The Trustees Dilemma...

FINDING THE PERFECT INVESTMENT STRATEGY

by Frank O'Brien

Just as fund managers of my generation were scarred for life by the hyper-inflation of the 1970s, so will the spectacular boom and bust of the technology bubble colour the attitudes of investors in general, and pension fund trustees in particular, into the future.

The technology bubble is reckoned to have begun with the 100-times oversubscribed Netscape IPO in 1995. Over the next five years equity market returns were spectacular.

Real (i.e. After Inflation) Equity Returns*	
1995 – 1999 (incl) % p.a.	
US	UK
24.5%	16.7%
domestic currency, includes income reinvested.	

The Irish equity market fully participated in this boom, benefiting from the international equity background and from the tangible impact on profits of the tiger economy. In the five years to end 1999 Irish equities generated a real return of 23.4% per annum.

The good times ended, however, in March 2000 as the technology boom imploded and realisation dawned that valuations then prevailing implied unsustainable rates of growth for impossibly long periods of time

The downside was dramatic, swift and bloody.

Real Equity Returns*		
2000 – 2002		% p.a.
US	UK	Ireland
(16.8)	(15.9)	(9.7)%

With the benefit of hindsight, it is now clear that investors made two critical errors during the boom period:

1. They made the mistake of presuming that the strong equity returns of the boom years would persist into the future.

2. They overlooked two central rules of investment. "Investment is a two-handed process – it is about risk and return. Diversification controls risk".

These mistakes were costly for Irish pension funds. By end 1999, just before the peak of the boom, the average equity exposure of Irish pension managed funds was standing at 74%. The sharp downturn had a dramatic impact on pension fund returns:

Pension Managed Funds Average Returns V Hurdle Rate 2000 – 2002	PMF Average	Hurdle Rate (Inflation+ 4%)
2000	2.6%	9.5%
2001	(5.7)%	8.9%
2002	(18.9)%	8.6%

Over the three years then to end 2002, the average pension managed fund under-performed its hurdle rate by a dramatic 16.8% per annum. A more satisfactory out-turn in 2003, when the average return of 12.3% compared to the hurdle rate of 7.5%, still leaves a large gap over the full four year period.

Attrition of this magnitude has, not surprisingly, caused many trustees to reconsider and review their approach to investment, particularly given their awareness of the burden that increasing longevity places on pension funds. There has been a wide ranging and heated debate in the UK where highly differentiated solutions have been advocated, ranging from the Boots plc Pension Fund's adoption of an all bonds strategy to the much more radical reshaping of asset mix, embracing unconstrained global equity mandates and alternative assets, implemented by the Merchants Navy Officers Pension Fund.

The debate is underway in Ireland also with many trustees revisiting the risk and reward dimensions of investment strategy. Rather worryingly, in terms of long term strategy, the average pension managed fund's asset mix is broadly unchanged on the pre-bust picture. There is little evidence here of any profound reassessment of risk, returns and the role of the different assets in the light of the poor out-turns of recent years.

Asset Mix Pension Managed Fund Average	31.12.2003	31.12.1999
Bonds	18	19
Equities	73	74
Property	5	4
Cash	4	4
	100	100

On the face of it, this appears to imply a remarkable level of complacency on the part of the Irish pension fund industry.

Even more surprising, given the key errors made by investors in the run up to the technology bust, is the infatuation, once again, with a single asset which has enjoyed strong recent returns. Property and leveraged property vehicles are the "asset du jour".

Clearly, the performance of property in recent years has impressed many investors, particularly its performance over the past five years.

Nominal Returns*on Irish Assets %p.a. Years to End 2003	1	5	10	20
Bonds	6.2	4.6	7.1	11.8
Equities	26.8	2.3	13.1	15.3
Property	12.7	16.1	19.0	13.3
Cash	2.3	3.5	4.5	7.7
Inflation	3.5	4.0	3.0	3.3

*income reinvested

Property, of course, has many attractive characteristics. Property shares with equities a conceptual linkage with pension fund liabilities. On the one hand, growth in the economy drives profits, dividends and share prices and also drives rents and property values. On the other hand, growth in the economy drives wages and pensions.

Property is a long term asset so it is therefore suitable for pension funds. Property generates a relatively high income return. Finally, property volatility is relatively low when compared to equities. However, because of their different pricing mechanisms – continuous mark to market for equities, periodic valuation for property – volatilities are not directly comparable.

There are, however, some property characteristics which are less desirable. Property is a high cost asset. Entry costs, because of penal stamp duty rates in Ireland, are extremely high. Secondly, property marketability can be difficult and may be very limited at certain times.

Property, to summarise, is an attractive but not an ideal asset. The relatively modest role allocated to property in balanced pension fund portfolios, in my opinion, reflects the emphasis placed on short term performance by the pension fund industry. Asset allocators are reluctant to commit large monies to an asset where exposures can't be shifted at short notice.

Property deserves a bigger role in pension fund investment strategy. I expect larger allocations to property will follow the reassessment of risk and return currently underway.

I am equally sure, however, that the recent trend, particularly in individual pensions, of putting a major part or all of pension fund monies into property is ill-founded. It repeats the errors of the technology boom. It places too much emphasis on the returns of the past few years. It ignores the benefits of diversification. Putting all the pension funds monies into a single asset class is imprudent. Putting it into a single individual property – rather than a diversified property portfolio – is closer to speculation than to investment. Putting the pension fund monies together with borrowed monies into a single individual property is extremely risky.

Leverage (or financial gearing) changes the dynamics of an investment, out-turns are magnified – in both directions. Where, for example, a property is funded 50% by equity (pension fund money) and by 50% borrowing a 10% change in the capital value of the property results in a 20% change in the capital value of the equity.

Secondly, because much or all of the property rent must be applied in meeting costs of borrowing the income attractions of property investment are lost.

It seems to me that the current enthusiasm for geared property investment is driven by over-emphasis on recent returns and by the apparent belief that property values rarely suffer a sustained fall.

Unfortunately, there is ample evidence from around the world that property values do indeed fall as well as rise. In Ireland, for example, even over the past twenty years there have been two periods of sustained falls in the capital values of property and this in nominal terms even before inflation is taken into account.

Irish Property: Nominal Capital Values

Period	No. or Years	Cum. Capital Fall
1984-1986	3	-15.1%
1991-1993	3	-15.9%

A geared property investor (assuming 50% borrowed) who began on Janunary 1, 1984 or Janunary 1, 1991 and suffered costs (at current levels) of perhaps 11% and the market falls above would have seen a decline in fund value in capital terms of 49.8% and 50.4% respectively over the following three years.

An ungeared investor, with no borrowings and thus enjoying the full capital and income returns from property, who began on Janunary 1, 1984 or Janunary 1, 1991 and suffered costs (at current levels) of perhaps 11% and received total property market returns would not have seen his fund restored to its opening value in real terms until 1989 and 1995 respectively.

Correct pension fund investing is not about finding the best performing asset. Certainly it is not about finding the asset that performed best over the past three or past five years. It is all about creating an investment strategy that is most appropriate for the liabilities of the fund. Analysis of those liabilities – nature of the liabilities, time horizons, risk appetite – will determine the appropriate asset strategy, which in turn informs our expectations for returns.

Because there is no single ideal asset, investment strategy for most pension funds will be based on a diversified asset mix. The appropriate mix is determined by matching the fund's requirements against the individual characteristics of the different assets. A diversified asset mix reduces and controls risk.

Irish pension funds suffered severely in the aftermath of the technology bubble because, in their enthusiasm for equities, they ignored two of the most fundamental principles of investment: "diversification controls risk" and "don't project recent short term returns into the long term future". This was perhaps unfortunate. To compound this error now by building over exposure to property would be careless.

Extracted from "Pension Fund Investment Strategy in the Post Bubble World" by Frank O'Brien and Brian O'Loughlin

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