

The *Ambachtsheer* Letter

Research and Commentary on Pension Governance, Finance and Investments

Letter # 212

September 2003

THE FUSS ABOUT POLICY PORTFOLIOS: ADRIFT IN INSTITUTIONAL WONDERLAND

“‘Curiouser and curiouser!’ cried Alice”.

Lewis Carroll

Tempest in a Teapot....or Not?

Our good friend Peter Bernstein put the institutional investment community in a tizzy earlier this year by pronouncing that policy portfolios (ie. the practice of managing investment funds with fixed policy asset mix benchmark weights) should be abandoned. The phone lines burned. The industry media wrote articles. It became the #1 topic of lunchtime conversations. Hands were wrung. Peter, oh Peter, why would you say such a thing? Have you become, heaven forbid, one of those... evil market timers?

After a summer of keeping the institutional investors waiting with bated breath, Peter gave them his answer. Policy portfolios have become a substitute for thinking, he said. The time has come to go back to investment basics. Every investment fund has a liability counterpart. That is where our benchmark thinking should take us. Only in asset-liability space can we think constructively about risk, and how much of it the balance sheet stakeholders can, want to, or should undertake.

In short, the reason why policy portfolios should be abandoned is because they have become a dysfunctional barrier between investment professionals, the fiduciaries accountable for setting risk

policy in pension and foundation balance sheets, and the beneficiaries/stakeholders in those balance sheets.

How does someone (specifically, this writer) who has had this viewpoint, and has been strenuously arguing for it for years, react to these developments? Let us tell you. The first reaction was envy (“...how come they listen to him more than to me?”). The second reaction was to heap scorn on an institutional investment community so far adrift that, when confronted with the patently obvious, it is seen as a radical new insight (“...an industry adrift on a sea of irrelevance”). The third reaction was to be thankful to Peter for getting everyone’s attention, and to sit down at the keyboard and write this *Letter*.

Below we retrace some of the history behind why liabilities matter in setting investment policy. We also demonstrate that when this fundamental idea is put into practice, the investment paradigm does indeed shift away from the policy portfolio-based investment paradigm that continues in vogue today. A much more powerful paradigm that integrates asset risk and return with liability risk and return takes its place. These conclusions are supported by new results from *CEM (Cost Effectiveness Measurement Inc.)*.