

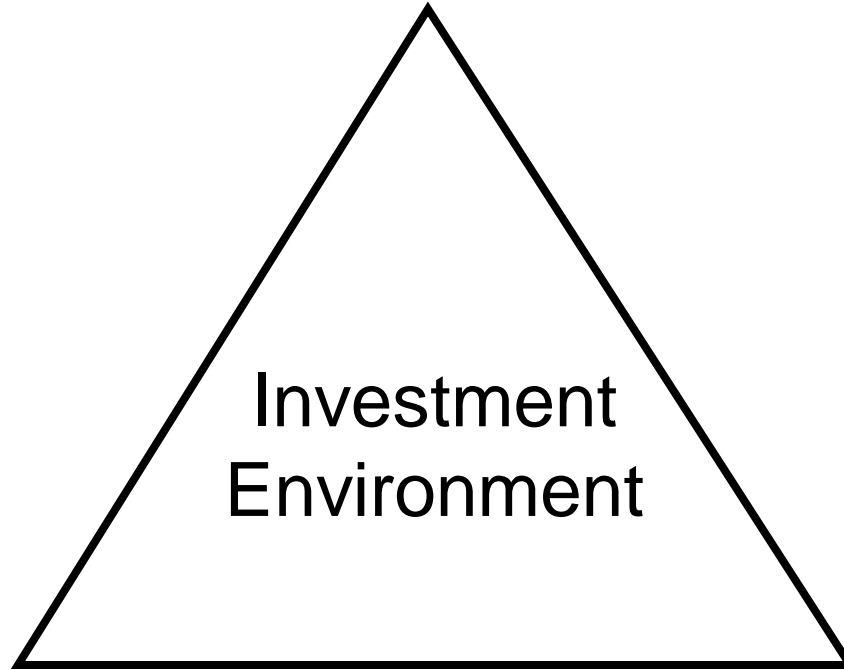
Pension Fund Management

Relationships, Finding an Edge & Common Sense

PAPERS Spring Forum
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Director, Equities
PSERS

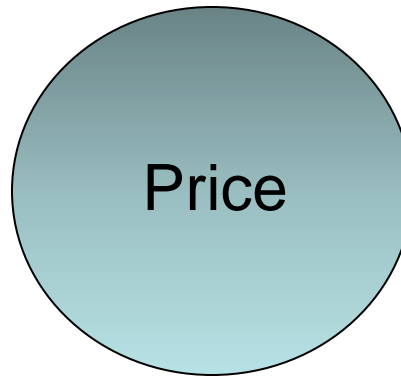
Common Sense



Finding an Edge

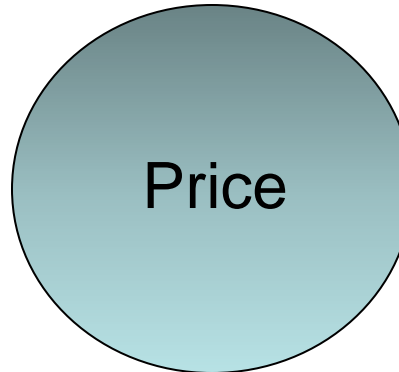
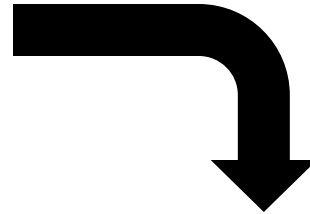
Relationships

Who and How are prices being set?



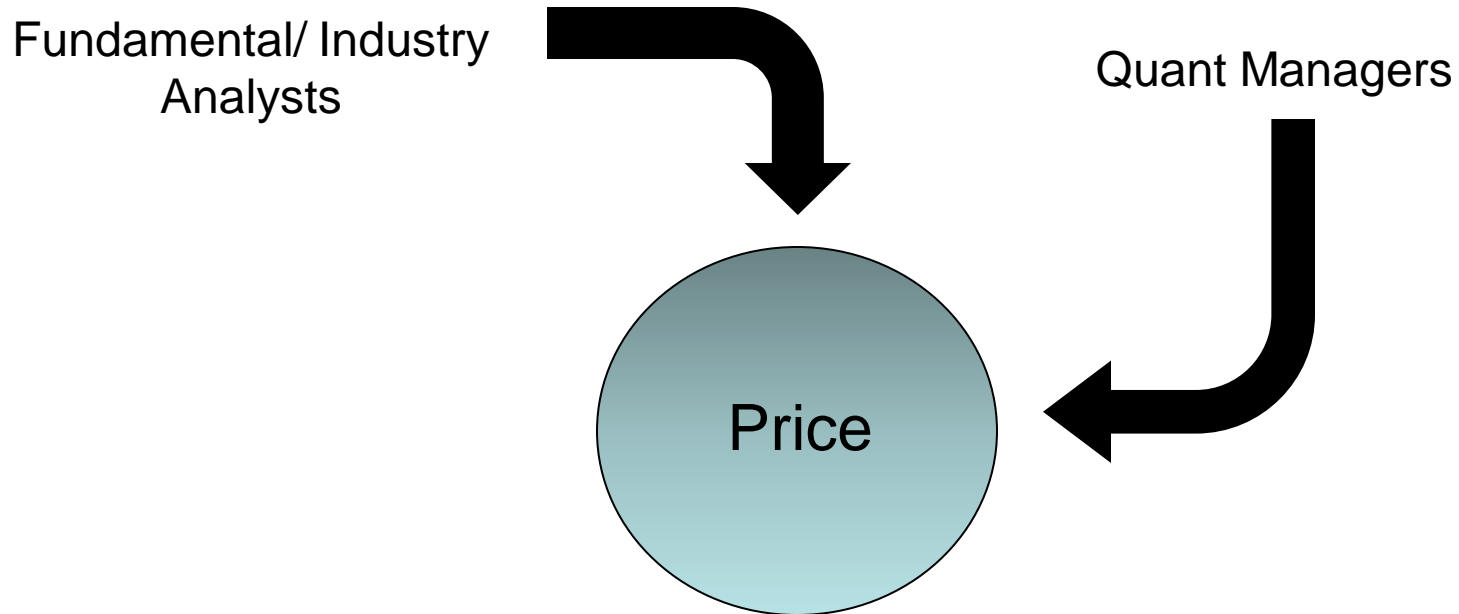
Who and How are prices being set?

Fundamental/ Industry
Analysts



- Wall Street Analysts
- 4,600 Mutual Funds (such as American Funds and Fidelity)
- 3,500 Institutional Funds
- Corporate and Public Pension Funds Analysts and Portfolio Managers

Who and How are prices being set?



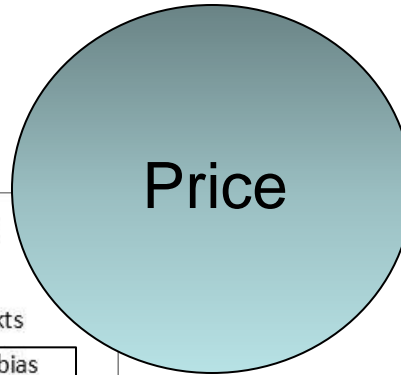
- Evaluate factors such as growth, valuation, sentiment & technicals
- Factor timing
- Track holdings by type of investment product – 13F filings

Who and How are prices being set?

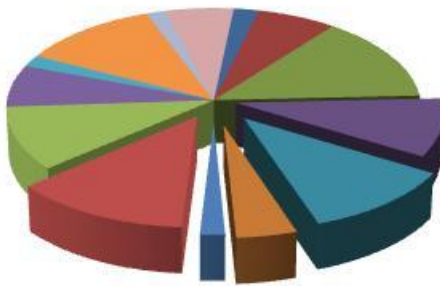
Fundamental/ Industry Analysts

Quant Managers

\$1.7 Trillion Assets



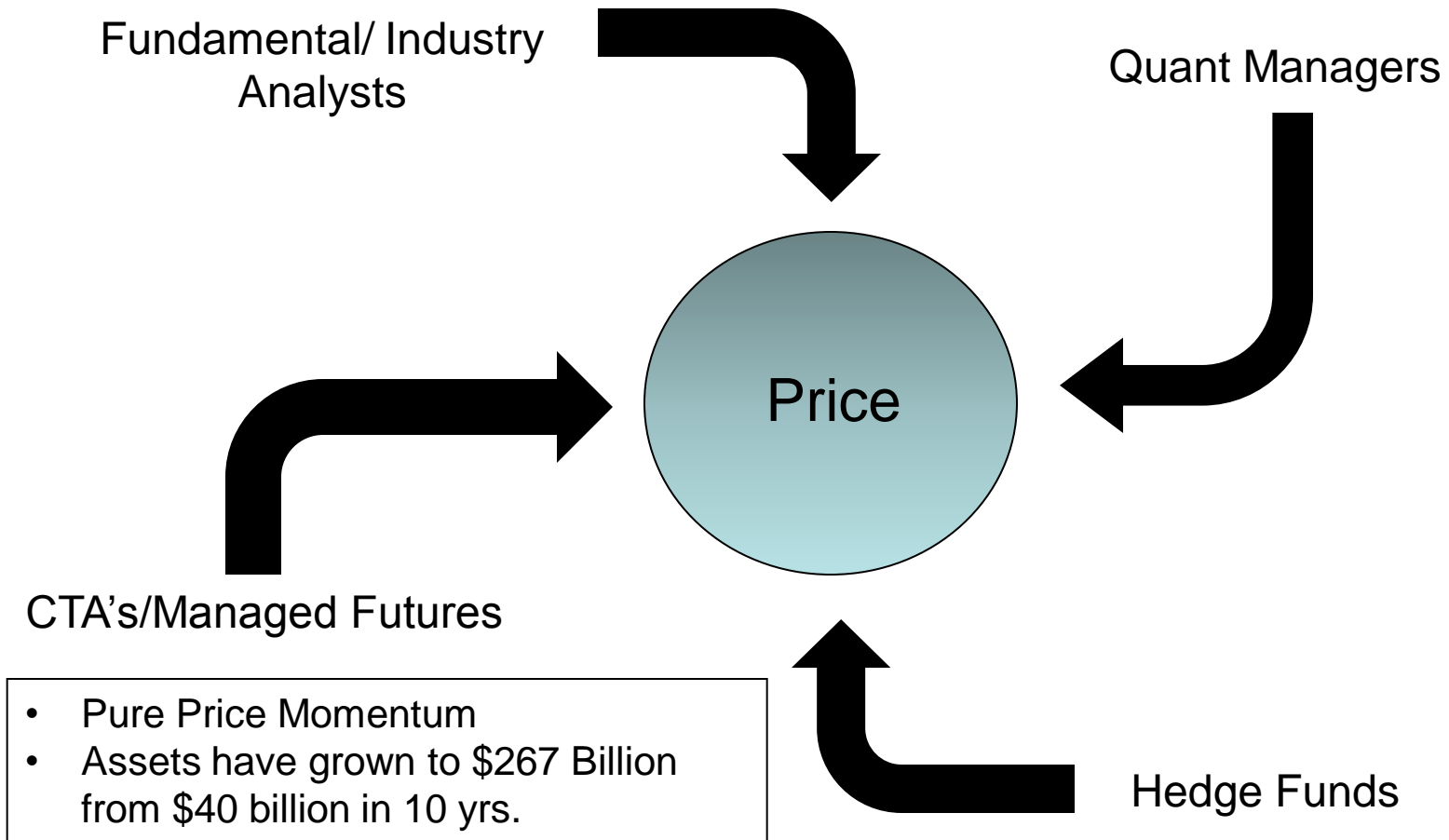
Hedge Funds



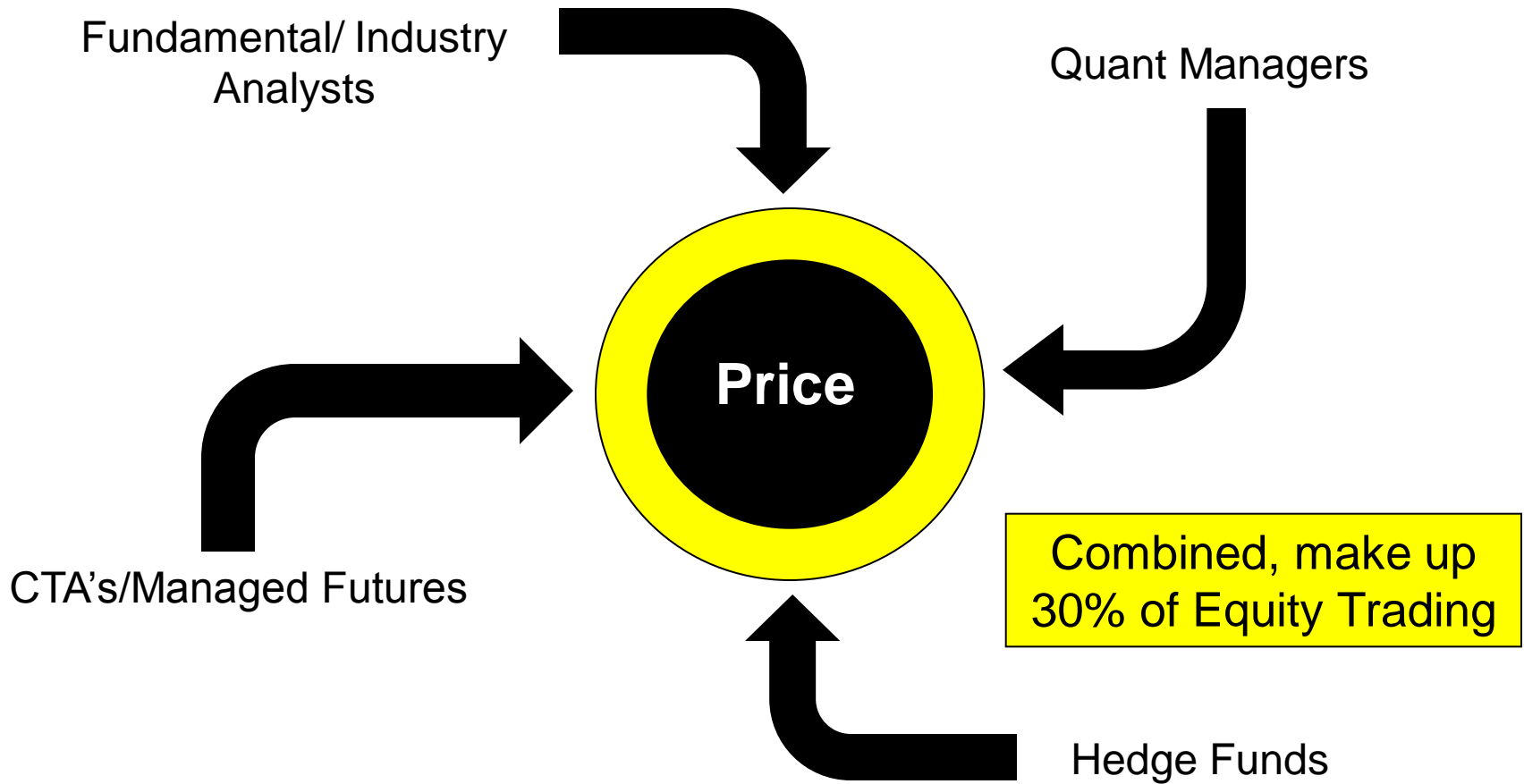
- Convert Arb
- Distressed
- Emerging Mkts
- Equity Long-bias
- Equity Long/Short
- Equity Long only
- Equity Mkt Neutral
- Event Driven
- Fixed Income
- Macro
- Merger Arb
- Multi strat
- Other
- Sector

Source: BarclayHedge.com

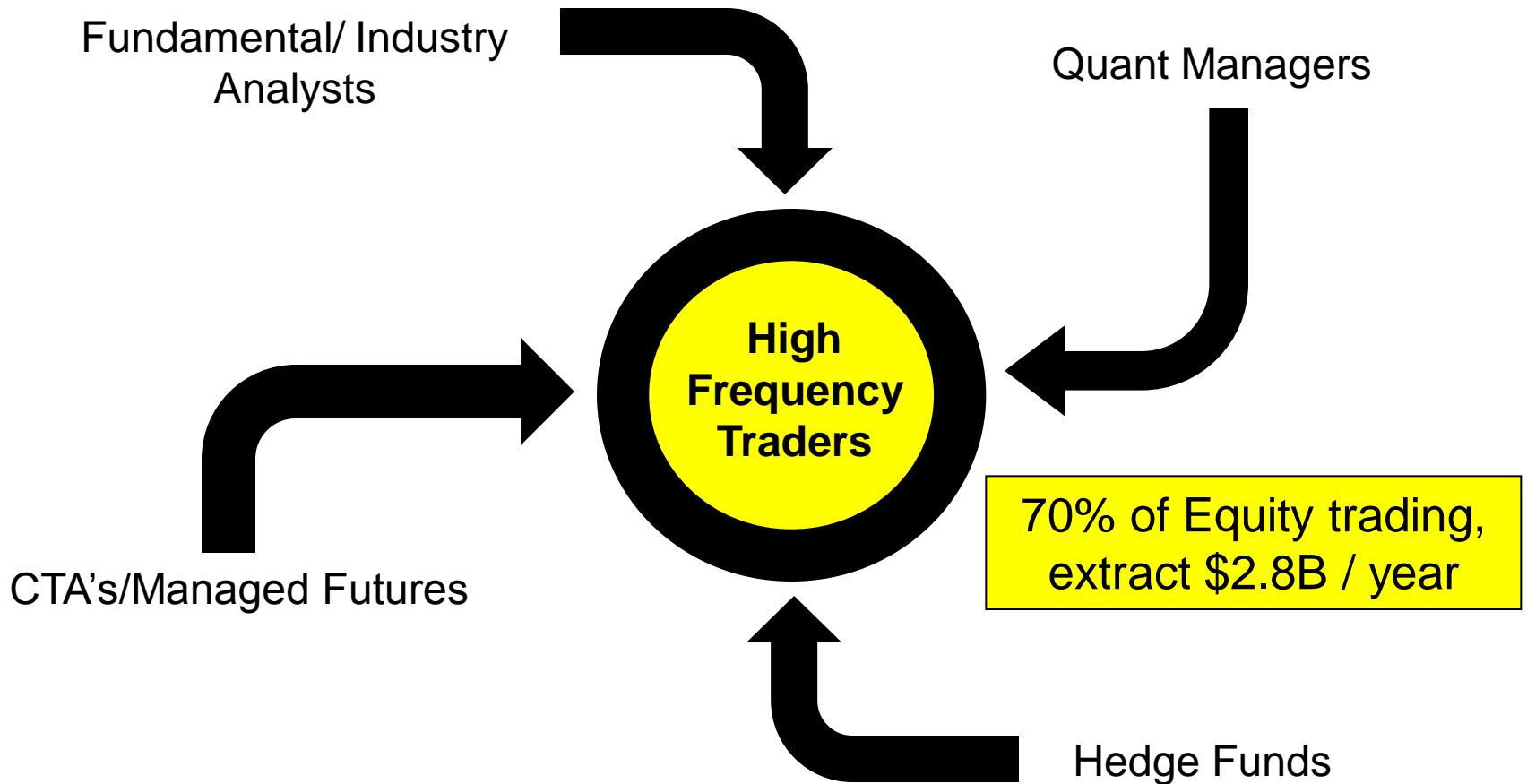
Who and How are prices being set?



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Who and How are prices being set?



Annual Turnover in US Equity Markets

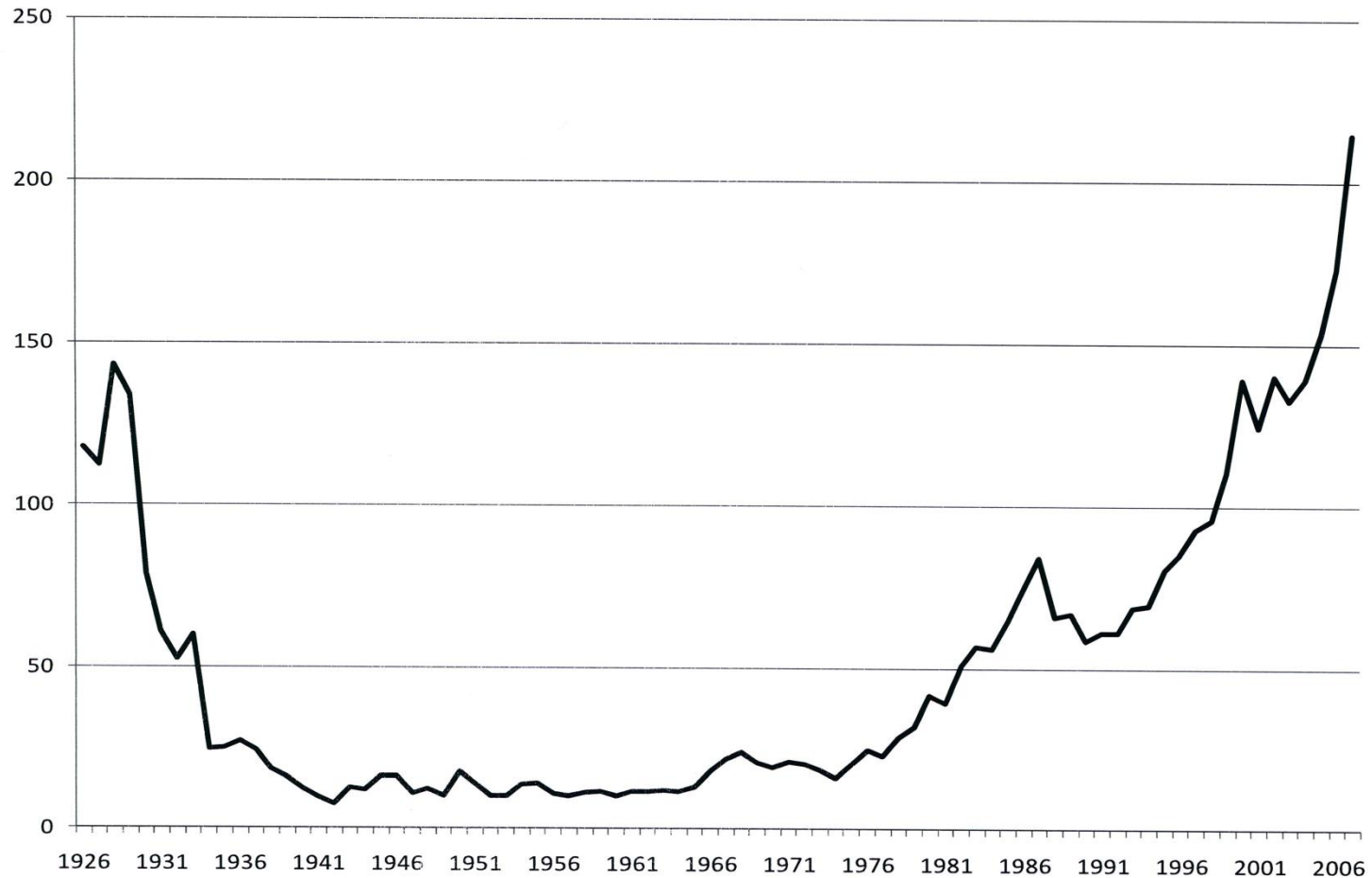
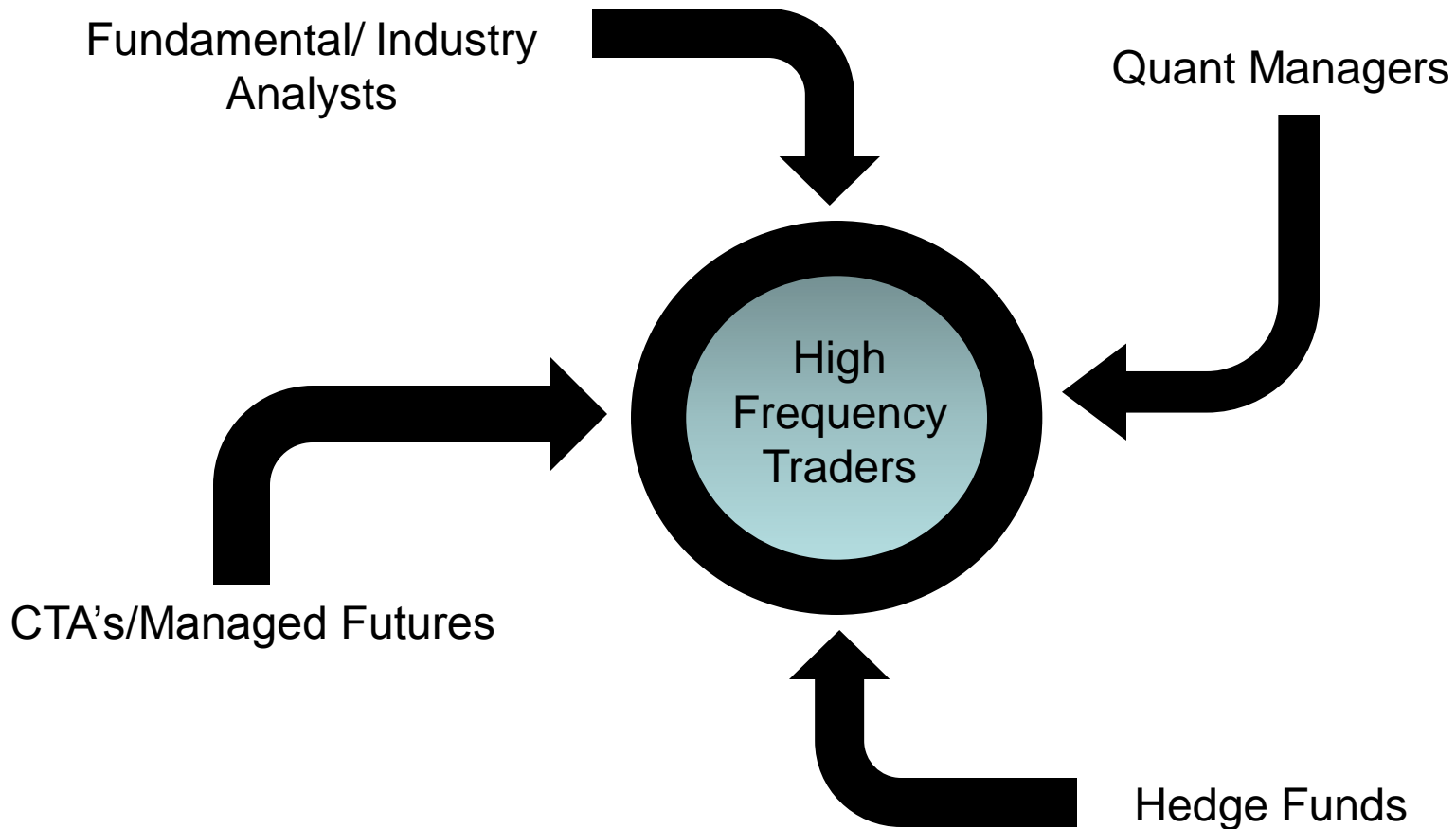


Figure 1. Annual Turnover of NYSE, Amex, and NASDAQ Stocks, in Percent, 1926 to 2007.

Source: Kenneth French, "Cost of Active Indexing"

Who and How are prices being set?



When you pick a stock, manager or strategy, you are saying that this process is not efficient and that you have the skill to beat it.

Which approach do you choose?



- Watson's Process (market efficiency) is rapidly evolving

From Cost Perspective

| | | | | |
|-------------------|---|-----------------------------|---|----------------|
| Market Returns | - | Mgt Fees & Trading costs | = | Net Returns |
|-------------------|---|-----------------------------|---|----------------|

| | | | | | |
|-------------------------------------|-------|---|------|---|-------|
| Active Investors: (Ken and Brad) | 8.00% | - | .76% | = | 7.24% |
|-------------------------------------|-------|---|------|---|-------|

| | | | | | |
|--------------------------------|-------|---|------|---|-------|
| Passive Investors: (Watson) | 8.00% | - | .09% | = | 7.91% |
|--------------------------------|-------|---|------|---|-------|

| | | | | | |
|--|--|--|------------|---|-------|
| | | | Difference | = | .67%* |
|--|--|--|------------|---|-------|

* Source: Kenneth French, "Cost of Active Investing", *Journal of Finance*, August 2008

Observations on Active Management

A. Average Active Manager underperforms.

Observations:

% Equity Funds Outperformed by Index

| <u>Category</u> | <u>5 Yrs ending 2004</u> |
|----------------------|------------------------------|
| Large Cap by S&P500 | 59% |
| Mid Cap by S&P 400 | 84% |
| Small Cap by S&P 600 | 72% |

Source: S&P Indices Versus Active Funds Scorecard, www.standardandpoors.com

Observations:

% Equity Funds Outperformed by Index

| <u>Category</u> | <u>5 Yrs ending 2004</u> | <u>5 Yrs ending 2010</u> |
|---------------------------|------------------------------|------------------------------|
| Large Cap by S&P500 | 59% | 62% |
| Mid Cap by S&P 400 | 84% | 78% |
| Small Cap by S&P 600 | 72% | 63% |
| Non US by S&P 700 | | 82% |
| Emerging Mkts by S&P/IFCI | | 90% |

Source: S&P Indices Versus Active Funds Scorecard, www.standardandpoors.com

Observations:

% Fixed Income Funds Outperformed by Index

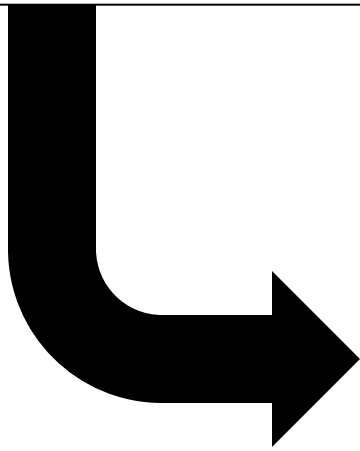
| <u>Category</u> | <u>5 Yrs ending 2010</u> |
|-------------------------------------|------------------------------|
| Government Long Bond Funds | 68% |
| Government Intermediate Bond Funds | 68% |
| Government Short Term Funds | 75% |
| Investment-Grade Long Bond Funds | 70% |
| Investment-Grade Intermediate Funds | 56% |
| Investment-Grade Short Term Funds | 97% |
| High Yield Funds | 92% |
| Mortgage-Back Securities Funds | 84% |
| Global Income Funds | 65% |
| Emerging Market Debt Funds | 44% |
| General Municipal Debt Funds | 86% |

Observations on Active Management

A. Average Active Manager underperforms.

B. Many Plan Sponsors use a similar method to select managers.

C. Institutions have a poor record of choosing of investment funds.



- People
- Process
- Performance

Plan Sponsor's Manager Selection Process

- Largest factor that drives institutional decision-making is performance.
- Extensive study shows products with largest inflows underperform products with largest outflows.

Sources: Heisler, Knittel, Neumann, Stewart, "Why Do Institutional Plan Sponsors Hire and Fire Their Investment Managers", *Journal of Business and Economic Studies*, Spring 2007

Stewart, Neumann, Knittel, Heisler, "Absence of Value: An Analysis of Investment Allocation Decisions by Institutional Plan Sponsors", *Financial Analysts Journal*, Nov/Dec 2009

Institutional Product Performance

Largest Inflows versus Largest Outflows

(average returns over 22 1-year periods)

| <u>Category</u> | <u>One Year Returns</u> | | |
|----------------------------|--------------------------------|-----------------------|----------------------|
| | <u>Inflow</u> | <u>Outflow</u> | <u>In-Out</u> |
| Domestic Growth | 12.87% | 14.65% | - 1.78% |
| Domestic GARP | 13.75% | 14.54% | - .79% |
| Domestic Balanced | 10.67% | 11.36% | - .69% |
| Domestic Value | 12.98% | 14.27% | - 1.29% |
| Domestic Core | 12.94% | 13.30% | - .36% |
| Global Equity | 11.48% | 12.72% | - 1.24% |
| International Equity | 13.29% | 14.99% | - 1.70% |
| Domestic Fixed Income | 7.72% | 8.02% | - .30% |
| Global Fixed Income | 7.84% | 8.58% | - .74% |
| International Fixed Income | 12.56% | 13.27% | - .71% |

Source: Stewart, Neumann, Knittel, Heisler, "Absence of Value: An Analysis of Investment Allocation Decisions by Institutional Plan Sponsors", *Financial Analysts Journal*, Nov/Dec 2009

Observations on Active Management

- A. Average Active Manager underperforms.
- B. Most institutions use similar method to selecting managers.
- C. Institutions have a poor record of choosing of investment funds.
- D. Outperforming by .50% will put in you in top 1/3.

Observations on Active Management

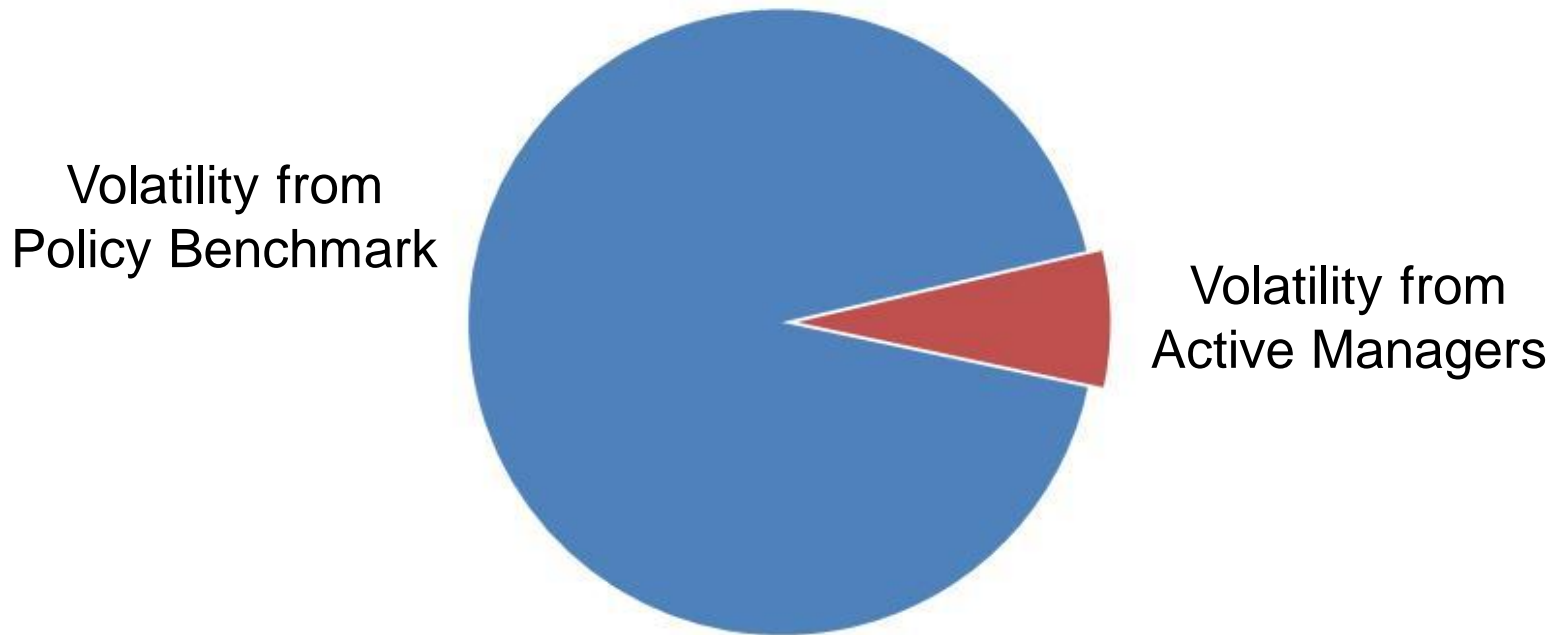
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Solutions

- A. Don't bet against Watson - select indexing – you'll outperform most funds.
- B. In addition to saving money, it will save you time. You can focus on more important issues – like asset allocation and finding and mining good relationships.
- C. Don't try to find an edge the same way as everybody else.

Observations on Investment Policy

- A. Generally 90-95% of a Fund's volatility comes from market volatility.



Observations on Investment Policy

- A. Generally 90-95% of a Fund's volatility comes from markets volatility.
- B. No one is good at consistently timing markets.
- C. Fiduciaries are generally time constrained.

Implication

- A. Asset Allocation should be prime focus of Plan Sponsors.
- B. Spend more effort on improving Policy than market timing.

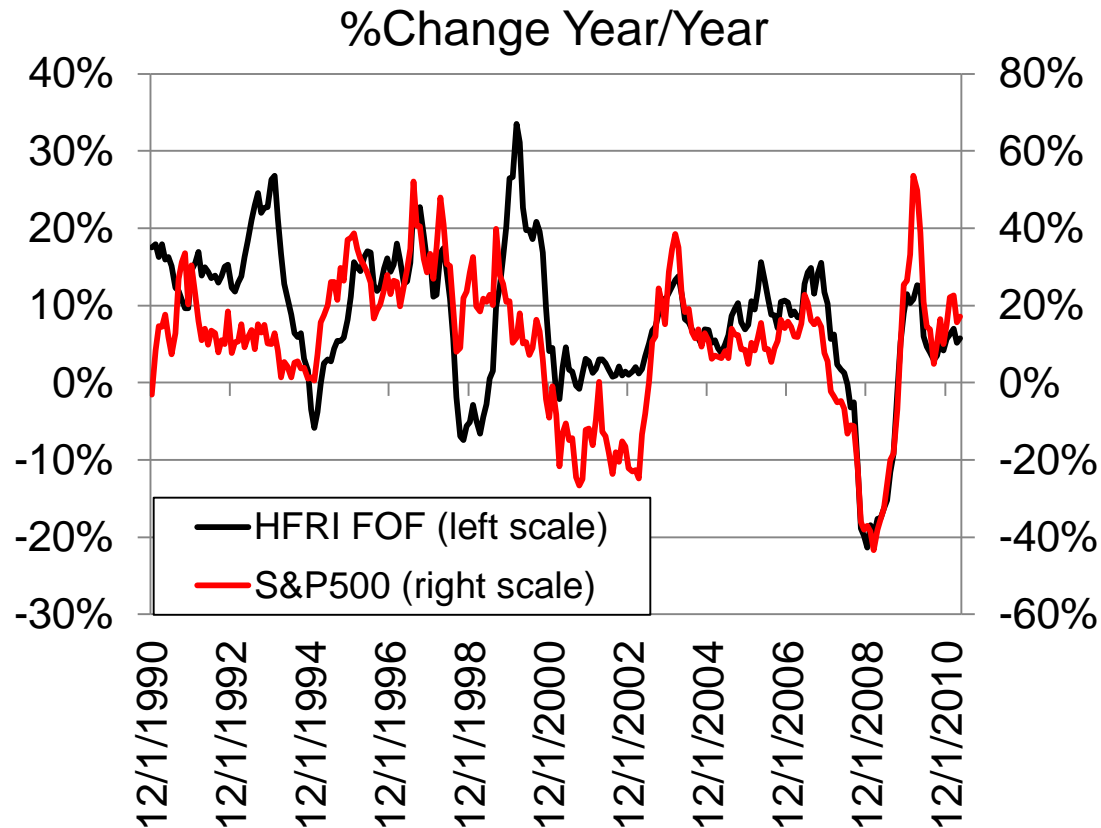
Solutions

- A. Find strategic partners that focus more on allocation.
- B. If you select indexing, you will have much more time to focus on policy decisions rather than active management issues.

Hedge Funds

Observations

- A. Hedge funds and fund of funds often contain systemic equity risk and other market risks.



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- A. Hedge funds and fund of funds often contain systemic equity risk and other market risks.

If you have a Hedge Fund program, you need to choose:

- A. Accept that portion of equity risk – use as an equity substitute.

or

- B. Make sure your hedge funds or Fund of Funds do not have systemic equity exposure.

Either approach is valid.