

The simplicity bug is spreading

In the second article in a series on a new study, Amin Rajan and Nicholas Lyster argue that, like other crises, this one will pass. But its pain will long endure

Worldwide, some \$15trn in stock market value vanished in the 15 months to December 2008 causing widespread loss of confidence in asset managers. 'Buy what you understand' is the new mantra for their clients, according to our latest global survey of 225 pension plans and asset managers*.

Investment goals of defined benefit (DB) and defined contribution (DC) plans over the next three years will be marked by a flight to quality, simplicity and safety:

- Quality defined by consistent risk-adjusted returns;
- Simplicity by liquidity and transparency around the returns;
- Safety by capital protection.

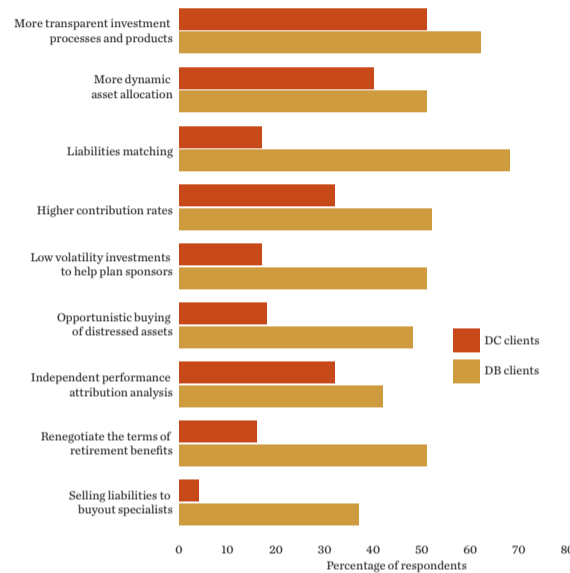
The speed and scale of the 2008 market collapse has been the immediate cause of this shift. However, as we argued in our article in the July issue of IPE, four fault lines had been developing under the surface of the pension landscape in the aftermath of the 2000-03 bear market: the buy-and-hold story was not working, nor was the core-satellite model, nor was asset diversification, nor were the regulatory and accounting changes aimed at preventing the repeat of the excesses of the last decade.

If anything, the latter had the unintended consequence of inflating the deficits in DB plans and weakening the strength of the sponsor covenant. These fault lines remained buried under the sandcastles erected by the 2003-07 boom. The 2008 collapse exposed the harsh truth buried under the surface.

Not surprisingly, therefore, as the pension fund deficits soared, the traditional question 'what is the expected return on my money?' became far less important than 'what is the risk that I can lose my money?' Likewise in the retail space 'return of my money' became more important than 'return on my money'.

With 'value-for-money' at its core, their new approach will be attracting differing emphasis from different client segments. DB clients will pursue consistent risk-adjusted (or absolute) returns to plug their burgeoning deficits. DC

What avenues will DB and DC clients use to achieve their key goals over the next three years?



Source: CREATE-Research

clients will go for less risky products offering capital protection and risk-adjusted returns.

Behavioural changes will be there for sure, but not necessarily for the better. Safe liquid assets do not deliver much in the long term. Most clients know that. But currently, they are unwilling to buy into the risk premium story which promised dreams but delivered nightmares.

What next?

Numerous avenues are likely to be used by clients in order to achieve their investment goals; some are common across the client segments; others more unique, reflecting the differences in their core preoccupations (see figure).

The common ones underscore a major point:

related absolute returns. Assets poured into alternatives, which grew to a \$5trn industry in record time, mostly powered by high net worth individuals and institutional clients. Long-only managers started using hedge fund type tools to deliver absolute returns.

"Then came the credit crunch, hitting every asset class, every client segment, every market, and every geography. The two bear markets in this decade have also turned out to be amongst the four worst ones on record. Hence, looking ahead, risk aversion will be the dominant theme for all investors. It will be reinforced by ageing populations, leaving 'baby boomers' worldwide little time to recoup the losses suffered in this decade. Additionally, the sponsor covenant will further weaken as large cash injections become inevitable. The omens are not good."

Case study of a Swiss asset manager

"Greed follows fear, as day follows the night. When the Nikkei 225 was powering ahead in the 1980s, Japanese equity warrants were all the rage worldwide. After its crash in 1989, Japanese investors began to withdraw from the market. Elsewhere, there was a recovery, led by equities and bonds till 1997, when tech stocks emerged on the scene to create a raging bull market. Even in countries where bonds had always been more popular – such as France, Denmark, Germany, Italy, Japan, and Sweden – the equity culture began to take root. When the tech bubble burst in 2000, losses shot up to \$7trn, the worst in living memory.

"But soon, a new theme emerged: uncor-

the days of opacity are over. The current crisis has shown that many investment products of recent years had hidden features such as leverage and asset class exposures that were out of synch with the expectations of those who bought them.

As an adjunct, many products also promised more liquidity than was inherent in the underlying asset classes in which they were invested. They lacked acceptable redemption processes that would minimise the gap between quoted prices and the exit prices. In their absence, investors have been shocked into discovering the true cost of liquidity during a stampede for the exit. Liquidity will be perceived as an asset class in its own right from here on.

Emphasis on transparency will also extend to execution costs, fees and business governance. Clients will require an independent oversight of performance measurement and attribution analysis if they venture into risky asset classes as part of a dynamic asset allocation strategy.

Moving on to the avenues that will be specific to client segments, three points are noteworthy.

First, despite the severity of the current crisis, the appetite for opportunism has not vanished, especially on the part of retail and DB clients. If anything, it has emerged as a major part of dynamic asset allocation, under the heading of 'core and explore' – as we shall see in the next article in this series.

It has involved holding the bulk of the assets in low volatility assets, with a small percentage earmarked for active trading in high-volatility strategies that aim to make money out of real-time market movements as well as opportunistic buying of distressed assets. As clients have lost 15 years' gains in the last 15 months, the notion of buy-and-hold investment has come under close scrutiny by DB clients and DC clients alike. Whether opportunism will pay off remains to be seen: being a bigger zero-sum game it requires special skills which most investors do not have.

Second, DB clients are also likely to pursue LDI strategies to immunise the unrewarded risks, raise the contribution rates to jack up the funding levels, renegotiate the plan benefits, and consider buy-out options to exit from the DB space. The adoption of mark-to-market rules in the US will accelerate this trend.

Third, DC clients are likely to engage in more dynamic asset allocation and raise their contribution rates, although the incidence of either of these options is unlikely to be widespread.

Yet, as markets recover, inertia may bring back the punters. But it would be foolish to bet on the idea that clients will remain gullible and trust their asset managers again – some will, most will not. If anything, when things get better, many will cash out and never return.

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*Future of investment; the next move? Available to download for free from www.create-research.co.uk