

Sure I Want to Lose Weight and Other Half-Truths

Examining the Risks Behind Getting What You Want

By: Robert DiMeo, Managing Director

April 2009

A group of nuns recently asked me to participate in their investment committee meeting being conducted by their current pension fund provider. Like most portfolios, the fund suffered losses over the past 18 months and the committee sought to assess the damage and determine whether a change in allocation or policy was in order.

As I listened to the vendor walk the Committee through a canned series of questions about risk tolerance and objectives, I felt empathetic and concerned all at once. *Would you prefer a less risky portfolio? Would you rather have more certainty or less certainty in required contribution levels?* This committee is composed of smart and caring individuals yet, given the lousy state of the stock market, it was predictable for them to demonstrate a strong desire for less risk and more certainty. The vendor failed to ask some of the most important questions and missed an opportunity to arm the group with meaningful information that facilitates smart decisions.

That's when it struck me. This dialogue was similar to asking a crowd of people if any of them would like to lose some weight. Toss that question out some time but be sure you're standing at a safe distance as arms and hands will quickly flail skyward. Of course most people would like to lose weight especially if the question is posed in "sugar coated" fashion. But the response could be quite different if the question contained essential details. *Would you like to lose weight knowing that it means you commit to vigorous exercise for 30 minutes each day and that you give up eating sweets?* A question phrased in this manner would engage appropriate thought and most certainly compel one to consider the advantages and disadvantages that accompany their reply.

The Investment Committee Conundrum

Most institutional investors have hurdle rates. An endowment may seek to earn 5% plus inflation or a pension plan might have an actuarial assumption of earning 8.1%. Your hurdle rate will likely impact the investment returns you seek and the corresponding asset allocation the committee chooses. But Investment Returns are merely one of three important levers, the other two being Inflows (revenues, donations...) and Outflows.

We are proponents of advising clients to assume only the risks they must in order to achieve their financial goals. The challenge is that most intuitions have hurdle rates of approximately 8% and returns of this level, even before the stock market tanked, are no simple feat. Returns of 8% imply portfolio allocations heavily weighted to stocks (note that our newly updated 10 year Capital Market Forecast has a return assumption of 8.3% for large-cap US stocks).

This is the Committee Conundrum and investors with high hurdle rates have limited choices:

1. Invest in Treasury bills and guarantee falling short of your return hurdle rate.
2. Invest 100% in large-cap U.S. stocks (or some other single asset class with expected returns that approximate your hurdle rate).
3. Invest in a thoughtful, diversified portfolio.
4. Slash your budget.

The *slash your budget* option is akin to the exercise and healthy eating habits required to lose weight. Moving to an extremely conservative allocation with lower expected returns may be the correct path for an institution but an investment committee should make an “eyes wide open” decision.

How will lower investment returns impact our mission?

If we settle for lower returns, what must we do with the other levers, Inflows and Outflows, to make things work?

No committee member jumps out of bed proclaiming “let’s take risk today!” Investments that can be perceived as risky are included in portfolios in an ultimate attempt to advance the organization’s mission in a thoughtful and necessary manner. These extremely challenging times increase the need for committee members to get a true handle on their hurdle rates and the impact of each of the Three Levers.

For more information, please contact Robert DiMeo at (312) 853-1000, bdimeo@dimeoschneider.com or www.dimeoschneider.com