

Risk Capital Allocation: Beyond Traditional Asset Allocation Approaches



Brian D. Singer, CFA

General Manager

UBS Global Asset Management

Bruce Tomlinson, CFA (Moderator)

AMP Capital Investors

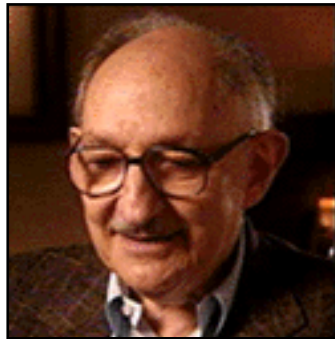
23 May 2006

Presented by CFA Institute

www.cfawebcasts.org

What Role for the Policy Portfolio?

“Our approach to investing’s fundamental problem, asset allocation, has to change. The thrust of my argument is that we are going to have to learn to live without the crutch of things like policy portfolios, because the conditions that justified their existence for so long have been shattered.”

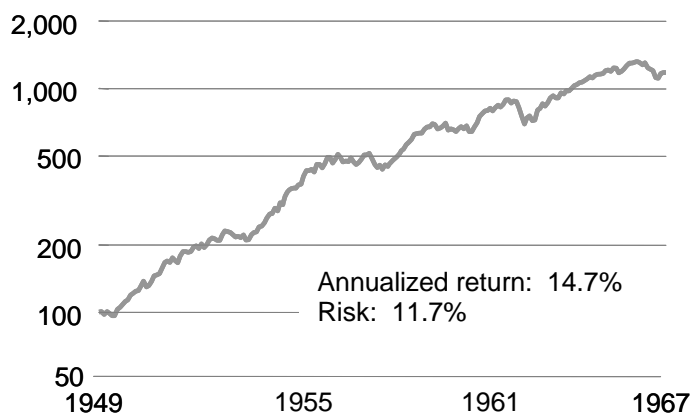


**– Peter L. Bernstein
April 2003**

US Equity Market Investment Regimes

S&P 500 total returns: January 1949 – December 2005

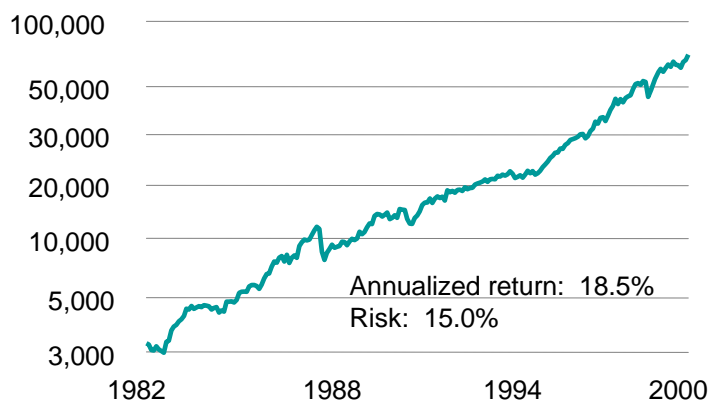
1 January 1949 - 31 December 1966



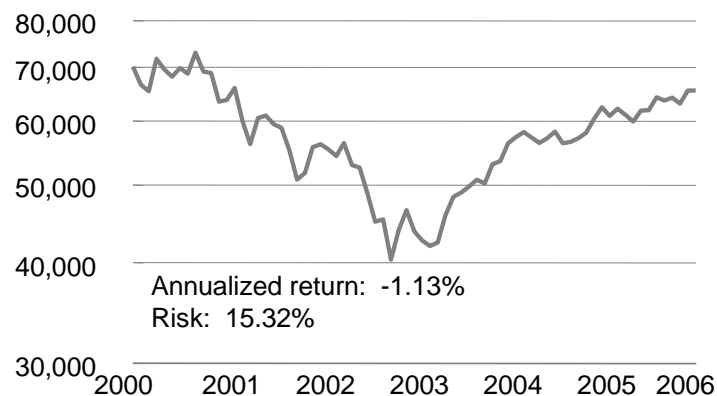
1 January 1967 - 31 December 1981



1 January 1982 - 31 December 1999



1 January 2000 – 31 December 2005



Source: UBS Global Asset Management

Returns are annualized S&P 500 total returns and risk is standard deviation based on monthly logarithmic returns

Past performance is no guarantee of future results

At the Mercy of the Markets

Major prolonged secular trends have defined the investment landscape

Ten-year Treasury bond yield, monthly average: 1925 – May 2005

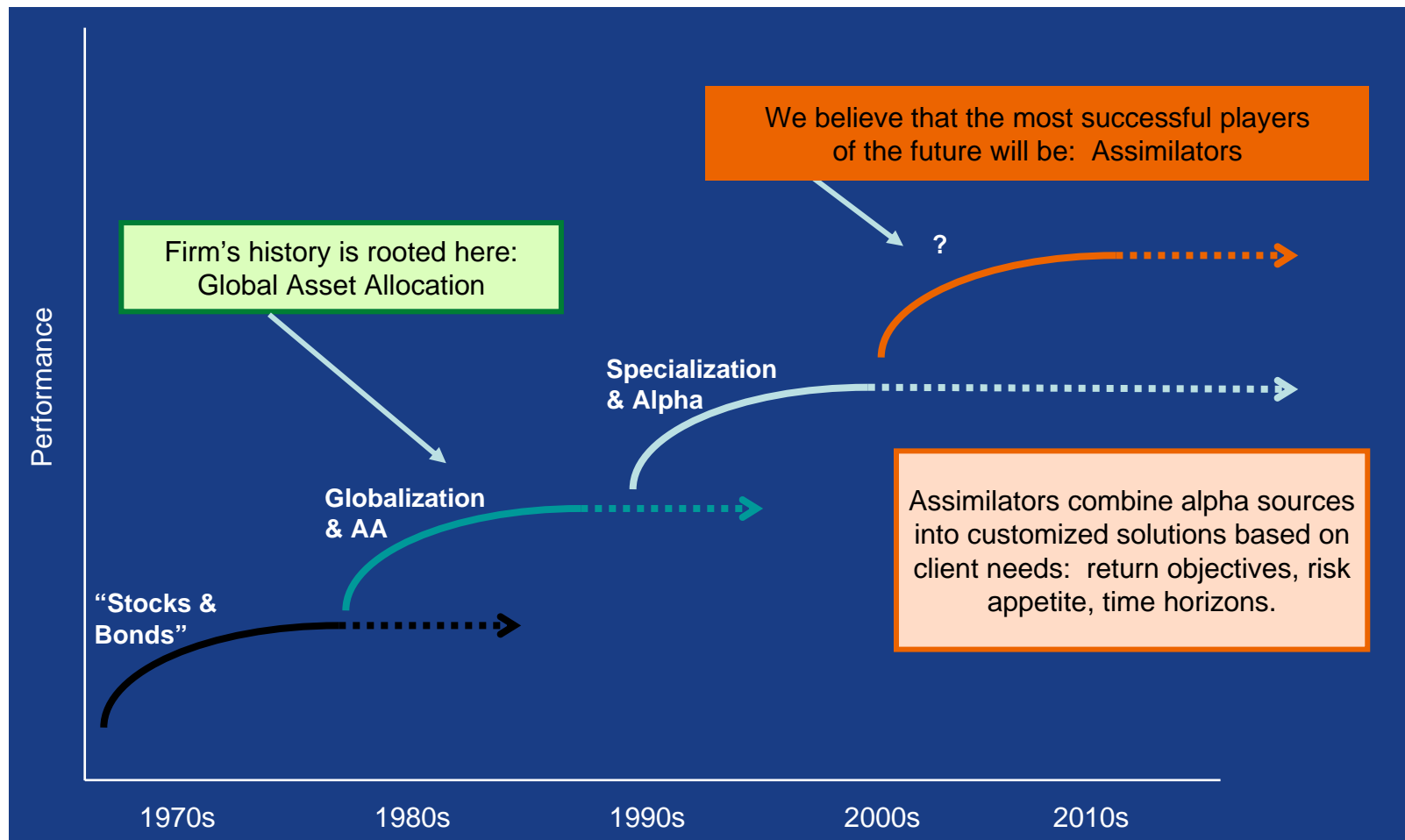


Source: Data from 1925 - 1956 was obtained from the Federal Reserve, <http://federalreserve.gov>. Data from this time period represents the unweighted average of yields on all issues of bonds outstanding during 1925-1956 that were neither due nor callable in less than 10 years. Data from 1957 - May 31, 2005 was obtained from Leuthold Group. Used with permission. Data from 1957 - 5/2005 represents the 10-year Treasury bond yield monthly average.

Past performance is no guarantee of future results.

The Evolution of Investment Management

Regime shifts have defined success in the asset management industry; focus on client needs, utilize new technologies



In Response, Investors Have Been Pushed to the Extremes...

100% security exposure - "alpha"

Security exposure:
Risk, and the potential for reward, inherent in individual security selection decisions

Market neutral hedge fund

Opportunities to add value, "going by the wayside"

100% market exposure - "beta"

Market exposure:
The risk and reward potential of markets and asset classes

Index fund

Traditional actively managed portfolio

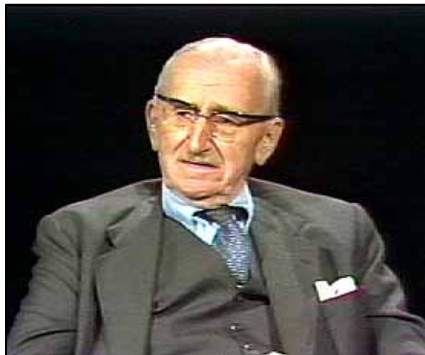
Investment spectrum

Some Common Responses to Recent Market Developments

- Bias policy portfolios toward higher-returning assets
- Allocate to illiquid assets to realize liquidity premium
 - Real Estate, Timber, Private Equity
- The predominant response: expose plan assets to more “active risk”
 - Alpha-intensive
 - Absolute return strategies
 - Loosen tracking error restrictions

A Different View

“The interaction of individuals, possessing different knowledge and different views, is what constitutes the life of thought. The growth of reason is a social process based on the existence of such differences.”



– Friedrich A. Hayek

Our Solution

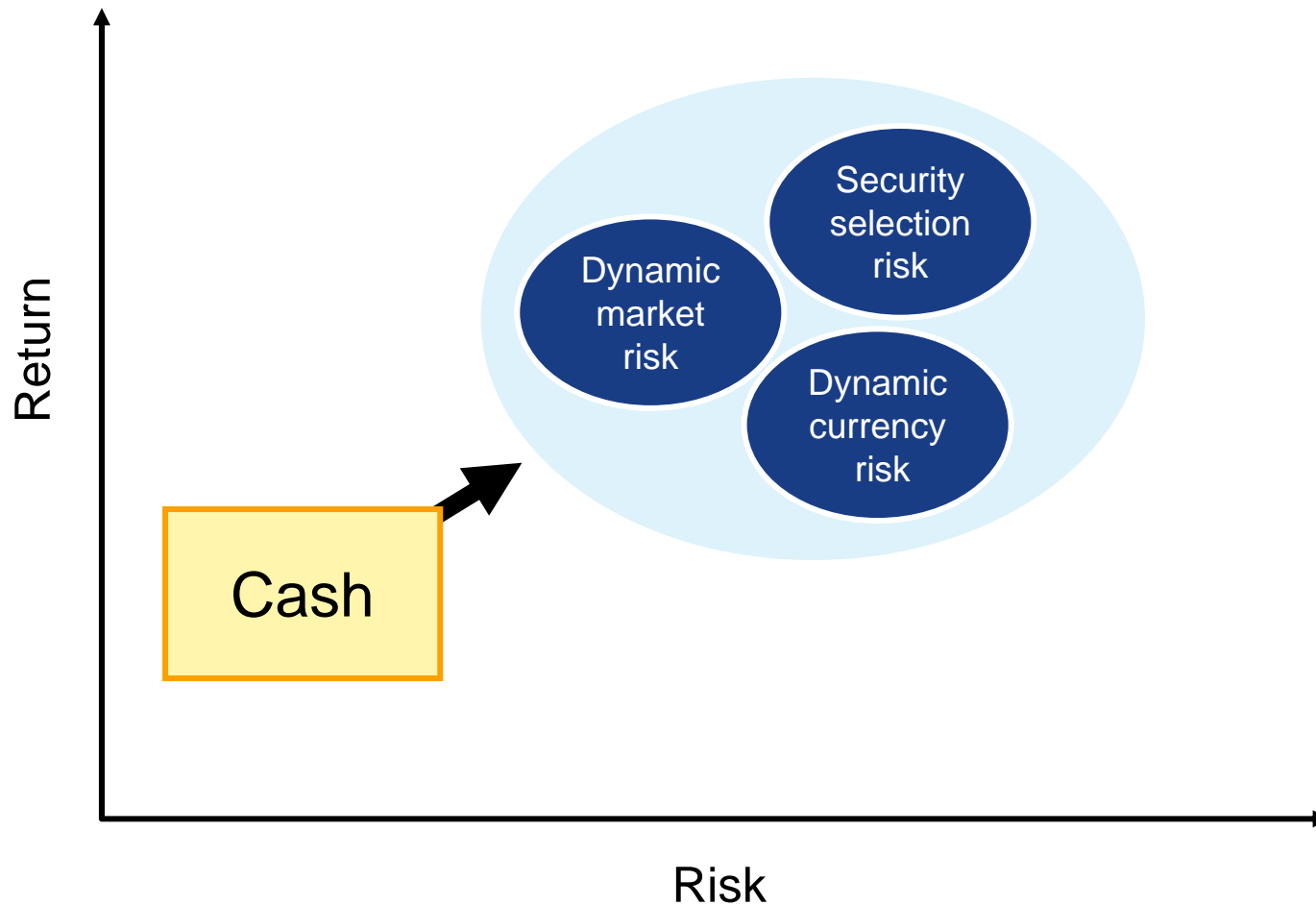
Policy portfolios are not obsolete...

... but policy portfolios do constrain “beta” management!

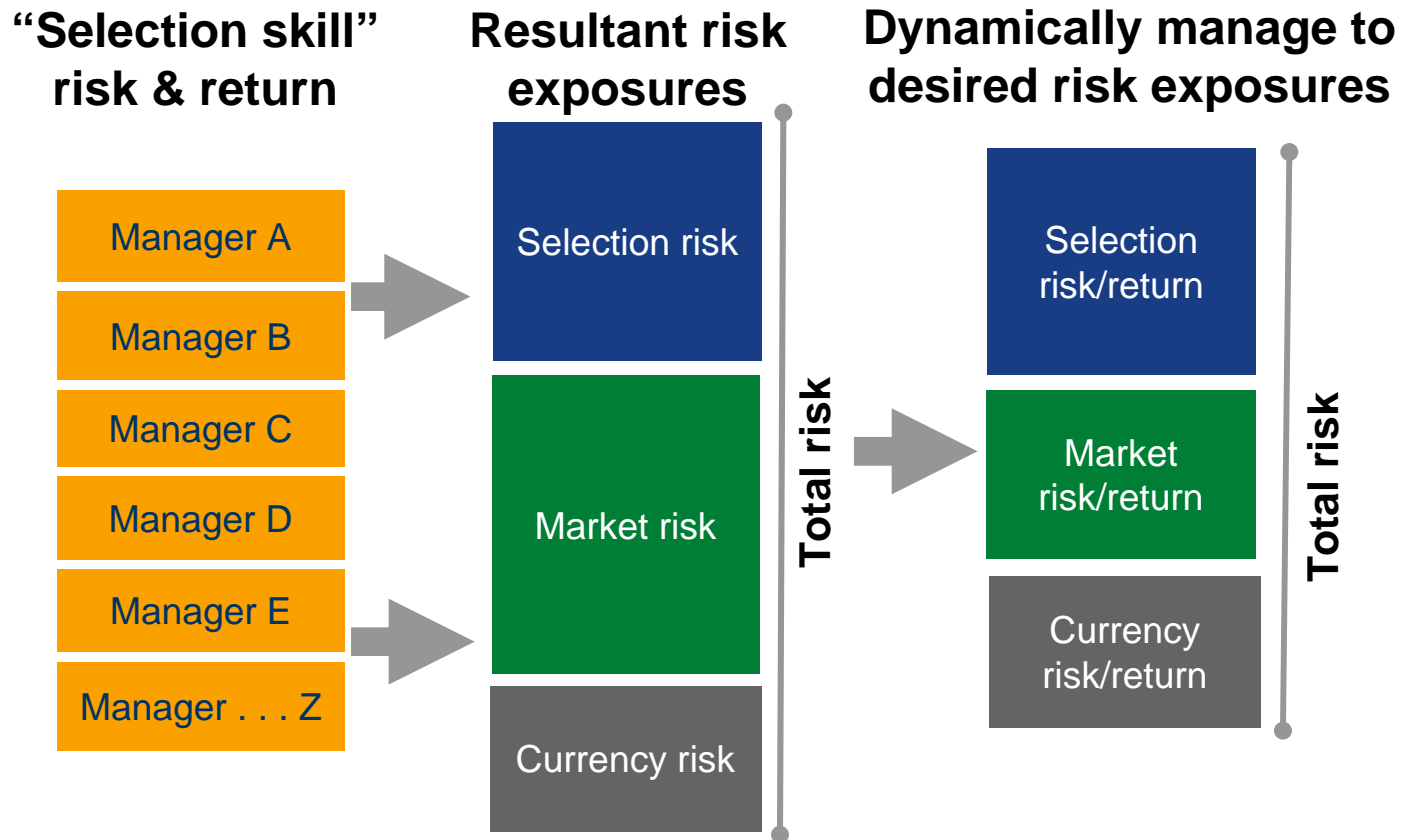
- UBS paradigm: Separate portfolio management into aspects of risk management
- Neutral (policy) asset allocation: Neutral “beta” exposure to defease and hedge liabilities
- Active “beta” management: Setting market exposures to capture compensated market risks (and avoid uncompensated risks!)
- Active “alpha” management: Setting selection exposures to capture uncorrelated opportunities
 - Market
 - Currency
 - Security

Risk Is Risk

“Alpha” and “Beta” can be dangerous terms

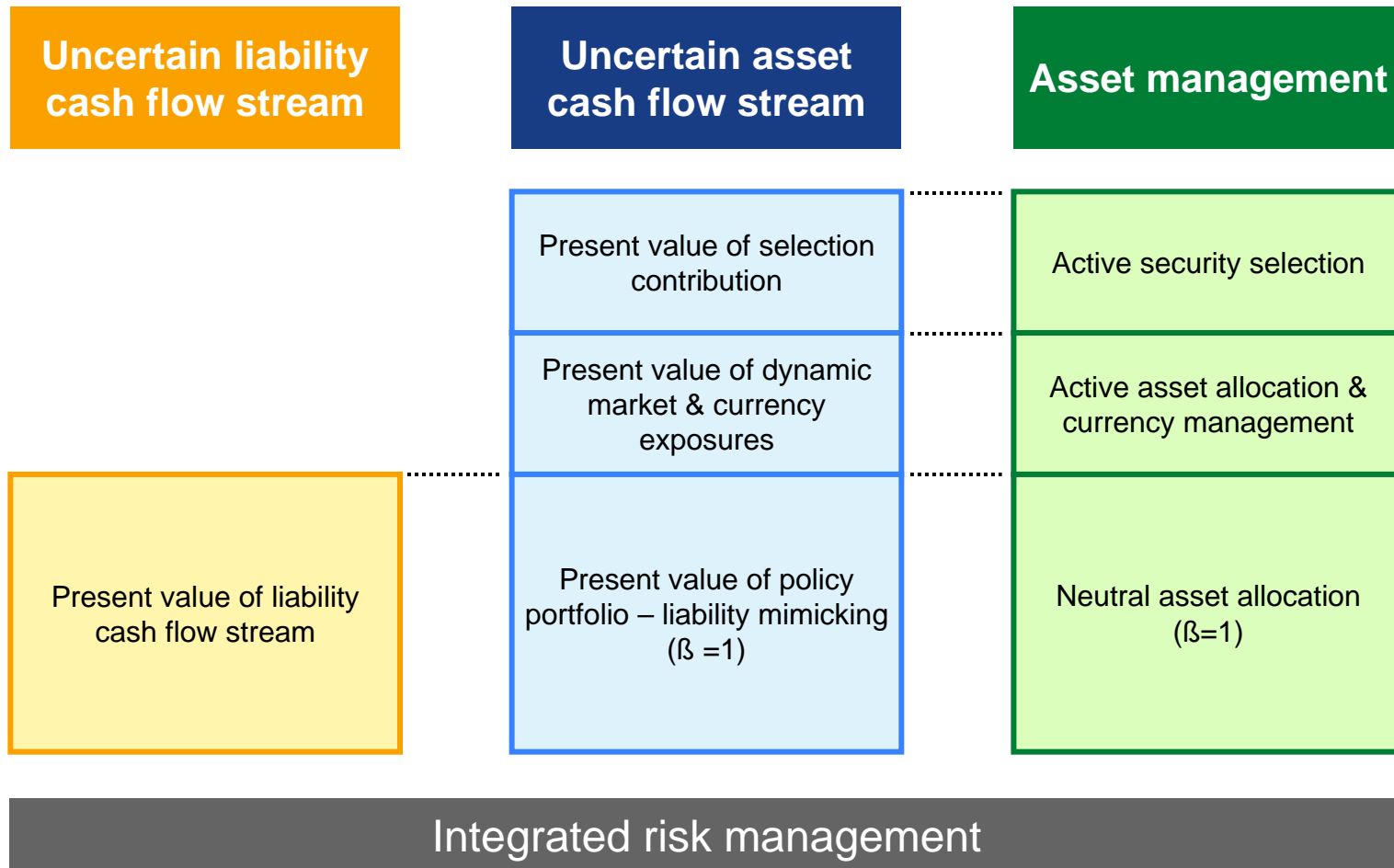


Risk Capital Allocation Process



Portfolios should be thought of as bundles of risk exposures

For Pension Plans, the Starting Point is the Liabilities



New Horizons in Portfolio Management

Challenges

- Flexibility is not a neat fit with the established paradigm
- Shifting the focus of Beta
- Education of decision-making committees (new tools, techniques, ways of looking at investment risk)
- “New” risks to measure and manage (administration, operations, accounting, counterparty, etc.)

New Horizons in Portfolio Management

Opportunities

- Success will follow those who can “assimilate” risk/return sources
- Expertise in portfolio construction is paramount (management in risk dimensions)
- Hedge funds have opened the door to new tools and techniques; use them
- Greater consideration of liabilities has value to sponsors, beneficiaries, society

The Final Horizon

“Am I destined to look like
Hayek and Bernstein if I stay in this
business for another 30 years?”



– **Brian Singer, CFA**

Question:

Are you sure that the evolution of the industry has benefited returns for investors as well as returns for investment firms?

Question:

Can you expand on your statement that hedging liabilities and not defeasing them is dumb?

Question:

It appears that a lot of work in this area is coming from the U.K.

Is this perception true?

At what stage are other countries in this evolution?

Question:

Can you discuss the risks from the client perspective and not only capital forecast type risks but other risks?

How do you help define that and how does that feed back into the process?

Question:

What are the costs of implementing some of these innovative techniques you mentioned (e.g. swaps, OTC instruments)?

Are clients willing to pay higher fees for the cost of implementing and how do you demonstrate the benefit of this new risk capital approach?

Can you quantify the benefit of reduced surplus volatility?