

Prudence:
Paradigm Shift in Pension & Wealth Management

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“Perhaps the sentiments contained in the following pages are not yet sufficiently fashionable to procure them general favor; a long habit of not thinking a thing wrong, gives it superficial appearance of being right, and raises at first a formidable outcry in defense of custom. But the tumult soon subsides. Time makes more converts than reason.”

—Thomas Paine
Common Sense, 1776

Summary

Conventions regarding the Prudent Man Rule have now entered an environment, and are in the presence of catalysts, which we believe are likely to change notions of prudence regarding pension plan and wealth management. Beginning in the mid 1970s, wealth management practices began a thirty-year migration leading to the dominance of Beta acquisition which is marked by passive exposures to market risks through index or index-like investments. The pervasive destruction of wealth in 2000–2002 and a battle with deflation on the part of G-8 central banks has led to a fundamental questioning of the efficacy of this paradigm within wealth management. Old conventions of the Prudent Man Rule are now being challenged by an approach that expands on Harry Markowitz’s concepts and leads to a superior risk diversification and expanded portfolio efficiency. This paradigm shift is recognizable by a separation of portfolio alpha (uncorrelated excess return) and Beta (market return) within a far more articulated risk management process. A new protocol views one measure of success as the breadth and effectiveness of an investment organization’s ability to expand the alpha investment pool and an increased diversity of portfolio risk factors. As with any paradigm shift, there is at present a rapidly widening gap between organizations shifting to this approach and those continuing to operate within the old paradigm. Participants in the financial markets are aware of a pervasive change taking place around them but many do not currently possess a comprehensive framework to identify either an impetus for these changes or the implications for themselves and their organization. This piece is intended to explore the

confluence of events that resulted in the prior interpretation of the Prudent Man Rule and the logic behind its current evolution.

The discussion will integrate the thinking of a number of people, with a particular focus on three: Justice Samuel Putnam, Harry Markowitz, and Alfred Winslow Jones. We will first explore Justice Putnam's Prudent Man Rule and how it evolves in light of technological and experiential advances, followed by Harry Markowitz's contributions to existing and future conventions. We will also consider the thought process and implementation of Alfred Winslow Jones's investment model. This discussion is intended for the policymakers who will want to understand the underlying nature of the paradigm shift as well as the CIO at pension plans, insurance companies, university endowments, and foundations. The ideas presented are meant to be shared with staff to create a basis for discussion as to why conventions to the Prudent Man Rule are taking place at this time as well as to develop an effective response to these changes.

“Do what you will the capital is at hazard . . . All that can be required of a Trustee to invest, is, that he shall conduct himself faithfully and exercise sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard of speculation, but in regard to permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.”

—Justice Samuel Putnam
The Prudent Man Rule
Harvard College v. Amory
Boston, 1830

Catalysts

The conventions regarding the Prudent Man Rule have entered an environment and are in the presence of catalysts that, we believe, will change notions of prudence in respect to

pension plan and wealth management. The Prudent Man Rule acts as a framework within which trustees can look to generally accepted principles guiding their conduct in exposing capital under their care to risk. The rule's durability lies in the fact that a trustee is governed not by what a person of prudence would have done in 1830, but by how persons of prudence *at a particular time* conduct their affairs. The trustee's conduct is free to evolve in light of technological and experiential advances in wealth management practices and capital markets. The Prudent Man Rule has the license to evolve, which it has done with impunity for the past 175 years.

Historically, changes in convention to wealth management practices take place after periods of notable wealth destruction. A drop in the global equity prices at the beginning of this century has been compounded by a coordinated effort to avoid deflation through massive liquidity infusions by the G-8 central banks. The resulting decline in real and nominal interest rates increased the present value of pension liabilities at the same time asset prices were falling. As of 2005 the combined U.S. public and private pension and healthcare liabilities exceed \$5 trillion, and Morgan Stanley estimates that the overall asset shortfall now exceeds \$1 trillion. Pension reform legislation is likely to emerge from these pressures, which does not so much address future issues, but reacts to economic factors now in our past. Independent of regulatory changes, pension plans themselves are starting to shift away from an asset only based relative performance approach to managing their pension and healthcare liabilities. There is a concurrent shift in the type of asset management services that pension plans are now seeking.

Harvard's Relevance

During the past seventeen years, a team at Harvard Management Company (HMC) led by Jack Meyer has pursued a nonconventional approach to wealth management that has resulted in Harvard's store of wealth increasing by \$8,000,000,000 more than would have been the case had HMC invested in a manner consistent with the average university endowment during that same period. Over time the wages paid to Meyer and his team at HMC increased substantially in order to retain their services. The public scrutiny

received by team and HMC Board members as a result of the compensation issue ultimately made the entire arrangement unsustainable. So at the beginning of 2005, Meyer and a number of key team members relinquished their posts at HMC. The philosophical issues underlying events at HMC possess an uncanny resemblance to those considered by Ayn Rand in her 1957 book, *Atlas Shrugged*. It is difficult to ascertain the ultimate “wealth cost” to Harvard University of these events and it brings into question the ability for such skills to exist within any university or corporation where investment management is not the core mission.

The confluence of these events involving pension plans and Harvard requires recognition of the primacy of a new set of conventions to prudence with respect to wealth management practices. These events will no longer allow the currently accepted relative performance paradigm within wealth management to be considered dominant, nor can sponsoring organizations or individuals operate within these conventions and expect to manage their pension liabilities effectively going forward.

Two Men of Unintended Consequences

In 1952 Harry Markowitz, then a graduate student at the University of Chicago, wrote a fourteen-page paper, “Portfolio Selection.” Markowitz did not initially specialize in finance but was studying linear programming, a mathematical modeling technique for maximizing the efficiency of limited corporate plant, equipment, and human capital resources. Yet his paper on the topic of investment decision-making dramatically changed the way nearly all wealth is managed today. Markowitz began his research with the recognized authority on investing at the time, John Burr Williams’s 1938 book, *The Theory of Investment Value*. He wouldn’t get past the first few lines:

“The value of any stock, bond, or business today is determined by the cash inflows and outflows—discounted by an appropriate interest rate—that can be expected to occur over the remaining life of the asset.”

—John Burr Williams
The Theory of Investment Value

As a result of Markowitz's diverse intellectual background, he believed that a risk component always exists when assessing the expected utility of any investment that addresses the inherent level of risk aversion of that individual or organization.

“Diversification is both observed and sensible; a rule of behavior which does not imply the superiority of diversification must be rejected both as a hypothesis and as a maxim.”

—Harry Markowitz
“Portfolio Selection”

“Portfolio Selection” rejects the expected return rule in practice since the days of Benjamin Graham, in favor of an expected return-variance of return rule. This concept is so fundamental to how wealth is currently managed that most investors take it for granted. Prudence in the latter half of the twentieth century is steeped in reliance on Markowitz's efficient “baskets” of securities. His efficient baskets would eventually lead to a world that embraces index funds and portfolios driven primarily by low cost portfolios delivering market exposure or Beta.

Alfred Winslow Jones was a graduate of Harvard's class of 1923 and subsequently studied sociology at Columbia University. In 1948, on assignment for *Fortune* magazine, he wrote a piece that he had been researching for some time, “Fashions in Forecasting.” His field of inquiry was a dozen or so “technicians” who, in the late 1940s, were considered pariahs by the disciples of the Graham and Dodd value approach. From Jones's observations in the article about the work of these technicians, it becomes clear that a handful of them are the forbears of quantitative investment methodologies, statistical arbitrage, and many fundamental relative value strategies. In “Fashions,” Jones assessed each approach, sometimes harshly and in other cases open to further exploration.

In a few instances he clearly embraces the insights of the analysis. One of these is a 1937 study published by Alfred Cowles and Herbert E. Jones (no relation) of stock price behavior over a 100-year period. Jones comments on their findings: “...*the market trend succeeded itself 62.5 times out of a hundred and reversed itself 37.5 times. The probability of obtaining such a result in a penny tossing series is infinitesimal.*” Jones was seeking insights that offered better than a ‘fair game,’ and he noted that certain approaches require trending markets, higher volatility environments, conditional liquidity, or improvement in credit markets. He was beginning to feel his way down a dimly lit path toward a factor-based approach to portfolio construction.

Jones’s conclusions about Molodovsky were far more detailed than the other approaches he surveyed. His remarks on Molodovsky’s work hinted at the concepts of risk-weighting individual stocks, assessing the magnitude of divergence from their intrinsic value, and finding insights that deal in probabilities. Jones finished one passage on Molodovsky saying, “*well controlled experimental work of this nature is important and likely to become more accurate as the methods are further developed.*” The development of these approaches was integral to the career path Jones followed and laid the foundations for the Jones model of investing as well as important aspects of the current paradigm shift.

The Hedge Fund

In 1949 A. W. Jones & Co. was formed and began a process of investing that is now broadly referred to as a hedge fund. He also established a 20 percent participating fee on returns to the partnership, a number established by Benjamin Graham for a similar partnership structure a half century earlier. Jones’s approach was to eliminate a good deal of the market exposure by holding both long and short securities positions, with returns primarily generated by security selection. These returns can be thought of as “insight rents” as opposed to market-driven returns. The 20 percent participation charge amounted to a licensing fee on Jones’ insight rents. In 1966 Carol Loomis wrote a *Fortune* article, “The Jones Nobody Keeps Up With.” The article’s opening line summarizes the results at A.W. Jones & Co.: “*There are reasons to believe that the best professional money*

manager of investors' money these days is a quiet-spoken seldom photographed man named Alfred Winslow Jones." Loomis pointed out that Jones was often wrong in one component of his approach: that of shifting his net long or short market exposure in anticipation of the market's overall direction. Jones was generating insight rents at the individual stock level, not predicting the direction of the overall market. Jones's strategy to source an informational advantage and then develop a probabilistic framework in terms of securities price divergence from intrinsic value was working. Jones had established one method by which returns not generated by pure market risk could be achieved.

Markowitz and Jones responded differently to the challenge of applying quantitative and mathematical techniques to securities valuation. Each shifted the center of attention to a risk management discipline, one theoretical and the other applied. Each approach was in and of itself powerful, but the combination of the two in their purest form provided the potential to turn a page in the book that Markowitz claimed "*to have only read the first page of the first chapter.*" For better or worse, turning that page in the history of wealth management would have to wait.

The Detour

The 1966 *Fortune* article by Loomis gave a good deal of coverage to Gerald Tsai, who had just left the Fidelity Trend Fund and had raised \$247 million from 150,000 investors to launch his new Manhattan Fund. Tsai was joined by Martin Deemer, a technician from Merrill Lynch whose statistical approach to the markets was similar to the one Billy Bean would bring to baseball thirty years later as explored in great detail by Michael Lewis in *Moneyball: The Art of Winning and Unfair Game*. In its first full year, 1967, the Manhattan Fund returned 39.4 percent. Funds structured similarly to Alfred Jones's in terms of fees and legal structure began to form in earnest around this time, and the majority of them set out in hot pursuit of besting Tsai. A young man named Barton Biggs, who was then working at Fairfield Partners, itself a spinoff of A. W. Jones & Co., wrote:

“It was different then, we were all just leveraged long the new small capitalization growth stocks. Morgan Guaranty was buying the Nifty Fifty, hedge funds were buying the riskier new issues. Hedging market risk or any risk was no longer part of the equation.”

—Barton Biggs
Traxis Partners

The bull market came to an end with an embargo on crude oil supplies by the Oil Producing and Exporting Countries (OPEC). In 1973–74 the S&P 500 dropped by nearly 40 percent, more when measured peak to trough. The Nifty Fifty stocks dropped on average 66 percent from their peak. Tsai’s Manhattan Fund lost nearly 80 percent of its value. In 1975 came an article, “Where Have All the Hedge Funds Gone?” Jones’s approaches to incorporating opportunities that offered better than a fair game, while eliminating much of the market risk, had largely been ignored during this period. As a result, this moment in history lacked the necessary risk tools and variety or concentration of alpha required for investors to broadly explore the efficiencies available through combining Markowitz’s work with Jones’s approach.

The Reign of Beta

While a great deal of wealth was destroyed in the 1973–74 bear market a group of companies known as the seven sisters thrived. These sisters were the largest oil companies in the world, but not one of them appeared in Kidder Peabody’s Nifty Fifty list of stocks.

Investors began to wonder how they could have been misled into owning only the Nifty Fifty and none of the seven sisters. The environment was right for a change in conventions regarding the Prudent Man Rule. It is no coincidence that index funds were born in 1976 when John Bogle opened First Index Investment Trust, now known as Vanguard. Benchmarks for pension plans began as more of a legal firewall for the

trustees operating under personal legal liability within ERISA. But the adoption of benchmarks began a two-decade pilgrimage toward the benchmark dictating 90 percent or more of the specific securities a manager must own, regardless of those securities' return or risk proposition. Institutional capital largely began to invest in the public markets through Beta basket allocations, a practice now referred to as "closet indexing." This Beta-dominant investment world has largely been the result of a narrow interpretation of Markowitz's expected return-expected variance rule and an explicit investment management cost minimization focus. "Long Term" assumptions about returns, risk and correlations are now fed analytic models that reveal Beta dominant asset allocations, or policy benchmarks. Institutions are led to believe that they are investing on the 'frontiers' of efficiency as a result of these highly scripted exercises.

"Our danger is that we shall substitute the consciences of others for our own, that we shall paralyze our faculties through dependence on foreign guides, that we shall be moulded from abroad instead of determining ourselves."

—William Ellery Channing
"Remarks on Associations"

Exploring Alternatives

A number of university endowments, some with multiple billions of dollars including Harvard and Yale, had successfully integrated hedge fund, private equity, real asset holdings, and a variety of other nontraditional investments into their portfolios. Their decision to engage in a nontraditional approach came from an explicit recognition of a longer time horizon and the lack of an ERISA-like legal stricture. While endowments also lost money in the downturn in 2000–2002, the damage was less severe. This seemed odd to more than a few pension plans since these were the same endowments that had been generating better returns in the more favorable market environments.

It was at this point that a few pension plans began to search for improvements to their wealth management practices. Previously these plans had viewed the endowments' success from a distance, adopting an attitude of, "Well, they can do things differently." But these pensions found evidence that a small number of their peers, managing wealth pools in the presence of explicit liabilities and ERISA, had set out along this trail a decade or so before them. BP Americas and Weyerhaeuser among others had focused on developing an "alpha pool" at the core of their portfolio and had achieved superior risk return characteristics. These organizations discovered the powerful improvements that could be achieved by extending Markowitz concepts in conjunction with A.W. Jones's investment approach.

Who Put Alpha in My Beta?

According to Ibbotson Advisors findings, the equity risk premium compounded from 1925-1998 produced large capitalization equity returns that were thirty-eight times greater than corporate bonds and small capitalization returns that were eighty-three times greater. A subsidization of the equity risk premium may have taken place over the past two decades. A bull market in both bonds and stocks began on August 13, 1982, when nominal thirty-year U.S. Treasury rates were 11.75 percent while real rates (a bonds yield less inflation) were 8.55 percent. Over the twenty-year period 1983–2003, the decline in real interest rates equated to 3.36 percent of additional alpha each year in equity returns. In order to maintain that 3.36 percent annual incremental return advantage over the coming decade, the level of real interest rates would be required to drop well below the lowest nonwar time levels seen in the UK bond market (for which we have the longest continuous history of a developed bond market) over the past 300 years since 1700, or to 0.10 percent. This issue alone makes this an opportune moment to consider developing a new concept of prudence with respect to investments.

Further, a team led by Robert Arnott, Jason Hsu, and Phil Moore found that the equal-weighted portfolios generated on average 165 bps higher returns relative to the capitalization-weighted S&P 500 or Russell 2000 indexes. The simplicity and explicit

cost reductions targeted by most organizations to recreate what they believe Markowitz was telling them drives pension plans and managers toward lower return higher risk market capitalization-weighted index investments.

One source of additional return that institutional investors have sought for decades is from tactical asset allocation (TAA). TAA involves shifting capital between asset classes in relationship to the policy benchmarks based on perceived valuation discrepancies. TAA was given a shot in the arm by a well intended paper written in 1995 by Gary Brinson, L. Randolph Hood, and Gilbert Beebower, "Determinants of Portfolio Performance." Their regression analysis eliminated all alternative investments and showed that 93.6 percent of the return of the Beta exposures was explained by the investment policy benchmarks when the only assets were stocks, bonds and cash. TAA has never proven to reliably add to returns but in the nuclear winter of a Beta-only investment environment, constrained to the three most efficiently priced assets classes, TAA begins to look like a plausible source of additional return. There are many ways to more rationally manage investments and achieve incremental returns by a shift away from the Beta-dominant investment paradigm.

The Alpha Core

Martin Liebowitz at Morgan Stanley has written a series of research notes, one of which is titled "The Efficient Frontiers Using 'Alpha Cores.'" In Liebowitz's piece, the alpha pool becomes the core asset of a portfolio and the traditional benchmarks, or Betas, become a "swing" asset. Within the old convention, international equity, real estate, emerging markets debt and equity, absolute return, real assets, and commodities were tertiary diversifying assets. In Liebowitz's framework, the portfolio is reversed and these diversifying assets become the core of the portfolio and the market risk a last alternative for investment capital once better investment opportunities have been exhausted. An alpha pool as the core investment and Beta as the risk completion exposure are consistent with the first premise in Markowitz: *"a rule of behavior which does not imply the superiority of diversification must be rejected."*

Organizations can manage risk far more effectively than they can predict the return of various assets in relationship to one another. In some respects this may sound simplistic. But maximizing the alpha pool's efficiency will require organizations to do things differently, not the same as others. It means sitting before a committee with capital allocation proposals for which one cannot easily cite others who are taking the same actions at the same time or in the same format, though some may very well exist. Many of these actions will not come easily to organizations conditioned to allocating risks among market Betas and doing the same thing as their peers. These decisions must, as a result, be conducted within a different governance context.

Governance as an Alpha Generator

David Swenson, the CIO at Yale University, has probably done as good a job as anyone in delineating a governance structure that leads to an effective alpha pool and expansion of an organization's investment efficiency. Swenson covers the critical aspects of developing a highly productive investment culture in his book, *Pioneering Portfolio Management: An Unconventional Approach to Investment Management*.

“By presuming that initiatives come from the staff, not from the committee members, responsibility for the nature and direction of the investment program rests squarely on the shoulders of the investment office. In short, the investment committee should play the role of a board of directors for the fund management operation.”

Organizations that cannot develop appropriate lines of governance, an effective division of labor, qualified staff, and productive working relationships between them should avoid any attempt at making the alpha pool the core of their assets. These organizations should continue to operate within the previous conventions of the Prudent Man Rule. They should simultaneously make it clear to their shareholders, constituency, taxpayers, staff,

and plan beneficiaries that they have decided as such. Before doing so, however, we encourage trustees and policymakers to read David Swensen's book.

Time Horizon Advantage

One advantage that plans will perceive they have lost as a result of pension reforms is the long time horizons bestowed upon them under the previous regime. But in a cost minimization beta-dominant investment program, liabilities with an average cash flow of twelve years were being managed to an asset profile that allowed for liquidation of 80 percent of the asset portfolio within thirty days or less, even for the largest plans. Warren Buffet must laugh himself to sleep every night. There is a far greater opportunity to extend the time horizon of investments even under the new pension reforms. A pension plan or foundation that exercises the full weight of its true time horizon will be advantaged in terms of returns over time.

Simultaneously, investors will be shifting from an exercise in minimizing explicit fees to one of optimizing net risk adjusted returns. Clearly fees play a role in arriving at returns net of fees but they do not lead the decision-making process. Beta is a commodity, and the price paid for exposure to it should be both fixed and low. That the Harvard team's absolute compensation level was too high from a sociopolitical perspective needs to be separated from the fact that the team generated significant amounts of net incremental wealth for the university. From a cost-benefit perspective, the compensation was of great value to the university despite the fact that the equation's numerator was too large from a political perspective. Organizations whose governance structure does not allow them to separate these two issues, for whatever reason, will in all likelihood remain more closely tethered to Beta-only efficiency limits and suboptimal portfolios as a result.

In the Future

It should be anticipated that the pension reforms will initially result in degradation and not improvement in many plans' approach to wealth management. Already many of the

largest defined benefit plans are abandoning traditional pension benefit provision. The intent throughout this discussion has been to establish that there are alternatives to retreating into the financial wilderness under the old convention of the Prudent Man Rule in managing pension liabilities. It is to be expected that many organizations will continue to operate within the context of the 1975–2005 paradigm. South Carolina and Indiana, for example, were not allowed to invest in equities by law until 1998. They were operating under the prudent convention dating back to an era in which the bulk of a pension plan's capital was deployed to government, steel, and railroad company bonds seven decades earlier. According to Ibbotson Associates, for the period 1925–1998, corporate bonds returned 61 times their original value, while large capitalization stocks returned 2,351 times their original value. One cannot say how large the future return differential will be between an alpha core approach and the old convention of Beta-only acquisition for the laggards. At least a portion of the difference may be measured in the risk taken by organizations operating under the two differing paradigms. But it is almost certain that, similar to South Carolina and Indiana, there will be plans that will not be able to make the transition from the old conventions for decades.

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