

Investment Management Review

A Quarterly Update for the Investment Management Industry



Pension Plans – A New Strategic Paradigm

With more than \$23 trillion AUM worldwide, pension funds represent the largest asset class in the global financial marketplace. Managing this massive amount is the responsibility of pension plan sponsors who, supported by investment managers and other service providers, are charged with delivering results to plan participants within an ever-changing and ever-challenging economic environment.

Investment Management Review spoke with Patrick Curtin, Citi's North American Head of Investor Client Management, about the dynamics that are driving the pension fund marketplace, the evolving role pension plan sponsors play in this shifting landscape and the new strategic paradigm he foresees transforming the space.

Investment Management Review: The pension landscape around the world has been changing for over a decade. Can you recap those changes and what have been the key drivers to explain where the industry is today and where it is headed?

Patrick Curtin: The principal reason for the changing landscape of the pension arena has been the shifting economic and capital markets environment.

In relative terms, the last couple of decades have seen a significant amount of interest rate volatility. Because the present value of a pension fund's liabilities is partly – one could even say largely – a function of long-term interest rates, we've watched pension funds frequently vacillate between overfunded and underfunded positions. If you layer on top of that the global capital markets environment, uncertain regulatory conditions and dislocations in the asset side of their portfolios, you create an almost perfect storm within which pension plan sponsors have operated over the last several years.

What have been the macro market factors that affected the asset side of pension fund sponsors' business?

On the asset side, several factors – including the tremendous financial crisis of 2007/2008 – gave major

headaches to pension plan sponsors: the relative underperformance of traditional long-only active managers; alternative investments, which in some cases did not fully deliver on what they were intended to do; and the breakdown of the correlation between different asset classes that were supposed to have added diversification to pension plan sponsors' portfolios in periods of high volatility.

This combination of market conditions is giving rise to a different paradigm in the way pension plan sponsors look to achieve their investment objectives. And as a result, their service providers – investment managers and other service providers alike – have had to and will continue to adapt their business model to accommodate this shifting paradigm.

Can you describe the new paradigm you see for pension plan sponsors and their service providers?

For the better part of the last ten years, pension plan sponsors and their consultants and advisers have been talking about separating the manufacture of their beta, which is their market returns, from their alpha, which is their ability to add value above an appropriate benchmark. In the new paradigm, pension plan sponsors will form a small handful of key strategic relationships with outside firms that they will depend on for their manufacture of alpha and beta, and the infrastructure necessary to facilitate that.

This shift will require a fundamental change in the working relationship between plan sponsors and their service providers – from a conventional buyer/vendor association to a strategic partnership.

That's not to say that sponsors will have only two or three or four fund managers. Certainly there will be pension plan sponsors with dozens and dozens of relationships, and who will be able to do so very successfully. However, there are others that may find greater value in managing a smaller, more strategic group of investments managers and other service providers. Importantly, this concentration of strategic relationships isn't about getting the best price. It's really about developing the strongest possible relationships with firms that understand the culture of a particular pension fund.

The new paradigm includes being able to efficiently and cheaply get access to beta. The most fundamental way to accomplish that is through passive investment management by indexing portfolios in developed equity and fixed income markets around the world. In the new paradigm, plan sponsors have the ability to access beta returns through ETFs or other passive structures, and efficiently manufacture beta exposure with derivatives.

Finally, in the new paradigm, plan sponsors may manufacture beta themselves, which does require some investment in technology to build or strengthen an infrastructure that may or may not exist in-house. Several market studies indicate that over the next three to five years more plan sponsors may well consider doing that, particularly the larger public pension plan sponsors – less so in the corporate pension plan space – and even in the endowment and foundation space.

How and where will pension fund sponsors attain alpha in this new paradigm?

The conventional answer has always been in the AI space. Alternative investments will still play a meaningful part in how and where plan sponsors get alpha, but it won't be the whole story. Going forward, it will be more about the way pension plan sponsors manage the business of being a pension plan sponsor.

Of course, alpha generated from portfolio performance will continue to contribute to a fund's overall returns. But there will also be something I call "organizational alpha."

Citi recently sponsored a CREATE-Research study that indicated that investment managers with strong back- and middle-office infrastructures are correlated to those that tend to outperform their benchmarks and create alpha. If you transfer that concept to the beneficial owners of the assets (i.e., the pension funds), you could argue that organizational alpha will become critically important for pension funds, particularly those that manage their business relationships and their strategic partnerships in-house.

Besides this paradigm shift toward strategic relationships between pension plan sponsors and a select number of service providers, what other changes do you see in the pension fund marketplace over the next five years?

Interest rates, at least in the United States, are at historical lows. And the consensus among economists and other market watchers is there's a good likelihood they will head higher over the next five years. Rising interest rates actually lower the present value of pension liabilities. If asset values were to stay the same, which is not realistic, rising interest rates would improve the funding position of many pension plans in the country.

To me, a pension plan is the ultimate exercise in asset/liability management. And I believe the science of asset/liability management will increasingly weave its way into pension management over the next five-plus years. The reason is straightforward: Pension plan sponsors – particularly those whose sponsoring entities are cash-strapped or earnings-strapped – have to minimize the contribution that the sponsoring organization has to make to keep funding levels where they need to be. As a result, the science of asset/liability management will become more and more important in the pension arena over the coming several years.

Also, macro-economic changes such as rising or falling interest rates or increasing or decreasing asset prices are factors that pension funds can't control. There is, however, another issue that pension plan sponsors can manage and will increasingly focus on – their tail, or downside risk. I believe that sponsors, given their worst-case-scenario experience of the recent financial crisis, might be willing

to give up some upside returns for protection on the downside. So we may see products being developed that are aimed at helping pension plan sponsors put a collar around the potential return distribution. I'm not saying this is going to be universal or transcend all pension funds, but I think that it will be considered by many sponsors of defined benefit plans, particularly in the public space.

What will be different about the way pension plan sponsors view their asset allocations within the context of this new paradigm?

In the traditional model, pension plan sponsors typically speak about their asset allocations as the percentage allocated to equities, to fixed income, to cash and perhaps to alternative investments. They might also talk about the percentage allocated in their domestic market or globally, or the percentage allocated to large-cap versus small-cap equities, or their investment style – how much of the allocation was for value investing versus growth. Those are all vectors in the traditional model pension plan along which sponsors talk about their asset allocations.

Going forward, I think the model might emphasize the allocation to beta returns and the allocation to alpha returns. I'm not saying that the traditional approach is going to disappear overnight. But I am suggesting that it's going to be supplemented by – and maybe even heavily supplemented by – this alternative view of measuring asset allocation.

What risks will pension plan sponsors be most concerned about?

The single biggest risk that pension plan sponsors are concerned about is not having enough cash to meet their liabilities and therefore needing to infuse cash from the

sponsoring organization. This is particularly worrisome in today's budget-constrained environment. To mitigate that risk, pension plan sponsors should embrace this new paradigm I've outlined.

What about risk managers? What risks are they facing in the pension fund space?

Investment managers that most quickly adapt to the fundamental shift in the mindset and needs of the pension plan sponsor will be the most successful. Those that don't adjust to the changing paradigm might do so at their peril.

Why have alternative investments been a growing part of pension portfolios? Will that growth continue and how might AI investing be viewed differently going forward?

The primary reason alternative investments have been a growing component of pension portfolios has been the promise of alpha. In certain cases, they've achieved it. Yet, if we're completely honest, in plenty of instances the promise of alpha on a risk-adjusted and fee-adjusted basis has not been delivered. Even so, private markets still offer a tremendous potential to outperform public markets. Going forward, alternative strategies that utilize long/short techniques as well as relative value plays between different markets, different securities and different asset classes will offer the potential for material alpha generation. Those opportunities will therefore continue to be heavily utilized for both defined benefit and defined contribution plans – and certainly in endowment and foundation portfolios. For asset managers in the AI space, it will all be about continuing to manufacture alpha in an efficient way that pension plan sponsors need to attain their performance objectives. ■

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