

Should Wealthy Families Act As Pension Funds Change Investment Strategy?

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The Wall Street Journal and other observers have recently pointed out that pension funds (“smart money”) are moving out of stocks and into bonds and alternative investments in a significant way. If this is indeed an historic shift, what are wealth holders of significant wealth “smart” to do? Should they follow suit?

To answer those questions, it is critical for families to understand the factors at work and then determine the best course of action by executing an investment strategy that is, first and foremost, appropriate for the family’s specific circumstances and consistent with what their wealth is intended to achieve. In fact, while institutions may be undertaking a fundamental reallocation of assets, that doesn’t necessarily mean families should do the same.

Volatility Averse

Why the seismic change in the pension fund industry? As a result of the financial crisis, corporate plans have been going through a soul searching. The asset allocation strategies that were supposed to insulate plans from a 20 per cent to 30 per cent catastrophe clearly failed.

Facing the same obligations – and with smaller asset bases to meet obligations – many plans are now seeking to minimize the volatility of their surplus (deficit) due to legislated or regulated requirements. Owning bonds, particularly long bonds, generally provides a better match between asset and liability movement. In making this change, corporate plans may be sacrificing return for less balance sheet volatility. Accounting realities are driving ERISA plans more than ever before.

At the same time, the move to bonds is being accompanied by an increased allocation to alternative investments. The expectation is that higher returns in

alternatives will offset some of the lower returns from moving from stocks to bonds. In essence, however, this is not fleeing stocks for the perceived safety of bonds. More precisely, it is the adoption of “minimization of surplus volatility” over the short term as a more important objective than total return over the long term. In other words, these corporate plans are reacting to a redefinition of risk – not a market-based event.

Structurally, the minimization of risk becomes important in terms of the plan’s goals and objectives and in meeting obligations over time. The construct between funds to meet obligations and “surplus” reflects the substance of how a pension fund should be analyzing its own needs; the fund has fixed obligations and those are fixed in dollar terms. Buying dollar denominated bonds helps the fund reserve for obligations in ways that do not look volatile. Many of these funds must also strongly consider the need for current income and liquidity due to defined cash flow needs resulting from mature plans with large retiree populations.

What lessons should the private wealth holder draw then from the movement by US corporate plans into US denominated bonds?

A key lesson is that any examination of investment performance must consider appropriateness as well as percentage return. Whether that appropriateness is determined by reference to after tax consequences, risk, and similar matters or by reference to political and social views, the evaluation will always be different from appropriateness for a corporate pension fund.

That a pension fund with obligations payable exclusively in US dollars is moving to dollar denominated bonds should lead to no conclusion for a family with members in Hong Kong, Paris and London as well as New York. Of course, similar concerns can possibly result in similar movement by private wealth holders. A wealth holder or trust with long-term fixed dollar obligations, such as a guaranteed annuity, charitable or otherwise, or a substantial dollar-based mortgage, should reserve for dollar obligations with dollars.

But for many families there will be no necessity to reduce dollar volatility. And for smart families today, currencies are seen as volatile themselves with exchange rates fluctuating dramatically. How many families would say that fundamentally the most appropriate investment for a long-term investor is the US dollar?

A family whose wealth was built over one hundred years in equities illustrates the central issue. About five years ago, this family had shifted investments toward alternatives and absolute return funds at the urging of advisors. After two years of anxiety due to the funds’ lack of transparency, the family’s inability to understand the strategies, and the delays in filing tax returns, all members of the family decided to move out of the alternatives and back to portfolios of stocks and bonds. They made a move back to traditional portfolios because they realized that they did not mind volatility; funds were available for their cash

needs. So long as the wealth was available as needed, volatility was fine with this family.

The specific issues raised by a modification of an investment strategy are actually part of a broader discussion of what is appropriate to ensure that the wealth is doing what it is intended to do. “What is the wealth for?” must be addressed person by person and entity by entity. If it is clear what the wealth is intended to do, then the investment strategy becomes self-evident. Without clarity, it’s easy to make mistakes. Unfortunately, many families go generations without asking what the wealth is intended to do.

The flight to bonds in the corporate pension industry is interesting and may prove wise for the pension plans. But private wealth holders should not see that flight as one they must mimic. Wisdom and process must set the investment strategy and must start with understanding appropriateness wealth holder by wealth holder.

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