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## EDITOR'S CORNER

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Editor

### Managing Investments for the Long Term

In this issue and elsewhere, Peter Bernstein has thrown down a gauntlet for our industry to stop misusing “normal policy benchmarks.” Many observers have misconstrued his remarks as suggesting that we *stop* using benchmarks altogether. I believe that the past misuse of benchmarks does not mean that they should be abandoned. Rather, we should use them correctly. Of course, this suggestion is easier said than done.

Performance benchmarking is one of the most influential developments in institutional investing since the 1970s. Benchmarking is not without merit. What can be measured *will* be measured, and indeed *should* be measured. Benchmarking allows us to measure the value that a manager adds, and the risk he or she is taking to produce additional return. Sophisticated investors use benchmarks to control their exposure to various markets, and to select managers based on their abilities to reliably add “alpha.”

But benchmarking has been used to suppress risk against a benchmark rather than to select and manage acceptable risks that are likely to deliver profits. Keith Ambachtsheer has demonstrated that the average U.S. pension fund has a 3 percent tracking error relative to its policy benchmark and an 18 percent tracking error relative to its liabilities.<sup>1</sup> This astounding gap has led directly to the unprece-

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<sup>1</sup>Keith Ambachtsheer, “Rethinking Risk Management and Measurement,” *Ambachtsheer Letter* (September 2002).

*Editor's Note:* Much of this work was prepared as part of an entry in a competition, sponsored by Universities Superannuation Scheme Ltd and Hewitt, Bacon & Woodrow in London, focusing on how a truly long-term investor ought to manage assets and measure results. I commend them for seeking to orchestrate a dialogue on the topic.

ented tumble, worldwide, in liability coverage since 2000. It also challenges the relevance of the average policy benchmark.

A benchmark must bear some resemblance to the obligations that a portfolio is intended to meet and should be used to gauge risk, not to suppress it. If the benchmark is a poor fit with the obligations that are served by a portfolio, then reducing tracking error is reducing an irrelevant risk—at the likely cost of lowered absolute returns. The industry's craze to “beat the bogey,” rather than to meet the fund's obligations, encourages asset managers to follow the market's “animal spirits” rather than to gauge when such risks are likely to bear rewards.

Long-term success requires relevant benchmarks. I propose the following three objectives for a benchmark:

1. Defeasible liabilities/obligations to allow management of risk relative to liabilities. A shortfall relative to liabilities requires catch-up contributions. For most funds, this objective implies modest equity risk and large interest rate sensitivity in their portfolios.
2. Deliver positive real returns and avoid material losses. A protracted drop in asset values is unnecessary in a world where some markets are always providing positive returns. This objective implies a quest for maximum Sharpe ratios.
3. Deliver performance above peer medians. Why? A shortfall relative to peers leads to incremental funding costs, relative to peers, which weakens the competitive position of the sponsor. Designing a benchmark to meet this objective requires some sensitivity to the normal asset mix of one's peers.

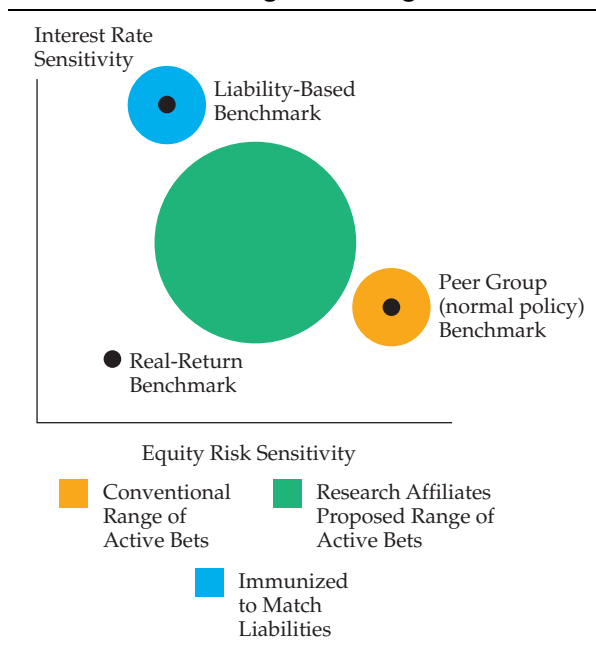
Among these three distinct objectives, most sponsors focus almost exclusively on the third, peer group comparisons, which is arguably the least important of the three. **Figure 1** illustrates that this

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limited focus locks an investor into a portfolio (chosen from the orange region) that is a poor fit with the first two, more important, objectives. Those who choose to immunize against the liabilities (the blue circle) have substantial risk of shortfall in a peer-group comparison and substantial volatility when measured against a real-returns benchmark.

The much larger green region represents a compromise, in which the objective is to manage

**Figure 1. The Tyranny of Benchmarks: Controlling the Wrong Risks**



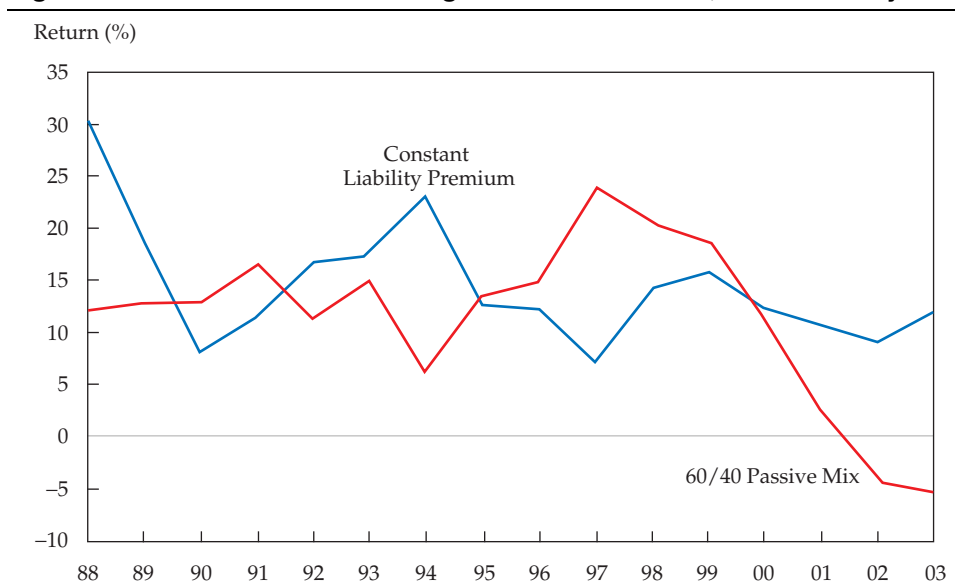
within acceptable tracking error relative to *all three* objectives. It is less risky than the status quo, a better fit with liabilities than the status quo, and acknowledges that we must not fall too far behind our peer group lest their funding costs fall relative to ours. With this blended structure, the range of possible investments is many times larger than when we are locked into the conventional obsession with peer groups (or, for that matter, immunization). This blended approach strengthens our ability to select attractive investments at sensible levels of risk.

An investor should demand acceptable risk, measured against *all three objectives*, while the manager adds value to at least two of the three measures most of the time. Although performance can be evaluated regularly, it is also important to recognize that the whims of the capital markets can bring about extended shortfalls on any *single* metric.

Imagine two strategies, each of which is “perfect” for one of the first two objectives.

■ *Model Portfolio 1.* The first strategy begins with an assumption that 15-year strips provide a nearly perfect fit with liabilities. Suppose we found a way in 1988 to earn 3 percent above this “liability return”—each and every year. **Figure 2** shows rolling three-year average returns for this strategy (liability return plus 3 percent) versus a classic 60/40 passive equity/fixed-income portfolio. Even though this liability-oriented strategy beat the 60/40 portfolio over the long term with less risk, few clients would have tolerated five consecutive three-year spans in which strips steadily underperformed the classic 60/40 portfolio.

**Figure 2. Model Portfolio 1: Rolling Three-Year Returns, 1988–January 2003**



■ *Model Portfolio 2.* For the second strategy, suppose in 1988 we found an absolute-return strategy that outpaced U.S. T-bills by 6 percent—each and every year. This strategy compared with a passive 60/40 portfolio is illustrated in **Figure 3**, again using rolling three-year average returns. Despite higher returns and less risk than a 60/40 portfolio, it underperformed the 60/40 asset mix in six consecutive three-year spans, so it also would

probably have been abandoned long before the end of 2000.

Both strategies would have soundly outpaced a passive 60/40 portfolio, with less volatility, over the past 16 years. Yet, despite implausibly large alphas, neither strategy would be likely to survive today’s benchmark-crazed investment world. Isn’t there something wrong with this picture?

**Figure 3. Model Portfolio 2: Rolling Three-Year Returns, 1988–January 2003**

