

The Ambachtsheer Letter

Letter #179

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PARADIGM LOST:

WHY PENSION FUND MANAGEMENT NEEDS REINVENTING

“Consultant Ennis Knupp & Associates is urging clients to abandon narrowly defined....portfolio [mandates].... If widely adopted, the recommendation would reverse

Through New Eyes

A paradigm shift implies moving from one way of seeing the world (or some part of it), to another. Our thinking about pension fund management is undergoing such a shift. How are we beginning to see the world differently? As the *LETTER* title suggests, we have concerns about the reigning paradigm of how pension funds should be managed. In this light, the goal of this *LETTER* is three-fold: (1) to share our concerns about the currently reigning pension fund management paradigm, (2) to sketch out a new paradigm, that we believe more accurately reflects current realities, and (3) to solicit your views on this critical issue.

The reigning pension fund management paradigm may be summarized as a 6-part liturgy:

1. Asset mix policy is the most important investment decision.
2. Given its importance, asset mix policy is a fund governance, rather than a management decision.
3. Fortunately, it is also an easy decision. This is because developed economies have well-behaved financial markets. Two key traits of investors in these markets is that they are (a) rational, and (b) risk-averse. Thus it follows that equities should provide a positive risk premium over the long term. Pension funds are natural long term investors. Ergo, most pension funds should have significant exposure to equities (eg., in the 60%-70% of total assets area).
4. The implementation of asset mix policy is both less important and more technical. Hence it can, and indeed should be left to some combination of internal pension fund managers, external consultants, and a team of (usually external) investment specialists.
5. The implementation process is controlled through a web of investment benchmarks, and specialized mandates relative to those benchmarks. Success (ie., the production of positive risk-adjusted net value-added) is dependent on selecting the right team of investment specialists. While finding the right team is challenging, it is worth the effort.