

The *Ambachtsheer* Letter

Research and Commentary on Pension Governance, Finance and Investments

Letter # 216

January 2004

IMPROVING PENSION FUND PERFORMANCE:

WHAT REALLY MATTERS

*“The meaning and purpose of a problem seems to lie not in its solution,
but in our working on it incessantly.”*

Carl Jung

Working on the Problem

The Jung quote and part of this *Letter*'s title came from a book by journalist Tony Schwartz. “What Really Matters” (Bantam Books, 1995) describes his five-year search for wisdom in America. The Jung quote heads the book's final chapter where Schwartz pulls all the strands of his search together. Jung and Schwartz both conclude that in our personal lives, it is the journey that matters, not the final destination. Can we apply this insight to the problem of improving pension fund performance? Read on, and judge for yourself.

Two prior *Letters* derived three important findings from a detailed study of pension fund behavior in the *Cost Effectiveness Measurement Inc. (CEM)* database over the 1993-2002 period:

- The average equity-debt policy mix of US pension funds went from 60-40 in 1993 to 70-30 in 2000. Thus as equity investments became increasingly overvalued relative to debt during the 1990s, investment policies called for more, rather than less equity exposure. This trend-following behavior was brutally punished in 2000, 2001, and 2002.
- There was evidence of successful active manager selection, on average, in the small cap, foreign, and private equity components of US pension funds. However, there was also con-

siderable ‘alpha’ variability within these asset classes. Thus success potential in these asset classes was accompanied by material under-performance risk. Some of this risk may actually have been ‘benchmark selection risk’, with the choice of asset class benchmarks measurably impacting how total fund returns split into their ‘policy’ and ‘implementation’ components.

- Poor cash management and cost management practices undid much of the documented active manager selection successes by the US funds over the 10-year period. Unlike good manager selection practices however, good cash and cost management practices are ‘free goods’ in the sense that their implementation does not involve undertaking any under-performance risk.

Now comes the hard part. The findings summarized above suggest that the ‘good’ funds in the *CEM* database reduced rather than increased their policy equity exposure as the 1990s drew to a close, had significantly positive ‘net alpha’ results in most asset classes, and did not suffer from the performance drags associated with the typically poor 10-year cash and cost management experiences embedded in the *CEM* database. What motivated the ‘good’ funds to make these ‘good’ decisions? In other words, what really mattered in improving pension fund performance?