

# The Ambachtsheer Letter

Research and Commentary on Pension Governance, Finance and Investments

Letter #183

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## PARADIGM FOUND: REINVENTING ASSET ALLOCATION

*“It might have been supposed that competition between expert professionals, possessing judgment and knowledge beyond that of the average individual investor, would correct the vagaries of ignorance in the securities markets. It happens however, that the energies and skills of these professionals are mainly occupied otherwise. For most of these persons are, in fact, largely concerned not with making superior long term forecasts of the probable yield of an investment over its whole life, but with foreseeing changes in the conventional basis of valuation ahead of the general public.....”*

John Maynard Keynes, 1936

### Does Asset Allocation Need Reinventing?

Yes, asset allocation needs reinventing. Below, we remind you why. How shall we reinvent it? That is what the rest of this *Letter* is about.

Last December’s “Paradigm Lost” *Letter* set out three reasons why asset allocation for pension and endowment funds needs reinventing:

- The post-World War II fat equity risk premium days are over, at least for the time being. Thus choosing the right asset mix policy is no longer a no-brainer. The time has come to begin thinking about prospective risk and reward more creatively.
- With the wide-spread belief that equities are really not very risky investments over the long run, fund fiduciaries have been giving the management of risk short shrift. The time has come to formally integrate the asset allocation and risk management disciplines in investment fund management.
- Active management is often treated as a trivial ‘add-on’ to the implementation of the chosen asset mix policy. As a consequence, most active management structures are dysfunctional from an organization design perspective. The time has come for funds that choose to use active strategies to create structures in which active management can be successful.

The three *Letters* prior to this one began to lay the conceptual foundation on which to build a new fund management paradigm.

### Risk Management in the New Paradigm

The 3-month search for elements on which to erect a new fund management paradigm produced important results. Regarding risk management: