now closed to new members, sought to minimize long-term costs and implement a specified risk budget (expressed as a percentage of company pre-tax profits). At the same time, the company topped up the plan with a cash contribution bringing it to 100% funding ratio. Brown detailed the changes in policy that Schroders put in place to achieve its goals and how the asset allocation changed.

After a detailed panel discussion on developing long-term approaches to pension risk, Aaron Meder, head of asset-liability investment solutions, Americas and Drew Carrington, senior US fixed income portfolio manager, both from UBS Global Asset Management, focused on hedging liability risk and generating investment return. Using a series of very clear examples, Meder and Carrington laid out the evidence for liability driven investing, showing how a focus on funding ratio leads to a different efficient investing frontier. The duo then turned to implementing liability hedging strategies, including developing benchmarks that reflect the status of the participant and ways to use absolute return strategies that improve the risk/return tradeoff.

After lunch, Laurence Siegel, director of research at the Ford Foundation, addressed the viability of defined benefit pension plans in his speech, Don't Kill the Golden Goose. After demonstrating that DB plans are under threat in the US and elsewhere, as plans are being frozen or dumped on the PBGC, he exhorted the audience to do all they could to keep DB plans alive. He argued that although common perception holds that pension funding risks and costs are unmanageable, that perception is not correct. Rather he explained that the pension community has the tools to sponsor DB plans at manageable levels of risk – and suggested that, "We use them!" DB plans, Siegel said, are a much better use of a given employee benefit dollar than defined contribution plans.

One of the dramatic changes in the perception of risk within pension plans is the recognition that plans are often taking a number of uncompensated risks. Joanne Hill, managing director and Karen

McQuiston, vice president in the pension services group at Goldman, Sachs & Co., focused on the potential solutions for managing a range of risks – from interest-rate risk to equity risk to liquidity risk. Using new approaches and risk management tools that involve a range of derivative instruments, pension plans can tailor-make risk control measures that help sustain funded status and reduce funding volatility. It isn't enough to identify risks, said Hill, but plan sponsors must develop policies and procedures to manage the risk according to the plan's own individual risk tolerance

Colm O'Cinneide, director of Deutsche Asset Management rounded out the day with a presentation on the counterintuitive impact of imposing investment constraints to manage risk. Most plan sponsors impose constraints on their investment managers, but O'Cinneide wondered if the unintended consequences of these constraints – failure to contain risk, limited diversification and hedging opportunities and forcing managers towards unreasonable portfolios – were worse than running unconstrained. After demonstrating the strangehold that some investment constraints place on investment manager performance and thus fund returns, O'Cinneide suggested that relaxing constraints could have positive benefits. By relaxing a 'long-only' constraint, a plan might avail itself of hedging opportunities from short-selling; by relaxing a 'no-futures' constraint it might capture tactical asset allocation alpha and employ portable alpha strategies; and by relaxing a 'low-active-risk' constraint, it might avoid index inefficiencies.

After a brief summary of the first day's proceedings, the second day of the conference kicked off with a trio of presentations that addressed particular solutions available for those concerned about the management of pension fund risk. Yasuyuki Kato, senior managing director and head of global quantitative research at Nomura Securities Co., laid out the problem. The key to pension asset management, he said, is to seek more alpha while maintaining lower volatility. Two solutions were proposed, fundamental indexing and dynamic asset/liability management. Robert Arnott, chairman of Research Affiliates, explained the case for tossing out traditional capital-weighted indexes to manage and benchmark equity investments, as they overweight overpriced stocks while

underweighting underpriced stocks. Instead, he said, plan sponsors should adopt indexes, such as Fundamental Indexes, that provide a more efficient full market portfolio of international or global stocks. Alla Gil, managing director and head of international capital solutions group of Nomura Securities International, moved to the larger canvas of enterprise-wide risk management. She unveiled a solution called strategic asset/liability management, which she said could be used to identify risk concentrations at the plan or sponsor level, and areas where there could be potential for added yield or risk mitigation using changes in capital allocation.

Pension plan sponsors today are forced by circumstances to look at all their options. These include maintaining a DB plan, but changing the investment and risk management to meet new paradigms; freezing or terminating a DB plan to curtail risk and cost; and starting or expanding a DC plan. In the workshop given by Paul Bosse, principal and director of asset allocation at Vanguard Institutional Asset Management, he provided a framework for plan sponsors and their sponsoring organizations to evaluate their choices. He identified the current funding level of a DB plan as the key determinant for plan sponsors, with those plans at lower funding levels making different choices than those in a better position. But he stressed that the solutions are no longer obvious or intuitive, as the relationships between the various factors is not linear.

After lunch on the second day, David Russell, managing director and portfolio strategist at Attalus Capital, took on the topic of portable alpha strategies and their usefulness in solving the pension fund risk conundrum. After adding hedge funds to their portfolios for the best part of a decade because in general, they lower fund volatility without sacrificing return, Russell suggested that the next investment evolution is portable alpha strategies. Using this approach, plan sponsors can accurately identify and capture that elusive commodity, alpha, across all asset classes. In less efficient asset classes, such as hedge funds, alpha forms a larger component of returns.

Robert Ferguson, senior investment officer of INTECH, rounded out the presentations on solutions for managing pension fund risk by focusing on structured products as a method for delivering alpha under risk-controlled conditions. Structured products, also known as enhanced index or risk-managed solutions, offer lower tracking error than other portfolios with similar excess return goals, higher information ratios and generally lower fees. Because of the unceasing funding demands of pension plans and low nominal returns coming from pure index products, Ferguson suggested that more plans will be looking closely at the advantages offered by structured products.

It was two days of complex presentations and lively panel discussions on all aspects of pension fund risk management. From the choices faced by plan sponsors in fulfilling their obligations to their plan participants and beneficiaries, to detailed explanations of methods to control risk and increase return, the conference provided food for thought to all involved.

Note to readers: A webcast of the entire conference, available on the Pensions & Investments website, allows you to listen to any of presentations and discussion from the day at www.pionline.com/riskwebcast

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