Asset Allocation and Portfolio Reconstruction

National Conference on Public Employee Retirement Systems

The Voice for Public Pensions

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ORLEANS CAPITAL MANAGEMENT

2009 Annual Conference and Exhibition

Orleans Capital Management

WHAT A LAST 12 MONTHS

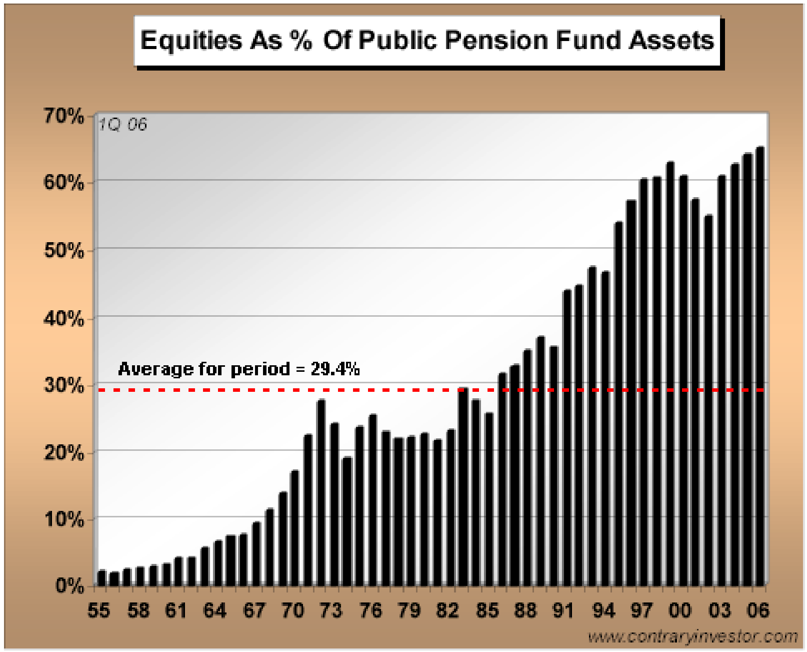
A year marked by generational changes-

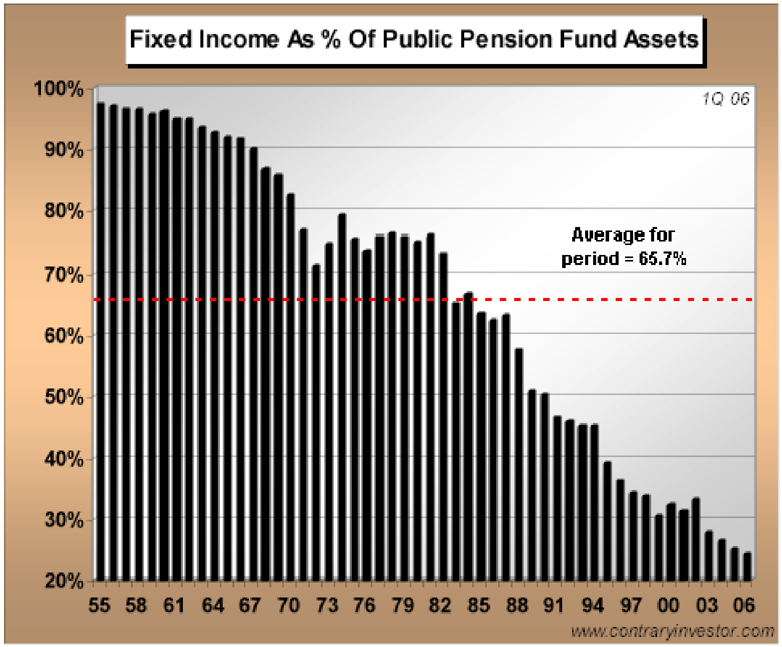
- **Dow Jones Industrial Average declines more than 50%**
- **S&P 500 declines more than 50%**
- **Corporate bonds widen to levels not seen since the Great Depression**
- **Business failures include Lehman Brothers, Bear Stearns, Merrill Lynch, AIG, General Motors and many others**
- **Crude oil prices rise to $145/barrel, with gasoline approaching $5/gallon, oil then falls precipitously to less than $40**
- **All of these events have had enormous effects on many pensions systems, leaving many significantly underfunded and forced to liquidate holdings to fund ongoing obligations**

HOW DID WE GET HERE?

- **The confluence of a number of factors has contributed to the maelstrom, including-**
  - **Aggressive use of leverage**
  - **Increased allocation to asset classes without an accurate risk assessment**
  - **Increased allocation to asset classes with a precise risk assessment that was precisely wrong**
  - **Greed (Prime brokers and Energy)**
  - **Hubris (Cost of not going along with the herd)**
  - **The impact of higher energy prices driven by supply and demand fundamentals (will we have the energy to sustain global growth?)**
  - **Most importantly, the universal acceptance of a flawed concept**

ASSET ALLOCATION DECISIONS: THE DEATH OF THE PRUDENT MAN





➢**Massive movement away from fixed income toward equities based primarily on the Ibbotson asset class return studies.**

➢**The force behind this change in asset allocation was the belief that risk could be known, quantified, and controlled.**

risk (rsk) *n.* **1.** The possibility of suffering harm or loss; danger.
2. A factor, thing, element, or course involving **uncertain** danger; a hazard

➢**By definition, risk = uncertainty**

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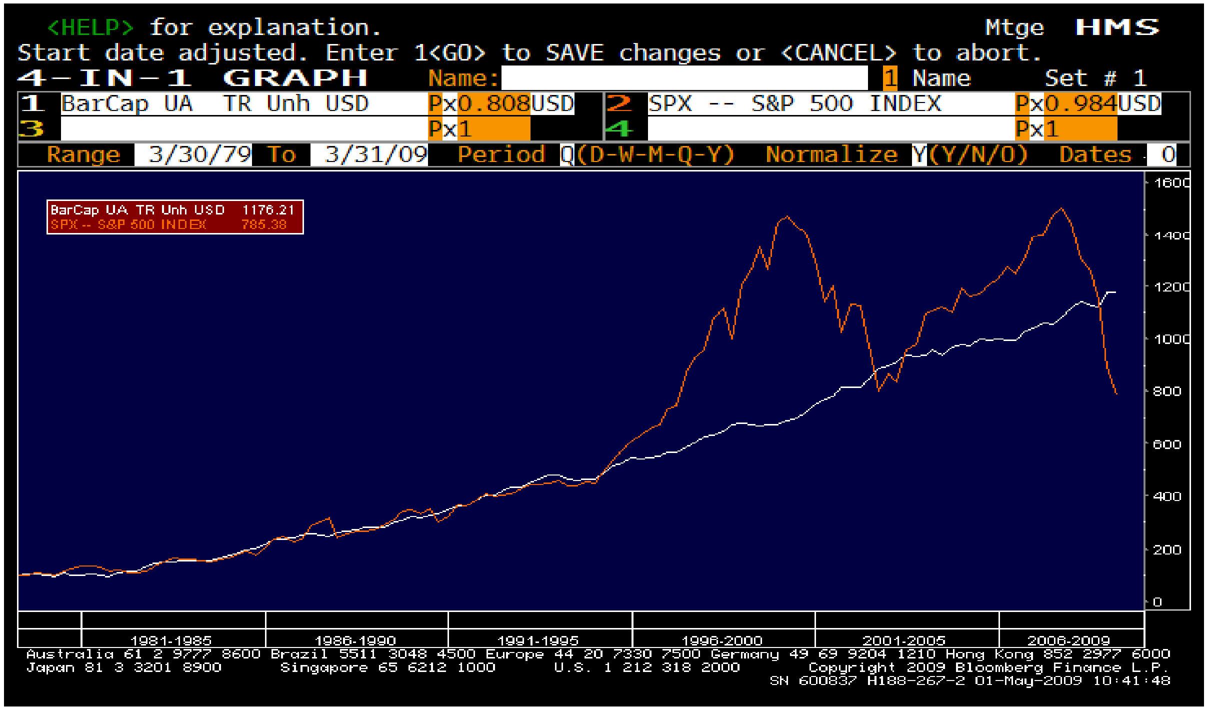
WHAT DID WE GET FOR TAKING ON MORE RISK?

➢**Interesting to note that fixed income returns have outpaced broad market equities over the last 3, 5, 7, 10 and 15 years (Lehman Aggregate vs. S&P 500).**

➢**Longer term? Last 30 years?**



➢**The reality is that a pension system with a 70% fixed/30% equity allocation over the last 10 years would have a return almost 40% better than a system with a 70% equity/30% fixed allocation.***

➢**Is this the difference in being over or under funded?**

* Using the Barclays Aggregate and the S&P 500 as proxies.

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IBBOTSON AND MODERN PORTFOLIO THEORY – SOME PROBLEMS

- **Does Volatility = Risk?**

  - **The insanity of quantifying risk out to several decimal points**
  - **Buffet and Munger on volatility as a measure of risk:**

Volatility is not a measure of risk. The people who teach risk in universities do not understand risk. Beta does not measure risk. Warren gave the example of farmland in Nebraska in the early 1980s, which he purchased at $600 an acre. Two years earlier, it was selling for $2000 an acre. However, when farmland was selling at $2000 an acre, its beta was lower. Thus, according to financial theory, farmland was less risky at $2000 an acre than it was at $600 an acre. Volatility as a measure of risk is nonsense.

Volatility arises from certain types of businesses and not knowing what you are doing. Using volatility as a measure of risk was useful for people who wanted a career in teaching. According to Charlie, 50% of financial theory as taught in universities is "twaddle." Very smart people do very dumb things. They want to know who those people are and avoid them**. People who talk about volatility being an accurate reflection of risk are crazy. You would have to believe in the tooth fairy to believe that Gaussian equations are a measure of risk in capital markets.**

IBBOTSON AND MODERN PORTFOLIO THEORY – SOME MORE PROBLEMS

- **What happens during extended periods in which actual returns are significantly less than the "historical" assumed return – the Great Depression (market down 66% during 5 year period), the 1970s (broad market returns flat for 10 years), Today?**

- **Is it fair to assume that the next 75 years will look like the last 75?**
  - **Industrialization of US**
  - **Advent of the automobile, airplane, TV, etc.**
  - **What are the implications of the developing world and globalization – did not exist during 1926-1998**
  - **Are there limits to growth – "peak" oil, food, water, etc.**
  - **Are the last 75 years actually the aberration in history?**

- **History is littered with failed investment strategies whose decisions were made based solely on quantitative historical analysis –**
  - **Long Term Capital Management - $4.6 billion lost in 4 months**
  - **Goldman's Global Alpha Fund in 2007**
  - **Current Sub-prime mortgage/SIV crisis**
  - **Black Swans do exist**

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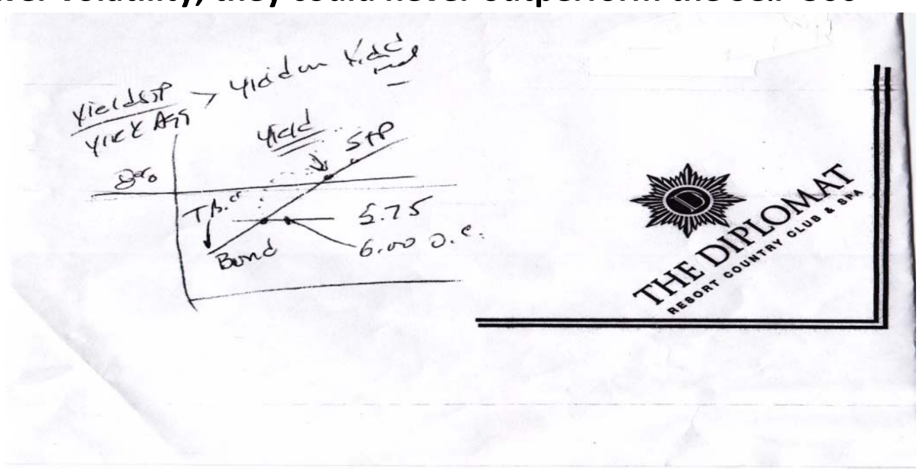
OUR EXPERIENCE

Over the last several years, we have been witness to the effects of Modern Portfolio Theory, and its rejection of ideas didn't fit the template

- **Rejection of energy specific investment strategies as "sector funds" – despite overwhelming evidence of tight supply and demand**

- **Dismissal of the equity income and "dividend" strategies on the basis that, given the expected lower volatility, they could never outperform the S&P 500**



- **Reductions in core fixed income investments on the basis that they did not provide the "opportunity" to realize the expected returns on high yield, sub-prime and other structured fixed income strategies**

- **All of these have been proven FALSE. Why? Because *real* consideration of the future is totally denied by Modern Portfolio Theory and its followers**

THE CURRENT LITANY OF SUGGESTIONS

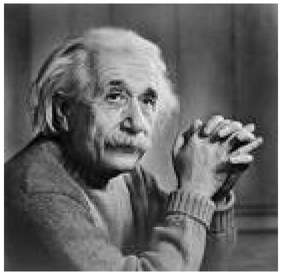
- **Thus far, there has been little questioning of the application of Modern Portfolio Theory and traditional asset allocation methodology**

- **Many are recommending "doubling down" – continued rebalancing into the underperforming, riskier asset classes – the market always recovers**

- **Development of new methods of financial engineering –**
  - **New uses of derivatives**
  - **Recommending giving complete portfolio discretion to certain advisers**

- **But, these approaches are from the same people and based on the same thinking that got us in today's predicament.**

- **"We can't solve problems using the same kind of thinking we used when we created them" – Albert Einstein**



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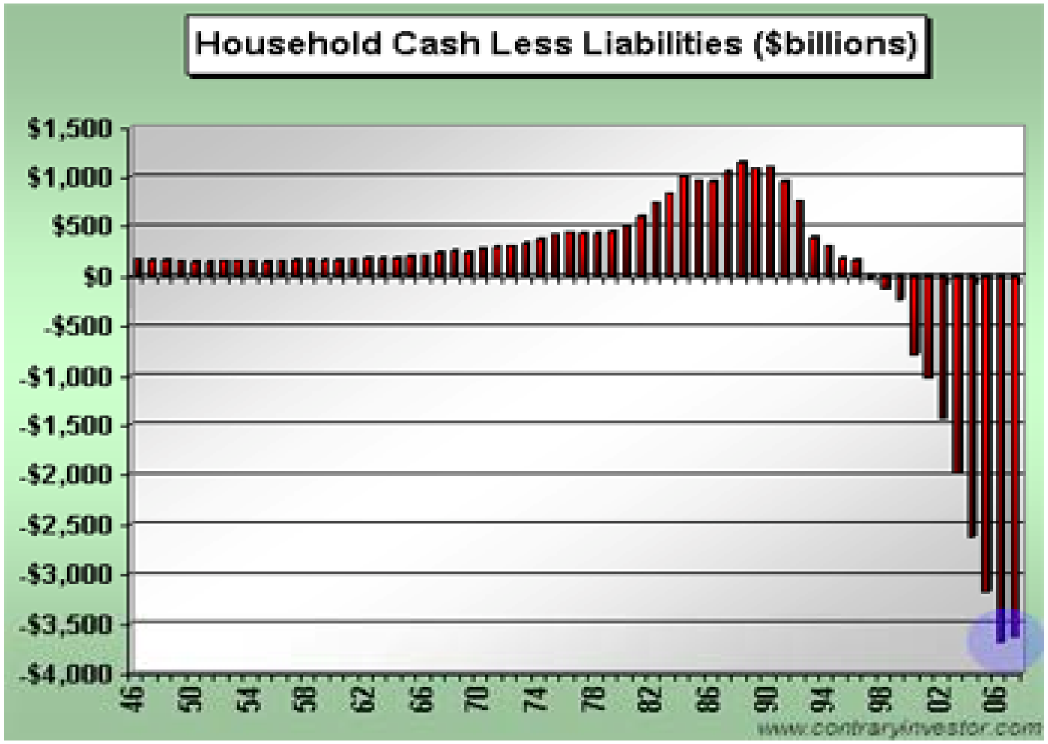
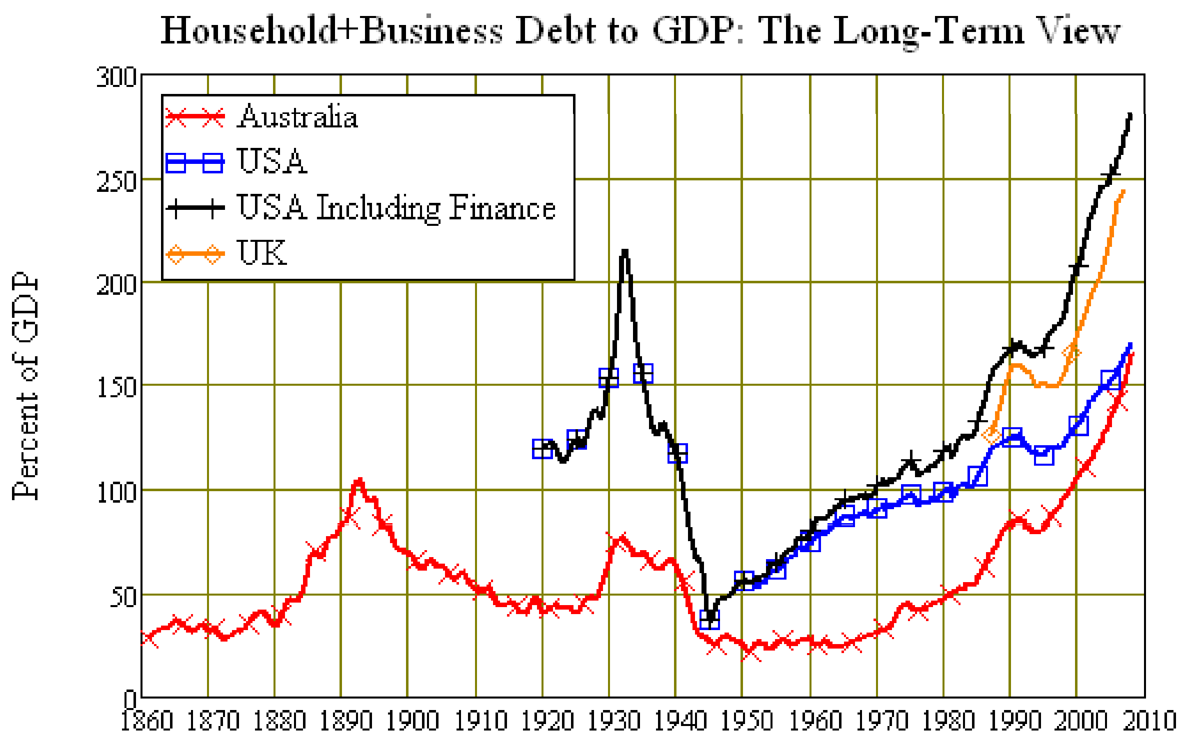
ARE PENSIONS AT A DARWIN MOMENT?

- **The capacity to change = survival.**
  The inability to adapt = extinction.
- **Can we adapt?**
- **How do we adapt?**
- **As noted by Nicholas Taleb (*The Black Swan*) – everyone agrees that Modern Portfolio Theory is wrong, but we continue on since it is "all we got".**

- **Are we confident that future returns will resemble history? Are we entitled to enjoy our actuarial assumed "birth right" returns?**
- **What are the true implication of the Financial Maelstrom and the requisite de-leveraging?**
- **Consider the state of our consumer nation:**



- **Consider the impact of unwinding the leverage:**



- **If the global economies are unlikely to grow as we had hoped (deleveraging, energy limits, etc.), how do we invest?**
- **Ensuring rather than maximizing returns?**

SOME CONSIDERATIONS – PART 1

- **Cash vs. Price**
- **Pension Mission Statement: Prevent a <u>failure</u> to pay benefits**
- **For want of a COLA a pension was lost**
- **The danger of pension fund competition**
- **Resurrect the Prudent Man, Kill the cookie cutter**
- **Think not of certainty but of a dynamic future requiring forward thinking**

SOME CONSIDERATIONS – PART 2

- **Get rid of the "Disconnect of Responsibility" –**
  - **Who is responsible for an underfunded/failed pension?**
  - **How do we measure and assess responsibility?**
  - **Consequences**

- **Test consultant asset allocation decisions and manager recommendations**
  - **Do not limit considerations to historical asset class returns**
  - **More open discussion/debate between managers and consultants**

- **Consider investment strategies that enhance cash flow and income to ensure the ability to pay benefits without the need to liquidate holdings**

- **Consider increased allocation to tactical investment designed to capitalize on current market conditions and forward looking investment themes**

- **Most of all, be guided by the Prudent Man and your Mission Statement**

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