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CAMBRIDGE ASSOCIATES LLC

PENSION PLANS THAT EMPHASIZE ACTIVE MANAGEMENT IN GROWTH PORTFOLIOS CAN REDUCE RISK MORE EFFECTIVELY THAN PLANS THAT FOCUS PRIMARILY ON ADDRESSING RISK BY BUILDING RISK-FREE HEDGING PORTFOLIOS

Cambridge Associates Report on Pension Risk Management Shows How Sophisticated Defined Benefit Sponsors Decrease Risk Without Decreasing Returns Via Highly Customized Growth Portfolios

BOSTON (August 3, 2011) – Recession and near-depression scenarios like 2001-2003 and 2007-2009 underscore that "perfect storms" of poor business operating environments, sharp declines in equity markets and plummeting interest rates can beset defined benefit pension plans at any time. The result: Plans find their asset values dropping just as liabilities increase, translating to significant erosion of a plan's funded status and the need to increase plan contributions during times of organizational stress.

Even though sponsors clearly recognize this harsh reality, they too often address it by shifting assets away from the growth portfolio to the "safe" hedging portfolio, and often think about the latter in isolation from the growth portfolio. There are significant costs – and risks – to this approach, according to a new report called **"Pension Risk Management"** from **Cambridge Associates**, provider of investment advice and research to pensions, endowments, foundations and other independent institutional and private investors.

"The hedging portfolio is the primary area of focus for many pension funds that implement liability-driven investment strategies. This approach actually only allows for a portion of the total risk reduction that could be achieved by using a *total-portfolio* risk-budgeting framework. For one thing, 'de-risking' by primarily increasing the allocation to the hedging portfolio unnecessarily reduces long-term expected returns," said report coauthor **David Druley**, a Managing Director at Cambridge Associates. "Construction of the growth portfolio is, too often, almost an afterthought."

Holistic Approach Needed: Introduce More Active Management to Growth Portfolio

A more holistic approach is likely to serve pension sponsors better, according to the report. If the growth portfolio is managed in a more robust way, sponsors can reduce risk and maximize return: They may want to move away from the traditional approach of allocating primarily to long-only equities (with just a modest allocation to other strategies like real estate and private equity).

"Many pension plans would do well to concentrate more on their growth portfolio with a focus on creating an extensively diversified pool of market exposures, or beta, and active risk exposures. Importantly, the active exposures should be uncorrelated to capital market betas and changes in interest rates – so they can provide an important source of diversification. In other words, sponsors should consider taking a good bit of the long-only equity exposure and replacing it with active strategies – such as long/short equity and absolute return hedge funds – that assume less market risk and still deliver attractive returns," Mr. Druley said.

The most effective pension fund sponsors will then reevaluate the hedging part of the fund in conjunction with the more customized growth portfolio – and perhaps change the composition and/or alter the size of the hedging portfolio. "In aggregate, these actions can increase returns at a given level of risk," said Mr. Druley.

Among the issues for pension plans that the report explores…

- **What a "smarter" growth portfolio might do.** A thoughtful growth portfolio in many cases can reduce plan surplus risk, and tail risk, by a similar magnitude as a customized hedging portfolio. Implementing a risk-controlled growth portfolio requires customization with a focus on maximizing expected return without taking on unnecessary liability-relative risk.

- **What might comprise a "smarter" growth portfolio.** Strategies for diversifying the growth portfolio across various betas and active exposures can include passive and active long-only equity strategies; long/short equity hedge funds; arbitrage-related hedge funds; excess return-oriented credit strategies; public and private real estate; natural resources investments; and private equity.

- **How to manage risk inherent in a "smarter" growth portfolio.** A strategy that allocates a significant amount of risk to active exposures must extensively diversify sources of active risk, or else total-plan surplus risk may increase. In other words, the holistic approach involves substituting directional equity market risk with active manager risk, so the sponsor has to be able to identify managers that add value, do extensive due diligence on those managers and size the positions appropriately. If that doesn't happen, the sponsor can easily fall short when it comes to generating attractive long-term, risk-adjusted returns.

"We propose a total-portfolio risk-budgeting framework that views a plan's growth and hedging portfolios individually and as a whole. This framework is a powerful tool for

allocating risk across various beta and active exposures and for hedging out undesirable risks. It can result in a portfolio that generates a significantly more attractive liability-relative risk/return profile, it can improve funded status, and it can dramatically reduce institutional tail risk," said Mr. Druley. "However, implementing this framework is not without its challenges, a key one being manager risk. That dimension needs to be handled extremely well."

To arrange a conversation with Mr. Druley and/or receive a copy of Cambridge Associates' "Pension Risk Management" report, please contact Itay Engelman at Sommerfield Communications, Inc. at 212-255-8386 or itay@sommerfield.com.

About Cambridge Associates

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