Maintaining a Long-term Outlook

Most plan sponsors claim to have a long-term investment horizon. However, too often they act in response to a strategy's short-term results, which in turn adversely affects overall plan performance.

Most pension plans develop asset allocations and select strategies based on their long-term outlook. However, too often circumstances challenge their convictions. Boards believe that they have a long-term outlook, but then show limited tolerance for significant underperformance, or lack patience for the payoffs of strategies with episodic returns. Strategies may have novel insights or an attractive longer-term payoff pattern, but their shorter-term behavior often makes it difficult, if not impossible, to retain them. Sometimes the strategy is a mismatch for the investor's liquidity needs, i.e., ability to raise cash quickly in volatile markets, or there is a misunderstanding of the inherent risks.

Whatever the cause, the impact on long-term performance can be severe. In this Viewpoint, we highlight the consequences of mismatches between a strategy's long-term performance potential and focusing on recent results.

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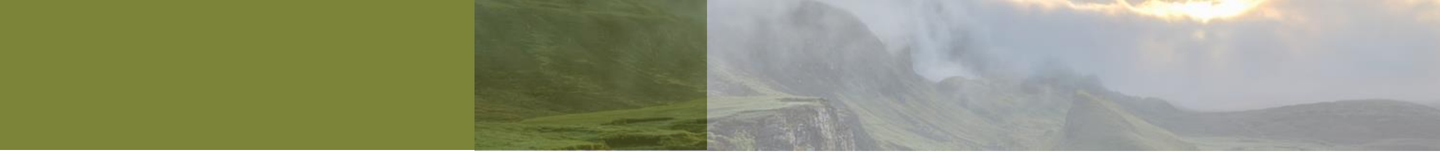
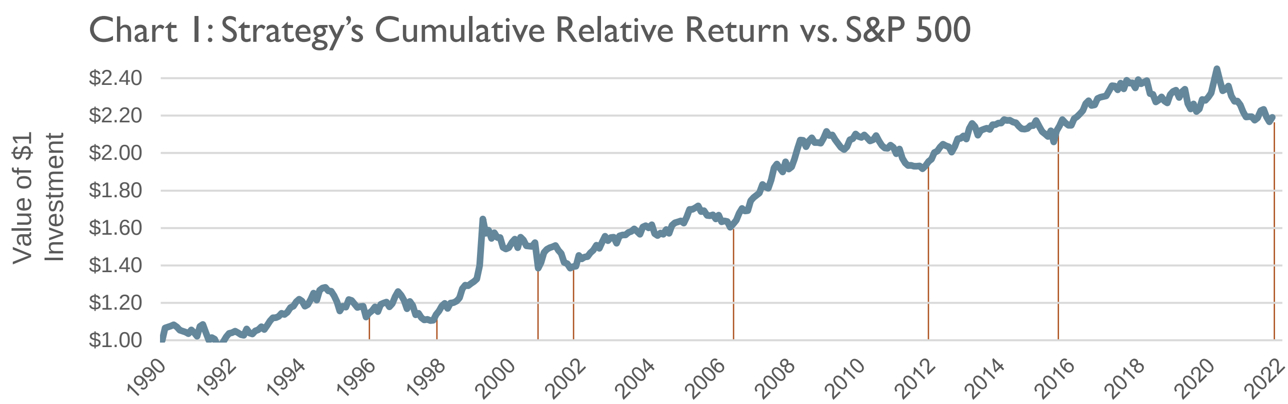
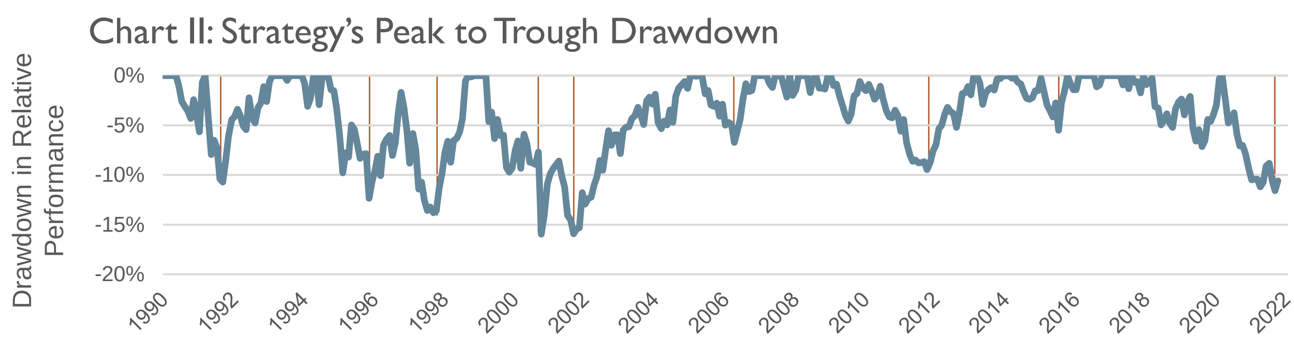


Common Mismatches

Strategies with expectedly large tracking errors Unsurprisingly, these strategies have periods of significant underperformance. Chart I below shows the cumulative return of a strategy which outperformed the S&P 500 by 2.7% per year since 1990 (12.6% versus 9.9%). Chart II shows that along the way—and consistent with its high expected tracking error—there were multiple episodes where it underperformed by more than 10%. If the board had reacted to one hiccup by exiting the strategy, the fund would have missed the recovery and the opportunity for future gains. Boards should think carefully about whether they can (will) tolerate such risks.



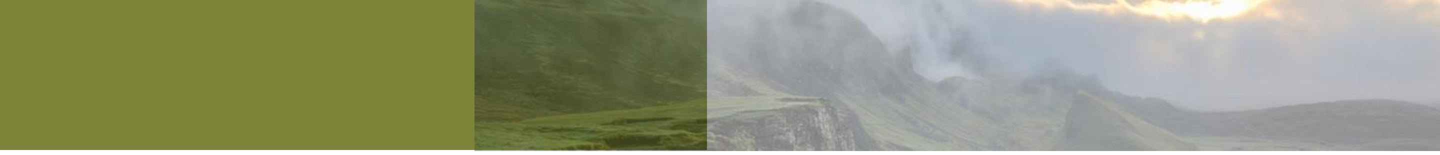


Data Sources: Markov Processes International (MPI), Alan Biller and Associates.

Other examples include:

Concentrated "high conviction" Because they are less diversified than their benchmarks, the performance of each security will have a larger return impact. Getting just a couple wrong can cause significant underperformance.

Top-down with significant sector, style or country bets These strategies' risk profiles can result in large tracking errors because the top-down views affect a broad portion of the portfolio.



Common Mismatches (cont.)

Benchmark agnostic While such managers do not consider a benchmark when constructing their portfolios, investors often do when evaluating their performance. This is a mistake: the appropriate question is: “do we still expect the strategy to produce attractive returns?”, not: “how it did it perform relative to an index?”.

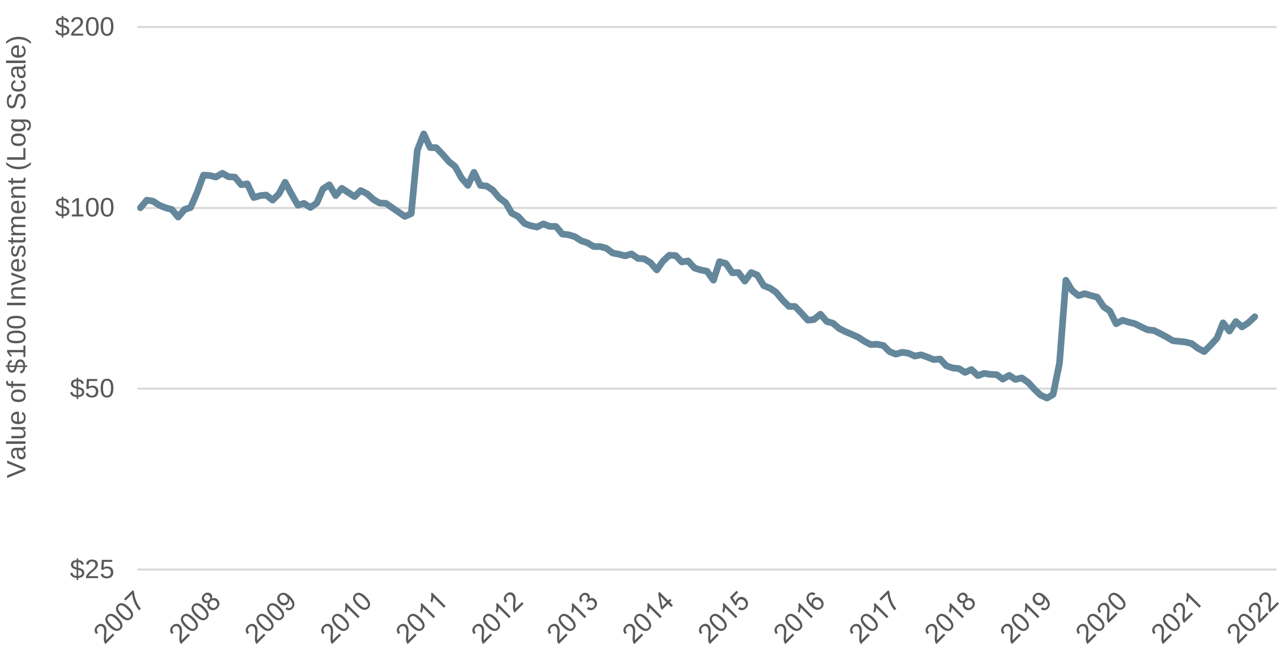
Style-tilted and smart beta Again, the appropriate question is if the approach still makes sense ex-ante, not how it might compare to a benchmark index’s recent performance.

Macro and Event-driven Value-add opportunities are typically episodic. Their strategy may be sound, but they may go lengthy periods without adding value.

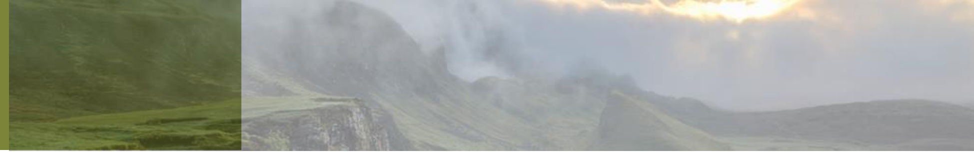
Tail-hedge Essentially a form of insurance, tail-hedge strategies pay off only in a declining market. In flat and up markets, there can be a significant opportunity cost. Chart III below shows the performance of the CBOE Eurekahedge Tail Risk Hedge Fund Index. It was up 37% between June and September 2011 (S&P 500 -14%) and 57% between December 2019 and March 2020 (S&P -20%). However, the cost was under-performance of 2.8% per year from the end of 2007 through September 2022, and a loss of 12% per year between September 2011 and December 2019.

Imagine if after suffering an extended period of poor returns, investors threw in the towel on their tail hedge in December 2019.

Chart III: Cumulative Relative Return Tail Risk Hedge Index



Data Source: CBOE.



Common Mismatches (cont.)

Illiquid, e.g. private equity and private debt Private assets can be sold in the secondary market, but often only at a significant discount. Investors should perform liquidity studies and stress test their asset allocation to understand their capacity for illiquid assets.

Derivative Overlays If they do not have a robust plan to raise cash to meet “marks,” investors can be forced to sell at the worst time, i.e., in volatile or sharply declining markets.

Complex combinations of the above Investors (and their advisors) may not understand the full distribution of potential returns and the types of events that may trigger an extreme outcome (let alone being able to monitor them in real time). As a result, boards may be forced or tempted to react to events that could have been foreseen had they fully understood the inherent risks.

Summary

Most plan sponsors claim to have a long-term investment horizon. However, too often they act in response to short-term results, which in turn adversely affects performance. If organizations understand not only the strategies that they select but their own behavior as well, they can avoid situations which may tempt them to react to recent results.

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