Markets, Policies and Beliefs

How have fund policies held up during the recent market downturn? Looking back, the past two years in the global capital markets have been tumultuous to say the least!

In June 2007, global stock markets were near their peak, world economic growth was strong, fueled by the burgeoning, developing economies (BRIC), volatility was low and times were good, with little indication of the financial crisis to follow.

Eighteen months later at the end of 2008, global stock markets were in a free fall (down -30% or more), the world economy seemed headed for recession, the VIX was at record levels and you couldn't pick up a newspaper without hearing more bad news.

These recent events like the sub-prime crisis, the unprecedented fall of major financial institutions such as Lehman Brothers, Fannie Mae, AIG, Bear Stearns etc and the subsequent economic crisis could not have been anticipated, yet have stress tested many a pension plans investment beliefs to their limits. Most so-called absolute return strategies failed and even many, supposed, low correlation strategies spiraled down at equal speed with the equity markets. As such, many pension funds suffered severely and are contemplating changes to their asset mix and investment policies. In some cases, due to extreme market illiquidity and / or high allocations to alternatives, conventional practices like rebalancing became more difficult or more costly. Some even considered abandoning these well developed policies. This sometimes led to confusion and a blurring of distinction between policies and beliefs.

So let's clarify the latter right up front. According to section 7.1 of the Canada -Pension Benefits Standard Act, every federally registered pension plan is required to have a written statement of investment policies and procedures (SIP&P). Similar regulations are also set forth for those plans under provincial legislation, which state the SIP&P should be reviewed at least annually and at a minimum should include:

a) categories of investments;
b) diversification of the portfolio;
c) asset and rate of return expectations;
d) liquidity of investments;
e) lending of cash & securities;
f) delegation of voting rights;
g) methodology for valuation of investments;
h) related party transactions permitted.

This is a compulsory, legal document requirement, which governs the plan, and which the plan administrator must provide to the actuary (DB) or the pension council (DC). Of course, there are various other guidelines suggested by OSFI for inclusion, exceptions from which, the administrator must be prepared to explain. Any amendments to the SIP&P require formal approval and submission within 60 days to the above noted actuary or pension council. Amendments however, can be a lengthy process for some, where the document requires formal approval by both an Investment Committee and a Board (of directors or trustees), who may meet quarterly or less frequently.

As such the SIP&P is often very unique to each plan based on circumstance and preference. Many plans favour a minimalist approach to the SIP&P, with wider latitude, to avoid constantly seeking formal approval, while others desire a more comprehensive document to ensure maximum control. The latter approach is also attractive for those who like finding their policy, procedures and rationale captured in the same document. This can be exceptionally handy for trustee orientation (providing new members with the rationale for existing policy) or when considering policy changes (by forcing the governing body to review their rationale simultaneously). However, it may also be cumbersome and time consuming to change minor items. But are we always forced to choose between lax and stringent policies? ...The answer is not necessarily.

There is a way to have your cake and eat it too. Many have sought the best of both worlds, by voluntarily creating a secondary document, often called the Statement of Investment Beliefs (SIB), which includes all of their operating, daily procedures and rationale (beliefs). The limitations placed in this operating document are usually more stringent than the wider policy (the SIP&P) but require less formal approvals for amendments (usually no Board approval if you stay within SIP&P), allowing the fund the flexibility to respond more quickly in unusual market circumstance. In sum, the policy is wide to accommodate the unforeseen and yet allows the sponsor to maintain more operational control by setting reasonable practical limits for normal markets. These working limits in the SIB, may however be breached in unusual times, provided they don’t contravene the broader SIP&P.

This simple choice in policy approach led to different outcomes during the latest economic upheaval and sometimes trying circumstances for some plans, with comprehensive, narrow SIP&Ps. A specific example might clarify it better for the reader. During the recent economic crisis, we noted earlier that liquidity was indeed an issue for the market. This meant bid / ask spreads were wide and it was at times costly to transact. Most funds believe in asset mix rebalancing, as a risk control mechanism and include a clause in the SIP&P for that purpose. They believe, and hopefully have research to support, that it forces them to follow the discipline of buying low and selling high or not allowing their asset mix to drift, at the whim of the market and beyond their risk tolerance. But such policies are usually designed for more normal markets not the unusual. Those funds which had a very stringent rebalancing policy in their SIP&P for control purposes (e.g ranges +/- 2% around the asset mix), were in many cases forced to transact at very wide bid ask spreads or be offside in terms of their policy. Where the plan also had large allocations to alternatives (private equity, real estate, etc.), whose asset values lagged the market due to delayed valuations, the costs to sell were exorbitant. In addition, the rebalancing may have been unnecessary as the true value of the private equity or real estate was significantly lower. Further, the markets during this unusual period, vacillated wildly on the release of new information, which often forced excessive rebalancing. A pension plan with a comprehensive SIP&P, heavy allocations to alternatives (the Yale approach) and tight rebalancing range was cost disadvantaged.

Those who had more flexible policies (+/-5%) but still maintained tighter operating guidelines in their SIB (+/-2%), were usually able to trade more effectively on behalf of the plan in the recent market downturn. This experience clearly demonstrates the need for good policies that can work in both unusual and normal markets!

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