

Passive Investment Strategies

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- First, let's examine why there is even a debate on this issue
 - We need to start with the overall goal for a plan, i.e. meeting its actuarial rate of return assumptions
 - Matching assets to liabilities
 - Creating a strategic asset allocation to hopefully deliver the necessary returns
 - In order to create the asset allocation the following are required
 - Definitions for asset classes-broad to narrow
 - Benchmarks to measure the asset classes
 - Weighting schemes and rebalancing rules
 - Executing the asset allocation
 - Where the active versus passive strategy comes into play
 - The costs of active management

- Second, let's look at what drives the decisions and why we end up where we are in the world today
 - The emotional issues that come into play
 - A professional staff that manages a pension fund should be smart enough to add value and beat indexes
 - Board members and beneficiaries don't want to settle for "average" performance
 - Indexing doesn't work in down markets; therefore timing the use of indexing is critical
 - Indexing doesn't work in inefficient markets, which is where active management should be used

- Third, let's go to the indexes since indexing is based on an index
 - Good indexes depend on good coverage of an asset class
 - Good indexes depend on good pricing
 - Good indexes should reflect as seamless a representation of the asset class in terms of turnover
 - But, you still have to contend with transactions costs, which indexes do not
 - In the absence of the above it becomes impossible to accurately measure performance and, hence, tell whether indexing really works.
 - This does not imply that active management is necessarily better, the results simply cannot be verified with accuracy