Strategic Investment Group®

Fiduciary Insights

BIRDS OF MANY FEATHERS

The Increasing Divergence of Investment Policies

FOR MANY YEARS, INSTITUTIONAL INVESTORS—I.E., PENSION PLANS, ENDOWMENTS AND FOUNDATIONS—HAVE FOLLOWED INVESTMENT POLICIES BASED ON A CONVENTIONAL 60/40 BLEND OF EQUITY AND FIXED INCOME SECURITIES. Recently, however, their investment policy allocations have begun to diverge and, due to differing policy constraints, will be forced to diverge even further in the future. For example, corporate pension plans will increase their allocations to fixed income, while endowments and large foundations will place greater emphasis on more illiquid alternative investments. One result will be a burgeoning demand for alternatives that will spur the creation of hybrid investment vehicles.

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The Inadequacy of the Single Standard

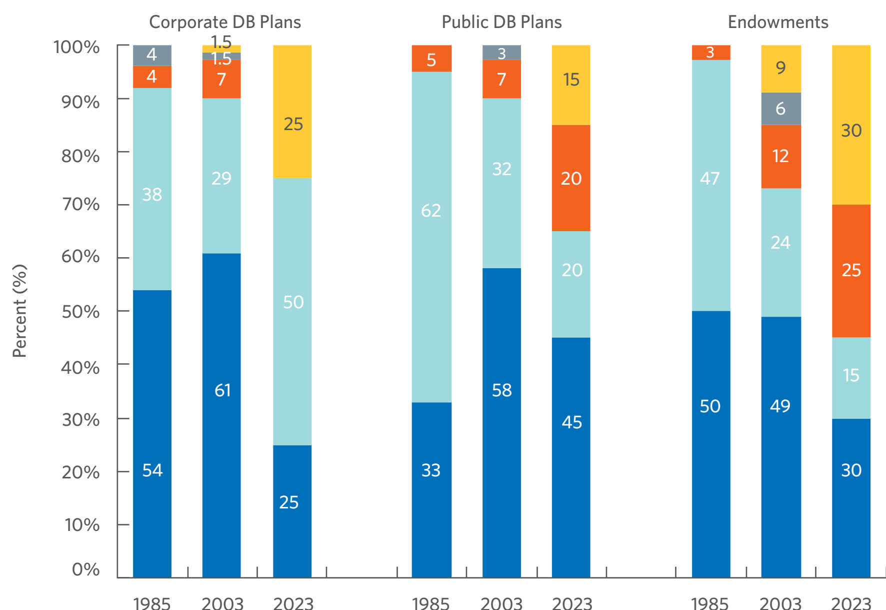
Twenty years ago, pension plans, endowments and foundations employed relatively simple, and similar, investment policies built around a conventional asset mix consisting of roughly 60% stocks and 40% fixed income securities. This standard allocation was developed using simple mean-variance optimization methods that indicated a roughly 60/40 mix produced an "optimal" return per unit of risk. Over the years, many institutions have used this convenient standard as a starting point for tailoring asset mixes that conformed to their own situations and preferences.

In recent years, as corporations have abandoned defined benefit plans in favor of defined contribution and profit-sharing plans, the institutional investment landscape has changed dramatically. The old formula has broken down and investment policies have become more diverse. A number of institutional investment policies now reflect a growing commitment to alternative asset classes. Fiduciaries are under increasing pressure to match their investment policies to new economic realities and evolving investment constraints, as summarized in Exhibit 2 on page 3.

Each of the principal segments of institutional investors—i.e., corporate and public defined benefit plans, endowments and foundations—will likely respond differently to the changing marketplace dynamics. As a result, the investment policies of each segment can be expected to diverge significantly from each other, as illustrated in Exhibit 1 below.

EXHIBIT 1:
DIVERGENT INVESTMENT ALLOCATIONS

Source: Greenwich Associates; Strategic Investment Group



Shortened investment horizons will encourage corporate plans to prefer less volatile, more liquid asset classes.

Corporate Defined Benefit Plans

Due to the growing popularity of defined contribution plans, the number of corporate sponsors providing defined benefit plans has dwindled and is likely to continue to shrink dramatically over the next twelve to twenty years. Increasingly, even large, mature corporations are abandoning defined benefit plans and their attendant expense, business risks and maintenance demands.

Many sponsors will simply terminate existing corporate plans. The accumulated benefit obligations, if not immediately paid out as lump sum distributions, will be managed for a shrinking group of older employees and retirees. As the duration of the liabilities declines, the allocation to equities will fall from 70% to 30% or lower. Some plans will defease their liabilities with immunized fixed income strategies and eliminate their equity exposure altogether. Shortened investment horizons will encourage corporate plans to prefer less volatile, more liquid asset classes over illiquid choices such as private equity and real estate.

Public Defined Benefit Plans

State and local government pension plans face a significantly different future than their corporate counterparts. As the "natural" holders of long-horizon assets, public plans will continue to be restrained by their large size and bureaucratic caution, as well as by the political agendas of their investment committees. Therefore, despite sensitivity to the fiscal situation of their states and localities, public plans will continue to grow for the foreseeable future. In addition, while public plans are expected to increase their allocations to alternative asset classes, their large relative size requires that they maintain substantial exposure to more liquid markets. As a result, stock and bond allocations, although reduced, will continue to dominate the total asset mix of public plans.

Endowments and Foundations

Endowments and large foundations, with their virtually perpetual investment horizon, face far fewer investment constraints than pension plans. Their fiduciaries are not subject to the same short-term pressures and have a far greater appetite for illiquidity and long-term risk. With a predisposition to forego liquidity for the potential of above average returns, endowments and large foundations will continue to increase their allocations to alternative asset classes. Alternatives can, over the long term, provide these institutions attractive diversification and tax-efficient leverage that can enhance long-term returns and help to control annual return volatility so that earnings will keep pace with spending needs.

EXHIBIT 2:
Divergent Institutional Policy Constraints

	Corporate DB Plans	Public DB Plans	Endowments and Large Foundations	Small Foundations
Assets (2004)	$2.9 trillion	$2.5 trillion	$300 billion (endowments only)	N/A
Investment Horizon	12 to 20 years	20 to 30 years	30+ years	12 to 30 years
Size	Varies	Large	Medium	Small
Effect of Size	Varies	Disadvantage	Advantage	Disadvantage
Key Sensitivities	- Beta - Sponsor's financial health - Discount rate of liabilities - Downward shift in asset/ liability discount rate spread	- Beta - Government's fiscal situation - Downward shift in asset/ liability discount rate spread	- Beta - Giving cycles - Inflation - Donations	- Beta - Stability of yearly returns
Influences on Governance	Corporate agendas	Political agendas	Some individual influence (large foundations)	Significant individual influence
Committee Turnover	High	Moderate	Low	High
Innovation	Low	Low	High	Low
Illiquidity Tolerance	Medium, but decreasing	Medium	High	Medium
Appetite for Diversification & Alternatives	Medium	Low	High	Medium

Endowments and large foundations are expected to follow the recent trend of leading university endowments and begin to increase their allocations to less liquid markets and hedged strategies to 40-60% of total assets.

The picture is significantly different for small foundations. While cycles of wealth creation—e.g., the late 1990s—give rise to new foundations, many small foundations, burdened with lower returns and unsustainable spending policies, will not survive.

Small foundation investment committees, faced with contracting investment horizons and dwindling resources, are generally not inclined to venture into illiquid alternative asset classes. Furthermore, as small foundations have limited opportunities to attract new contributions, their donors have greater influence over their investment policies. Accordingly, the investment allocations of this segment can be expected to fall between the extremes of corporate plans and endowments.

Fiduciaries will increasingly find that a variety of constraints are driving their investment policies away from the standard 60%/40% stock/bond mix.

Expert Indexing and Blurring Asset Mix and Style Boundaries

As the investment horizons and liquidity needs of the major institutional players continue to change and diverge, more intelligent, better liquidity-matched, passive vehicles will appear. It is expected that "expert" indices—e.g., equal-weighted growth or value indices for DB plans and endowments or market and float-weighted indices for larger, more liquidity-constrained plans—will increasingly replace the more popular market-weighted indices.

In addition, as the increasing use of alternative asset classes taxes the available supply, it is inevitable that the capital markets will quickly respond with new products to fill the void. For example, once the more liquid hedge fund alternatives have been exhausted, the illiquid providers of alternatives—namely, the private equity and real estate markets—will satisfy the ongoing demand by blurring the distinction between hedge funds, real estate, private equity, and debt. In response to the need to match the characteristics of hedge funds, illiquid investments will offer a variety of time horizons in place of the 10-year structure that is the current standard for private equity partnerships. Increasingly, long-only managers are offering hedged and less liquid investments to present a broader product line to their institutional clients.

A Proliferation of Policies

Fiduciaries in various segments of the institutional investment arena will increasingly find that a variety of constraints are driving their investment policies away from the standard 60%/40% stock/bond mix. The traditional one-size-fits-all approach will be replaced by several new "model" mixes, defined by investor segment. As a result, developing investment policies and determining the appropriate asset mix might not be as simple as before—but it is bound to be more rational and more interesting. Returns will be increasingly differentiated by how policies respond to applicable constraints, and performance will depend on the development and implementation of innovative and risk-controlled approaches.

Strategic Investment Group

Strategic, a pioneer in dedicated Outsourced CIO (OCIO) solutions since 1987, offers a comprehensive service platform for managing customized portfolios for institutional and private investors. Our proprietary process combines active portfolio management, rigorous risk management, and open architecture manager selection.

Strategic functions as our clients' investment partner and co-fiduciary, effectively becoming an extension of their resources. Clients are then free to focus on their core businesses, while we focus on providing the highly specialized portfolio management expertise that clients need to meet their investment goals. Depending on a client's needs and preferences, Strategic can orchestrate the management of an entire portfolio comprising multiple asset classes, focus on specific asset classes, such as alternatives (e.g., hedge funds, real estate, and/or private equity) or international investments, or manage strategies with high potential for adding value (e.g., portable alpha through investor-friendly turnkey structures). Customized liability-driven investing (LDI) solutions, whether through an integrated total portfolio approach or a targeted long-duration strategy, are also available, as are solutions that address mission-related investment objectives.

We strive to build enduring partnerships with our clients by strengthening their investment programs through a dynamic, value-enhancing investment process, sound governance framework, and world class client service. Our mission is to empower investors through experience, innovation, and excellence.

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