

# The *Ambachtsheer* Letter

*Research and Commentary on Pension Governance, Finance and Investments*

Letter #181

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## **PARADIGM FOUND:**

### **REINVENTING CORE EQUITY INVESTING**

*“It is long term investors who most promote the public interest. Yet it is they, wherever investment funds are managed by committees or boards, who will in practice come in for the most criticism. For the behavior of long term investors will seem eccentric, unconventional, and rash in the eyes of average opinion. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally”.*

#### **Paradigm Lost**

We recently pronounced pension fund management in need of reinventing (see Letter #179, “Paradigm Lost: Why Pension Fund Management Needs Reinventing”). The need arises because the bedrock of the current pension fund paradigm is the assumption of a permanently positive equity risk premium. All that really matters in deciding investment policy with the current paradigm follows directly from this assumption. A heavy (ie., 60-75%) long term exposure to equities using a broadly-based market portfolio will carry the day over the long run. Compared to this primary investment policy conclusion, all others pale in significance.

We noted it is the very success of this reigning fund management paradigm that has rendered it, at least for now, obsolete. Specifically, the risk premium on broad stock market portfolios that should be earned in the first decade of this new century has already been earned. As a result, these portfolios now offer little if any excess return over such risk free investments as long inflation-linked return bonds. Ergo, pension fund management needs a new paradigm.

#### **Back to Basics**

Where do we begin to look for such a new paradigm? We noted that the current situation necessarily takes us back to a pre-efficient markets hypothesis (EMH) world (see Letter #180, “Investing Without An Equity Risk Premium: A Brave New World?”). Fate would have it that we, and the EMH, entered the investment world about the same time (the late 1960s). The investment professionals of that day considered the new EMH a joke. Subsequent events would prove them wrong. Thirty years later, the pendulum has swung the other way. The view now is that the EMH guarantees the holy grail: a permanently positive long term equity risk premium. Ironically, we believe that subsequent events will prove this view wrong too.