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SHIFTING THE INVESTMENT PARADIGM:

A PROGRESS REPORT

"The significant problems we face cannot be solved at the same level of thinking we were at when we created them".

Albert Einstein

The 'Policy Portfolio' Debate Continues

It was at the NMS Investment Management Forum in Phoenix in January last year that Peter Bernstein questioned the value of policy portfolios in managing pension and endowment funds. Peter's questioning touched off a heated debate on the future value of the 'old' institutional investment paradigm, and whether there is a superior 'new' paradigm that should replace it. This debate has now spilled over into 2004. Indeed, it was the lead-off topic at the just-concluded 2004 NMS Forum, in which we were invited to participate. All 500 seats for this year's sequel were already taken last fall. Obviously, the 'old vs. new investment paradigm' debate continues to attract serious attention.

This *Letter* commences with a summary of the arguments we made at the recent Forum against continuing with the 'old' investment paradigm, and why we believe the time has come to shift to a 'new' one. From there, we take a stab at the question of whether, or to what degree the institutional investment community is actually 'getting it'. Paraphrasing Albert Einstein, has institutional thinking advanced enough to be able to solve the significant problems embedded in 'old' paradigm thinking? We conclude by observing that while it is still pretty dark out there, unmistakable glimmers of light have begun to appear at the end of the investment paradigm tunnel.

A Lens to See the World

A paradigm is a lens through which to see the world. The 'old' lens through which the institutional investment community has been seeing its world has three key components:

1. On average, stocks have outperformed bonds by about 5% per annum in the past. Looking ahead, this 5% equity risk premium is also available in the future, as long as you are patient enough.

2. A 60-40 equity-bond mix provides enough diversification over shorter term periods to create long term sustainability in most pension plans and foundations, while still providing a 3% risk premium over a 100% bonds policy. This is a good reward/risk 'deal'. (Indeed, the experience of the 1990s persuaded many that even a more aggressive 70-30 mix can pass the prudence test).

3. Given components #1 and #2, the bulk of the resources allocated to managing pension and endowment funds can focus on generating 'alpha' (ie., additional net return) relative to a passively implemented 60-40 (or 70-30) policy portfolio.

The question now comes down to this: is this a good lens through which to see the world?