

The Ambachtsheer Letter

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RISK IN PENSION AND ENDOWMENT FUNDS:

PRINCIPAL INTERESTS AND AGENT RESPONSIBILITIES

“RISK: the possibility of something bad happening.”

Webster Dictionary

“RISK: the chance of injury, damage, or loss.”

Cambridge Dictionary

When Possibility becomes Reality

The annoying thing about ‘risk’ is that every once in a while, possibility becomes reality. Today both the beneficiaries of pension and endowment arrangements, and the agents who make decisions on their behalf, are living with the reality that something bad has indeed happened. The experience of 2008 has turned ‘the chance of loss’ into the reality of actual 15-30% losses, or even worse. So this is an appropriate time to ask some hard questions about how well agents have been, and are serving the interests of pension and endowment fund principals today.

The essence of such an assessment revolves around addressing three questions:

- Did the agents (i.e., pension and endowment fund trustees and the people who advise them) really understand how risk bearing was, and is allocated between various stakeholders in the pension or endowment ‘deal’ they were overseeing, and continue to oversee today?
- Did the agents have a reasonable understanding of the likelihood and size of ‘damage or loss’ they were subjecting the pension or endowment risk-underwriting principals to? Do they today?
- If the answers to the questions above are not a series of resounding ‘yesses’, what changes should be made in how pension and endowment ‘deals’ are structured? In how risk exposure decisions are framed and made?

We address each of these questions in this issue of the letter.

A Grave Responsibility

Pension and endowment ‘deals’ are about investing money now to make pension or endowment payments later. With the availability of bonds that guarantee inflation-indexed payment of income and repayment of principal, such ‘deals’ can be structured so that there is a high degree of certainty about how much money is required today to make inflation-indexed target payments in the future. However, adopting such a risk-minimizing approach is not the only option for the agents to whom such decisions have been delegated. An alternative for these agents is to adopt risk-seeking strategies with the hope that they will generate higher returns than the risk-minimizing strategy.

Real world experience tells us that the vast majority of pension and endowment fund agents indeed choose the latter strategies. Earning higher returns is an attractive proposition. Funding future pension payments will cost less. Higher endowment payments become possible. Further, both investment theory and practice teach that, most of the time, properly devised and executed risk-seeking investment strategies will deliver the goods. Expected higher returns become realized higher returns. However, by choosing a risk-seeking strategy, pension and endowment agents take on a grave responsibility. They now have an obligation to understand the consequences of the ‘possibility of something bad happening’. Specifically, pension and endowment fiduciaries must assess the willingness and capability of the risk underwriters to undertake the risks being thrust upon them.