

The *Ambachtsheer* Letter

Research and Commentary on Pension Governance, Finance and Investments

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ADJUSTING INVESTMENT RETURNS FOR RISK:

WHAT'S THE BEST WAY?

“Consider a put option that pays off only when a firm is insolvent. This put option provides insurance against the firm’s insolvency. Its cost is an intuitive measure of insolvency risk and...measures the economic cost of avoiding bankruptcy”.

Robert Jarrow
“Put Option Premiums and Coherent Risk Measures”
Mathematical Finance
April, 2002

Resurrecting RANVA

Last December’s *Letter* (“Resurrecting RANVA: Adjusting Investment Returns for Risk”) asserted that creating comparability in investment results is critical to the pension fund industry’s legitimacy, and that it requires two things. To be comparable, gross investment returns have to be reduced to reflect all incurred investment expenses. Then the net returns should be further reduced to reflect the risks undertaken to earn them. Generally, small risk exposures require small risk-adjustment ‘haircuts’, and large exposures large ones.

The *Letter* recalled that we introduced a specific risk-adjustment methodology some nine years ago that led to the metric RANVA (Risk-Adjusted Net Value-Added). After reviewing the methodology, and showing what kind of risk-adjustment ‘haircuts’ it has produced in the *CEM Benchmarking Inc.* database since 2000, we listed the following three requirements for broad acceptance of a RANVA metric in the global pension fund community.