

The *Ambachtsheer* Letter

Research and Commentary on Pension Governance, Finance and Investments

Letter # 218

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BUT WHAT ABOUT RISK?

“Pension funds have been moderately successful in employing active management techniques to enhance returns...”

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The Risk Side of the Story

Recent *Letters* noted that by ‘old’ paradigm standards, pension funds performed reasonably well during the 10 years ending 2002. Net excess return averaged 11 basis points (bps), or 20 bps recognizing even the 100% passive implementation of the typical asset mix policy would cost some 9 bps. We also noted that this 20 bps of extra return could easily have been doubled if funds had paid careful attention to the management of their cash and their total operating costs. Finally, we produced evidence that those funds who had their organizational acts together performed better than those who did not.

This *Letter* addresses the risk side of the pension fund management story. Last month’s *Letter* contrasted ‘old’ and ‘new’ paradigm frameworks through which to understand pension fund management. We noted there that the primary risk to be managed and monitored in the ‘old’ framework is a fund’s ‘implementation risk’ relative to its policy portfolio. Not so in the ‘new’ framework. Now the primary risk to be monitored is ‘total balance sheet mismatch risk’. Why? Because the ‘new’ paradigm recognizes that ‘implementation risk’ is but one risk component, with ‘policy risk’ being the other. Our study leads to four key findings and three critical questions for fiduciaries interested in the risk side of the pension fund management story.