by Robert D. Arnott

The Pension Sponsor's View of Asset Allocation

Responses to a questionnaire asking pension plan sponsors their views on aspects of pension fund management reveal much diversity of opinion. The most intriguing finding is that equity and bond management absorb the greatest proportion of sponsor expenses, yet are viewed as only modest avenues for adding value. By contrast, both long-term and strategic (short-term) asset allocation are deemed as being potentially excellent avenues for adding value yet receive very low commitments from sponsors. Sponsors do not pay the most for those aspects they perceive as offering the greatest opportunity for adding value.

Another interesting finding is that sponsors ascribe greatest importance to those aspects of pension plan management that are seen as having the greatest impact on performance, rather than on those aspects perceived as likely avenues for enhancing performance. The distinction is subtle but significant. Equity manager selection is viewed as having considerable impact on performance, for example, but the opportunity to add value through effective equity management is viewed as less significant. It may be that equity markets are viewed as too efficient to offer significant opportunities to add value, even though their impact on pension plan performance can be considerable.

NO ONE DENIES the importance of asset allocation. Indeed, a sizable cottage industry exists to advise pension sponsors on the proper long-range asset allocation needed to meet pension plan needs and on targeting cash flow to exploit current market opportunities.

But what do pension sponsors *do* in the area of asset allocation? Responses to a questionnaire answered by 50 of the largest pension plans in the country, with assets totalling some $100 billion, provide some insights into the current actions of sponsors.

The Issues Addressed

The questionnaire was designed to measure the attitudes of pension sponsors to the importance, impact and potential for adding value of certain decisions in pension management.

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The questionnaire addressed the following key decisions faced by the pension sponsor:

- long-term asset allocation, or the long-term "target" mix of a pension plan;
- strategic asset allocation, or the shifting of pension plan asset mix in response to changing market or economic conditions (sometimes referred to as "tactical asset allocation");
- specialty asset allocation, including specialized products such as the "synthetic put";
- allocation to alternative investments, including real estate, international, venture capital and other nontraditional investments;
- equity management;
- bond management; and
- conventional balanced management.

For each of these pension management decisions, the questionnaire addressed the following issues:

- How important are various aspects of pension plan management?

- How much money is paid for the effective management of various aspects of the pension management process?
- Which aspects of pension plan management have the greatest potential *impact* on aggregate pension plan performance over the course of a market cycle?
- Which aspects of pension plan management offer the best opportunity for *adding value*, for enhancing pension plan performance?
- Which aspects of pension plan management should be controlled by the sponsor, and which aspects should be controlled by the outside manager?

Importance and Cost in Pension Management

Tables I through V summarize the plan sponsors' responses to these five questions. Table I, covering the decisions deemed most important in pension plan management, shows that well over half the sponsors rank the long-term asset allocation decision as the most important decision in pension plan management. No other aspect of pension plan management matches the long-term asset allocation decision in perceived importance.

Effective equity management and effective strategic asset allocation are viewed by the majority of pension sponsors as being the second and third most important factors. A substantial majority of sponsors rank bond management and effective management of alternative investments as having moderate importance. Finally, specialty asset allocation and balanced management are viewed as comparatively unimportant by the great majority of pension sponsors. None attaches high importance to balanced management, confirming the declining credibility of the balanced manager in the investment community.

Table II highlights those aspects of pension management that sponsors are *paying* for. The questionnaire asked for the amount paid to control each aspect of pension management, whether the amount paid is in the form of management fees, consulting fees or in-house management expense. This was transformed into a ranking, which appears on Table II. By comparing these rankings with other rankings, we have a measure of how closely spending by the sponsors corresponds to their subjective priorities.

Not surprisingly, equity and bond management cost more than any other aspect of pension management. Although the management of alternative investments is the most expensive aspect for the largest percentage of sponsors, a substantial minority of sponsors spend nothing

Table I What Importance Does the Sponsor Community Ascribe to Aspects of Pension Management?

	Rank of Importance							*Average Rank*
	1	*2*	*3*	*4*	*5*	*6*	*7 or blank*	
Long-Term Asset Allocation	29	5	5	2	4	3	1	2.2
Strategic Asset Allocation	8	17	5	5	5	7	2	3.2
Specialty Asset Allocation	0	1	5	3	5	14	21	5.8
Alternative Investments	1	3	10	10	17	4	4	4.4
Equity Management	7	15	14	10	2	0	1	2.8
Bond Management	2	5	13	15	10	4	0	3.8
Balanced Management	2	1	2	1	5	9	29	6.0

Table II How Much Do Pension Sponsors Pay for Aspects of Pension Plan Management?

	Rank of Amount Paid							*Average Payment Rank*
	1	*2*	*3*	*4*	*5*	*6*	*7 or None Paid*	
Long-Term Asset Allocation	1	1	6	5	5	3	19	5.4
Strategic Asset Allocation	0	1	4	3	4	2	25	6.0
Specialty Asset Allocation	0	4	0	2	2	1	30	6.2
Alternative Investments	18	3	1	2	2	0	13	3.5
Equity Management	15	20	4	0	0	0	1	1.8
Bond Management	3	14	17	3	1	0	1	2.7
Balanced Management	1	3	3	0	0	0	32	6.2

Table III Perceived Impact Over a Market Cycle

	Rank of Impact Over Market Cycle							*Average Rank*
	1	*2*	*3*	*4*	*5*	*6*	*7*	
Long-Term Asset Allocation	28	8	2	2	1	6	0	2.1
Strategic Asset Allocation	13	15	7	5	3	4	1	2.7
Specialty Asset Allocation	1	1	7	7	4	12	16	5.3
Alternative Investments	1	5	10	11	11	5	5	4.3
Equity Management	3	15	10	11	5	2	2	3.3
Bond Management	1	2	10	10	9	11	5	4.6
Balanced Management	1	1	2	4	5	7	28	6.0

Table IV Perceived Potential for Adding Value

	Rank of Potential to Add Value							*Average Rank*
	1	*2*	*3*	*4*	*5*	*6*	*7*	
Long-Term Asset Allocation	23	7	5	5	1	2	4	2.5
Strategic Asset Allocation	19	15	4	4	4	1	0	2.2
Specialty Asset Allocation	2	8	10	3	5	8	11	4.5
Alternative Investments	1	5	12	6	10	8	5	4.3
Equity Management	2	6	11	13	9	4	2	3.9
Bond Management	1	1	9	7	13	9	7	4.8
Balanced Management	1	2	2	1	7	6	28	6.0

on the management of alternative investments. The net result is that the average rank for alternative investments is well below those for equities or bonds.

Pension sponsors spend very little to control long-term asset allocation, strategic asset allocation, balanced management and specialty asset allocation. Some of the striking disparities between these rankings and the importance assigned to each aspect of pension plan management are discussed below.

Impact and Value Added

Our third question asked sponsors how much impact each of the factors would have on aggregate pension plan performance over the course of a typical market cycle (three to five years). This differs from their ranking of subjective *importance;* this ranks the sponsors' views on the significance each factor can have on bottom line pension performance.

The results, detailed in Table III, follow a pattern similar to the sponsors' ranking of importance. Most sponsors believe that the long-term asset allocation decision has more impact on pension results than any other single factor. Strategic asset allocation and equity management are judged second and third in terms of performance impact. Following well behind these top three are alternative investments and bond management, with specialty asset allocation and balanced management bringing up the rear.

A related question asked how much *value* could potentially be added through effective management of each of these seven return factors. This is *not* the same as performance impact: Equity results might have a great potential impact but, if the stock market is efficient, then the potential for adding value through equities would rank very low.

Table IV shows that two aspects of pension management—long-term asset allocation and strategic asset allocation—clearly dominate. Nearly all sponsors rank one of these as the best avenue for enhancing pension performance. A few sponsors view the potential for adding value through long-term asset allocation as quite low, while very few hold that opinion about strategic asset allocation. The surprising result is that strategic asset allocation is generally viewed as offering more potential for adding value than any other decision faced by the sponsor.

A wide gap exists between these top two aspects of pension management and the third ranked aspect. Equity management, alternative investments, specialty asset allocation and bond management rank well behind the top two.

Some of the changes in rank from Table III are intriguing. For example, while many sponsors believe that bond management is quite important and has significant impact over a market cycle, few believe there is much opportunity to *add value* through effective bond management. Conversely, a sizable number of the sponsors believe that specialty asset allocation has limited impact over a market cycle, but that it *does* offer an opportunity to add value to the pension plan. The results for specialty asset allocation cover an unusually wide range. It would seem that sponsors either buy the idea of a "protective put" strategy or don't buy it; there is almost no middle ground.

Control Issues

Table V focuses on sponsor control. Sponsors unanimously agree that the long-term asset allocation decision must be handled by the sponsor. A substantial majority supports the idea that the sponsor should control the selection of alternative investments, the management of strategic asset allocation and the management of specialty asset allocation. A modest majority believes that the sponsor should not interfere in portfolio manager discretion in the areas of equity management, bond management and balanced management. On the other hand, a sizable minority believes that the sponsor should step in if a portfolio manager in equities, bonds or balanced management chooses to change style.

Disparities in Thought and Deed

The most interesting aspect of the survey is not the answers to the questions, *per se*, but comparisons between answers to different questions. Table VI compares sponsor payment with sponsor assessment of importance. In short, do the sponsors pay for those aspects of pension plan management they feel are most important?

Certain major disparities are evident. The three factors that receive the most financial attention by most pension sponsors—equity management, bond management and alternative investments—appear to receive more financial attention than warranted by their respective importance ranking. Long-term asset allocation and strategic asset allocation receive the fourth and fifth greatest financial commitment from the sponsors, despite the fact that these aspects of pension management have the first and third highest average importance ranks. In short, it would appear that sponsors do not necessarily pay for the aspects of pension management that they deem most important.

This result may be a function of cost. A multibillion dollar sponsor cannot spend more than a few basis points on the long-term asset allocation decision, even if it makes a real effort to spend money on that decision. A low expense commitment for long-term allocation is thus inevitable. By the same token, management of equities, bonds and alternative investments is costly, regardless of how much effort is made to economize on this process.

What do sponsors view as important? Do their views of relative importance correlate more closely with the perceived *impact* of those decisions or with their potential to *add value*? Table VII provides a clear answer. We might assume that sponsors ascribe the greatest importance to those pension management activities deemed most likely to *add value* to pension plan performance. This is largely the case, but some interesting disparities crop up.

Strategic asset allocation has the highest average rank as an avenue for adding value to pension plan performance, yet it ranks only third in perceived importance, behind the long-term asset allocation and equity management decisions. Most sponsors assign a low relative importance to specialty asset allocation, even though many view it as an excellent avenue for enhancing results. Equity management and bond management have higher average importance ranks than average value-added ranks. Sponsors appear to believe that the possibility of adding value in equity management or in bond management is limited (perhaps by efficiency in these markets).

Table V What Percentage Believe Sponsor Should Retain Control?

Long-Term Asset Allocation	100%
Strategic Asset Allocation	77%
Specialty Asset Allocation	71%
Alternative Investments	90%
Equity Management	40%
Bond Management	38%
Balanced Management	41%

Table VI Do Sponsors Pay for What They Deem Important?

	Average Importance Rank	*Average Payment Rank*	*Difference*
Long-Term Asset Allocation	2.2	5.4	−3.2
Strategic Asset Allocation	3.2	6.0	−2.8
Specialty Asset Allocation	5.8	6.2	−0.4
Alternative Investments	4.4	3.5	+0.9
Equity Management	2.8	1.8	+1.0
Bond Management	3.8	2.7	+1.1
Balanced Management	6.0	6.2	−0.2

Table VII What Defines Importance for the Sponsors, Impact on Performance or Potential to Add Value?

	Average Importance Rank	*Average Impact Rank*	*Average Value-Added Rank*	*Differences*		
				Importance vs. Impact	*Importance vs. Value-Added*	*Impact vs. Value-Added*
Long-Term Asset Allocation	2.2	2.1	2.5	+0.1	−0.3	−0.4
Strategic Asset Allocation	3.2	2.7	2.2	+0.5	+1.0	+0.5
Specialty Asset Allocation	5.8	5.3	4.5	+0.5	+1.3	+0.8
Alternative Investments	4.4	4.3	4.3	+0.1	+0.1	0.0
Equity Management	2.8	3.3	3.9	−0.5	−1.1	−0.6
Bond Management	3.8	4.6	4.8	−0.8	−1.0	−0.2
Balanced Management	6.0	6.0	6.0	0.0	0.0	0.0

Table VIII Do The Sponsors Pay For What They Think Can Add Value?

	Average Value-Added Rank	*Average Payment Rank Including Nonpayment*	*Difference*
Long-Term Asset Allocation	2.5	5.4	−2.9
Stragetic Asset Allocation	2.2	6.0	−3.8
Specialty Asset Allocation	4.5	6.2	−1.7
Alternative Investments	4.3	3.5	+0.8
Equity Management	3.9	1.8	+2.1
Bond Management	4.8	2.7	+2.1
Balanced Management	6.0	6.2	−0.2

There is a very close fit between average importance rank and the average rank of perceived impact over the course of a market cycle. We find only one instance in which the average impact rank differs from the average importance rank by more than 0.5. The results are clear: Most sponsors deem those aspects of pension management that have the greatest impact on pension plan results to be the most important decisions they make.

Finally, Table VIII compares opportunities to add value with expenses. Disparities abound: Equity management and bond management cost pension sponsors much more than is consistent with their perceived potential for adding value. All three asset allocation activities—specialty asset allocation, long-term asset allocation and strategic asset allocation—entail minimal expenditure by the sponsors, yet each is believed to offer good-to-excellent opportunity for adding value.

Conclusions

No true "consensus" results emerged from our survey. Pension sponsors have diverse views on every subject. However, certain conclusions may be drawn from the average results for each question.

First, there is a marked disparity between the potential for adding value from each aspect of pension plan management and the expenses incurred by the pension sponsor.

Second, there is a striking breadth of opinions on specialty asset allocation, including the synthetic put. While specialty asset allocation is viewed as having limited importance, it is viewed favorably by many sponsors in terms of its impact over a market cycle and still more favorably in its potential for adding value.

Third, strategic asset allocation is viewed as an important decision in pension plan management. Its impact on pension plan results over a market cycle is viewed as significant, and it is perceived as the best avenue for adding value. Yet strategic asset allocation receives very limited commitment of resources by the pension sponsor community.

Finally, it is striking how far from favor balanced management has fallen. Over half the pension sponsors surveyed rank balanced management last on every single question! ■