Pension Plan Best Practices: Ways to Reduce “Drag” on Returns

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Pension Plan Best Practices: Ways to Reduce “Drag” on Returns

- Securities Lending
- Cash Overlay (Equitization)
- Pool of Transition Managers

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Securities Lending

- Investment strategy employed to generate incremental yield from existing assets, thereby increasing portfolio performance.
- Transaction in which the owner of a security lends the security to a borrower according to negotiated terms.
- A large institutional portfolio can earn 17 to 20 basis points loaning U. S. Government securities and a greater spread loaning international stocks.
- Investment practice that has been around since the 1970's.
- The vast majority of large portfolios participate in securities lending in some manner either directly through separately managed accounts or through commingled funds and collective trusts.

Securities Lending

- Principle Players:
  - Lender
  - Lending Agent
  - Borrower

- The securities lending transaction involves the temporary transfer of stock or bonds to another party, typically dealers who need the securities to support their trading, financing or arbitrage activities.

- The lender retains all economic benefits of ownership.

- When the security is out-on-loan, the legal title to the security is transferred to the borrower and the loan is secured with collateral.

- For the time period that these securities are out on loan, they are secured with cash collateral in excess of the value of the securities that are lent, and in return for the use of the securities the Lender earns a fee.

- The borrower pays the fee that is split between lending agent and lender.
  - Lending Agent generally receives 25% to 40% with the remainder going to the Lender
  - Lending Agent absorbs operational expenses

Cash Overlay (Equitization)

- Use financial futures (Index Futures) to offset effects of "cash drag" on a Plan.

- Cash Overlay Definition:
  - Use of Financial (Index) Futures to overlay the cash portion of a portfolio to replicate the market returns for a particular asset class.

  - For example: Purchasing S&P 500 Index Futures with cash to get the market exposure to the S&P 500 securities without actually purchasing the underling securities.

- Provides market performance without the associated cost of purchasing and holding the securities.

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Cash Overlay (Equitization)

- This is accomplished by converting excess administrative cash and cash held by investment managers into the desired market exposure through the use of these Futures.
  - Pension Plans need liquidity in the form of administrative cash to pay benefits and plan expenses.
  - Excess cash held by investment managers is usually not fully invested in the securities they are hired to manage.
- Keep the desired asset allocation while maintaining liquidity to pay benefits and expenses.
- This can be done without adversely affecting the investment fund managers.

Cash Overlay (Equitization)

Sample Pension Plan
Market Value as of 8/31/08

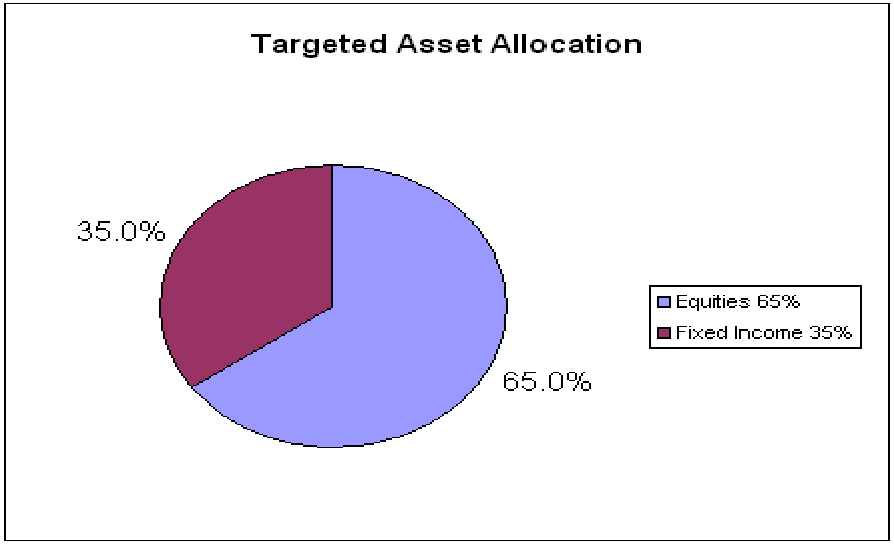
	Equities	Fixed Income	Cash and Equivalents	Net Assets
Administrative Cash	0	0	10,000,000	10,000,000
S&P 500 - Equities	62,000,000	0	3,000,000	65,000,000
Bonds - Fixed Income	0	33,000,000	2,000,000	35,000,000
Portfolio Total	62,000,000	33,000,000	15,000,000	110,000,000

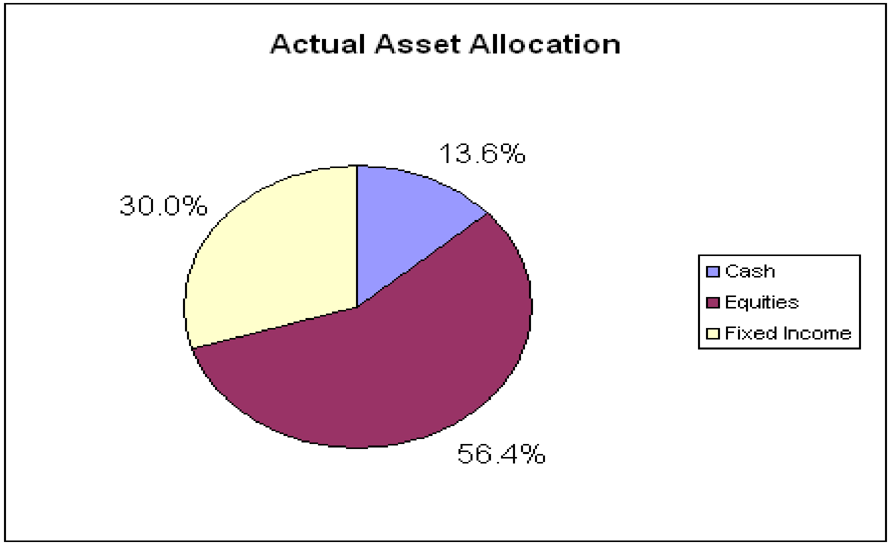
Targeted Asset Allocation:

Equities 65%	65.0%
Fixed Income 35%	35.0%

Actual Asset Allocation:

Cash	13.6%
Equities	56.4%
Fixed Income	30.0%





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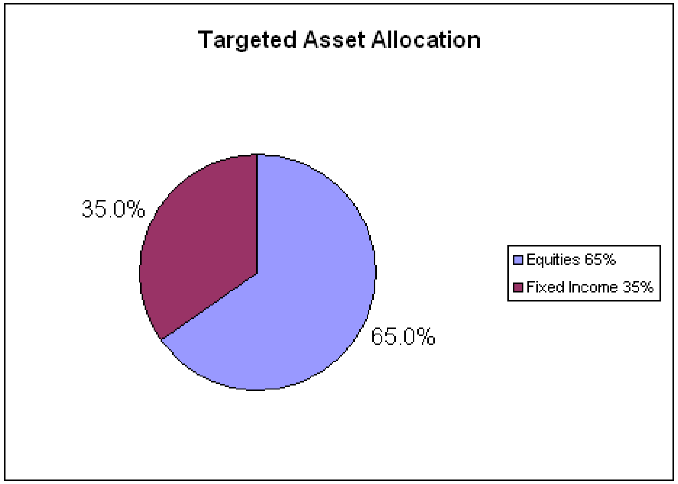
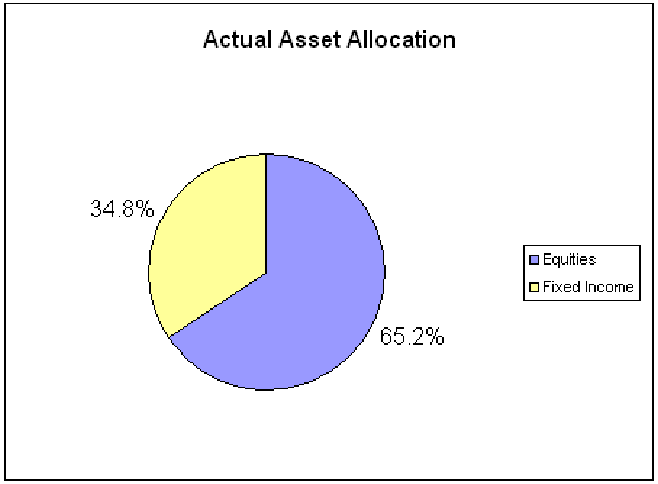
Cash Overlay (Equitization)

Sample Pension Plan
Market Value as of 8/31/08
(With Cash Overlay)

	Equities	Fixed Income	Cash and Equivalents	Net Assets
Administrative Cash	0	0	10,000,000	10,000,000
S&P 500 - Equities	62,000,000	0	3,000,000	65,000,000
Bonds - Fixed Income	0	33,000,000	2,000,000	35,000,000
S&P 500 Index - Futures	9,750,000	0	-9,750,000	0
Lehman Brothers Aggregate Index - Futures	0	5,250,000	-5,250,000	0
Portfolio Total	71,750,000	38,250,000	0	110,000,000

Targeted Asset Allocation:		**Actual Asset Allocation:**	
Equities 65%	65.0%	Equities	65.2%
Fixed Income 35%	35.0%	Fixed Income	34.8%





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Pool of Transition Managers

- Transition Management Definition
  - the process of planning and managing a change in an investment portfolio.
  - a controlled and systematic process that utilizes all available sources of liquidity to minimize the total cost of transition while managing the overall risk.

Pool of Transition Managers

- Events Requiring a Transition Manager:
  - Cash Contributions
  - Hiring/changing investment managers
  - Changing or rebalancing asset allocation
  - Changing asset mix
  - Moving assets
- Why is a Transition Manager Important:
  - assists with design of a market strategy, reducing market and security risk, thus lowering overall cost of transition and helping to reduce administrative burden and operational risk
  - helps to reduce market and security specific risk by creating a well-developed trading strategy

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Pool of Transition Managers

- Transition Cost:
  - Explicit: commissions, taxes and fees
    - Generally comprise only a small portion of the total cost
  - Implicit: market movements, spreads and market impact
    - Generally greater portion of transition cost

- Process for Employing Pool of Transition Managers:
  - Develop pool of qualified Transition Managers
  - Confidentiality agreements
  - Plan the transition event
  - Obtain pre-trade analysis from each manager
  - Select best proposal based on cost, operational expertise/capabilities, and reporting

Pool of Transition Managers

- Hold meeting with Transition Manager to review Post-Trade Analysis
- Compare results of the Post-Trade Analysis with the Pre-Trade Analysis and evaluate variances
- Share Post-Trade Analysis with all bidding Transition Managers and solicit their opinion of results
- Develop list of "Lessons Learned" for the next Transition
- Incorporate "Lessons Learned" in next transition event

Thank You

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