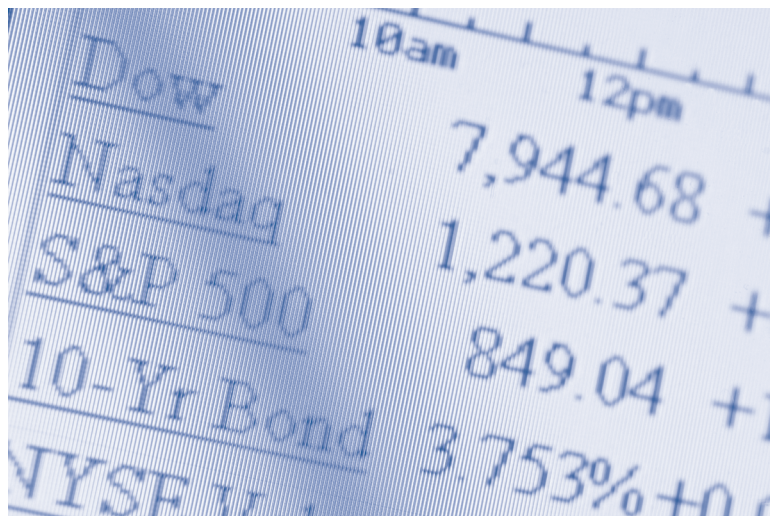




# INVESTMENT MANAGEMENT

## Behavioral Finance Says Markets Are Inefficient



*Gil Kreiter*

How we view markets and the behavior of markets determines how we invest our clients' money. If we believe that markets are efficient, then we recommend index funds and allocate assets according to the needs and risk profiles of our clients. Conversely, if markets are not efficient, then our job is harder. We have to decide what the current behavior of the market means for its future and invest accordingly. It is much less comforting, but if I convince you that the markets are inefficient, you will have a truer view of the world and you will invest more profitably with less risk.

Newtonian mechanics is an elegant description of how the planets move. Yet there were a few anomalies like the precession of the orbit of Mercury that nagged astronomers. It took the creation of General Relativity to explain the anomalies and much more.

*continued on page 2*

### IN THIS ISSUE

**3**

Insight into the Future of  
Pension Risk Management

**5**

Basel Committee on  
Banking Supervision  
Announces Enhancements  
to the Basel II  
Capital Framework

**6**

eGroup Eavesdropping



## **Behavioral Finance**

*continued from page 1*

As a first approximation markets are efficient and investors are rational. But there are certain puzzles of finance that open up new ways of thinking about investment that lead to powerful results.

### **Efficient Market Hypothesis**

There are three forms of the efficient market hypothesis. The weakest form is that no one can earn high risk-adjusted returns trading solely on the knowledge of previous prices. There is good evidence for this: technical trading systems do not work.

A stronger version says that no public knowledge will help you beat the market. For aficionados, this is called the semistrong form.

The strong form insists that no knowledge, public or private, gives an investor an edge in investing. The Federal prosecutor for the Southern District of New York does not agree with the strong form, which is why he accommodates insider traders at Club Fed.

Rational investors value a security as the net present value of the cash flows that it throws off. So there is no reason for a stock price to move unless there is news about earnings. In fact, the distribution of changes in stock price is narrow and skinny around zero with fat tails. Most of the time prices do not change much and every once in a while there is a big move, up or down.

### **Noise Traders**

What really convinced scientists that atoms exist was Einstein's explanation of Brownian motion. When Robert Brown looked at pollen in a microscope, he saw it moving around in a random way. Einstein explained that he was seeing the effect of atoms buffeting the pollen. First more of them hit it from the left and the

pollen moved right. The next instant more atoms hit it from the top and moved the pollen grain down.

In the same way, noise traders trade stock with each other, moving the price one way one day, and then the other way the next day. If they start to herd, and move the stock way out of line then arbitrageurs step in and short the mispriced expensive stock and buy the improperly cheap stock. D.E. Shaw & Co., Renaissance Capital, Citadel, and Millennium Partners and others each trade about two percent of the daily NYSE volume with pair trading strategies to take the other side of these trades.

Irrational traders lose money and eventually disappear from the market. This is another mechanism that Milton Friedman posited would make the markets efficient.

### **We Are All Irrational**

Investors hold onto losers hoping that they will come back, and sell winners too soon fearing that their profit will turn into a loss. We do not update our evaluation of securities as Bayes' Theorem says that we should (see [www.bloomingtondalepartners.com/blog/articles/](http://www.bloomingtondalepartners.com/blog/articles/) for a full discussion of Bayes' Theorem in investing). We discount surprises (called conservatism), then when there is a short series of surprises in the same direction, we extrapolate earnings to the moon (representativeness heuristic). Witness Cisco's market value in late 1999.

### **Window Dressing and Closet Index Funds**

Not all market inefficiencies are due to investors' irrationality. Professional money managers contribute to market inefficiency too. Pension fund managers and mutual fund managers are measured against a benchmark,

*continued on page 7*

# Insight into the Future of Pension Risk Management

Toni L. Griffin

Plan sponsors for the largest U.S. defined benefit (DB) pension plans, which account for \$2.3 trillion in assets and cover nearly 42 million plan participants, report that they are focused on only a few risk factors associated with their pension plans. Many also report inconsistent success in addressing the risks they view as most important. These are two of the key findings from the *MetLife U.S. Pension Risk Behavior Index* (PRBI), recently released.

The first-of-its-kind study polled 168 corporate plan sponsors among the 1,000 largest U.S. defined benefit plans on 18 different risk factors identified by a panel of industry experts and researchers.

MetLife designed and fielded this study to encourage public dialogue around pension risk issues. The primary objective of the research is to help plan sponsors develop a new framework for understanding risks, and to explore solutions for mitigating risk exposure.

On an aggregate basis, the plan sponsors surveyed by MetLife ranked asset allocation, meeting return goals, and underfunding of liabilities as most important factors that are relatively easy to model and measure. The risks ranked least important by plan sponsors are slower to change, more difficult to model/measure and may be less well understood. Among them: longevity risk, mortality risk, and early retirement risk.

What is surprising about the ranking is not the order in which the risk factors appear; this is relatively consistent with the asset centric, total rate of return pension plan management model that has prevailed over the past 15 years. What is unexpected, however, is the range of importance among risk items. The top four risk factors received the vast majority of attention, while the bottom four items received nearly negligible readings. Asset allocation (the most

important attribute) was ranked most important 54 percent of the time, while 13 of the remaining 18 factors were picked as most important fewer than 30 percent of the time.

We believe that the results of this study will help increase awareness among pension plan sponsors about the need to take a more comprehensive view of the risks associated with today's pension plans, said Bill Mullaney, President of MetLife's Institutional Business division.

Looking separately at the responses of individual plan sponsors, the gap between most and least important risk factors is even greater. Only 26 percent of the individual respondents rated a majority of risk items (i.e., more than half) as important. Every respondent did not consider at least five of the 18 risk factors (assigning at least five an importance rating of 0.00 percent).

"This research suggests that many plan sponsors tend to view and manage risks individually rather than holistically," said Cynthia Mallett, Vice President of MetLife's Institutional Business. "Over time, the approach of focusing on some risks, and ignoring others, could have serious repercussions, including unnecessary volatility in earnings and/or cash flow with the potential to adversely affect the ability of the plans to provide retirement security to plan participants. During the next 12 to 24 months, we expect DB plans to develop a broader view of the risks to which their plans may be exposed as demographic forces, regulatory pressures and market volatility combine to make pension plan management more challenging and more transparent," said Mallett.

## Gap between Importance and Success Scores

In addition to measuring the relative importance of the 18 risk factors, the PRBI

*continued on page 4*



## Insight

continued from page 3

tracks how well plan sponsors report that they are managing each area of risk ( i.e., the study tracks aptitude as well as attitudes). Looking at these two measures together, the PRBI shows a significant gap between importance and success. Nearly two-thirds of the study respondents report some degree of inconsistency between importance and success, and about one of every six reports significantly greater discrepancies. Of the 18 risk factors studied, eight were given an above-average importance score but below-average success score or vice versa. Only two of the risk factors had the same ranking for importance and success.

“The research indicates that, for many plan sponsors, risk management is out of alignment. As a result, many plan sponsors may be missing the opportunity to manage the array of risk factors applicable to their plan as optimally as possible,” added Mallett. “Against this backdrop, the potential for incomplete decision-making could be significant. Today’s corporate plan sponsors should be encouraged more than ever to improve the processes by which they identify the full range of short- and long-term risks associated

with their plans, and the industry has an opportunity to focus on the importance of developing tools and protocols for managing these risks.”

### MetLife U.S. Pension Risk Behavior Index<sup>SM</sup> Score: A Baseline Measure with Room for Improvement

By comparing the consistency of plan sponsors’ rankings for importance and success, MetLife developed a PRBI score. The score takes into account the relative importance of each risk and the relative size of each retirement plan. The PRBI score is 76 out 100. This score establishes a baseline for risk management practices against which future changes may be measured.

“The PRBI score leaves significant room for improvement,” remarked Dev Clifford from Greenwich Associates and Richard Dunne from Bdelium, Inc., two researchers who collaborated with MetLife on the PRBI study. “It would be desirable to see every plan sponsor agreeing that they are addressing the risk factors that they believe are most important. While it is unrealistic to expect an index value of 100, a score in excess of 87 is both achievable and desirable.”

Dr. Susan Mangiero of Pension Governance, Inc., who also collaborated with MetLife on the groundbreaking research, commented: “This research should broaden awareness among plan sponsors of risk factors outside their present comfort zone, thereby enabling them to have a more balanced understanding of their plan’s dynamics.” ●

*Toni L. Griffin is Director, Global Brand/Reputation, with the Institutional Business Group of MetLife.*

*Reprinted with permission from RiskCenter.com.*

KEEPING **I** CURRENT

### Translating the theoretical into the practical

Featuring editor  
Stephan R. Leimberg  
and his team of experts.

Quarterly audio  
subscription service  
available in CD or  
Podcast format.

**Limited time only** special  
pricing for new subscribers:  
\$89.00 (member)  
\$119.00 (nonmember)

To subscribe call  
800-392-6900 or go to  
[www.keepingcurrent.com](http://www.keepingcurrent.com)

# Basel Committee on Banking Supervision Announces Enhancements to the Basel II Capital Framework

*RiskCenter.com Basel Staff*

The Basel Committee on Banking Supervision last week issued a package of consultative documents to strengthen the Basel II capital framework. These enhancements are part of a broader effort the committee has undertaken to strengthen the regulation and supervision of internationally active banks in light of weaknesses revealed by the financial markets crisis.

Nout Wellink, Chairman of the Basel Committee and President of the Netherlands Bank, said that “the proposed enhancements will help ensure that the risks inherent in banks’ portfolios related to trading activities, securitizations and exposures to off-balance sheet vehicles are better reflected in minimum capital requirements, risk management practices and accompanying disclosures to the public.”

The proposed changes to capital requirements cover:

- Trading book exposures, including complex and illiquid credit products
- Certain complex securitizations in the banking book (e.g. so-called CDOs of ABS)
- Exposures to off-balance sheet vehicles (i.e. asset-backed commercial paper conduits)

The committee is also proposing standards to promote more rigorous supervision and risk management of risk concentrations, off-balance sheet exposures, securitizations and related reputation risks. Through the supervisory review process, the committee is promoting improvements to valuations of financial instruments, the management of funding liquidity risks and firm-wide stress testing practices.

In addition, the committee is proposing

enhanced disclosure requirements for securitizations and sponsorship of off-balance sheet vehicles, which should provide market participants with a better understanding of an institution’s overall risk profile.

The committee proposes that the capital requirements for the trading book be implemented in December 2010 while the other improvements, including those related to risk management and disclosures, be introduced by the end of 2009.

These proposed changes are part of the committee’s broader work program, as set out in its November 20, 2008 press release, to strengthen in a fundamental way bank capital adequacy, risk management and supervision. In particular, this includes assessing ways to mitigate procyclicality, for example, by promoting capital buffers above the regulatory minimum that can be drawn upon during periods of stress. These efforts are in support of the April 2008 recommendations of the Financial Stability Forum and the G20’s November 2008 action plan.

Wellink underscored that “the committee intends to coordinate and implement this work program in a manner that strengthens financial confidence and avoids aggravating current market conditions. It will not increase required global minimum capital ratios during periods of economic and financial stress. The committee notes that adequate capital buffers above the regulatory minimum are designed to absorb losses and support continued lending to the economy.” ●

*Reprinted with permission from RiskCenter.com.*



## eGroup Eavesdropping

*In a lively discussion on Modern Portfolio Theory on the Investment Management Section eGroup, Benjamin Baldwin III offered the following.*

Are the questions of Modern Portfolio Theory's relevance in guiding investment decisions, and keeping our clients' objectives in mind last year even adequate? Many suffered devastating losses regardless. It seems to me that MPT is very descriptive of much of our market experience, but perhaps not all of it. Perhaps keeping objectives in mind leads us to particular investment allocations that will "usually" or almost always work, but perhaps didn't, or did so far but won't if we see a repeat of last year.

I think economic theory is one of the closest relatives to this space and the differences in the theories of Classical Economic Principles and Keynesian Economics have yet to be settled. Now I'm a liberal arts major so forgive my simplicity here. Those two theories seem to be alternately effective in describing and proscribing appropriate actions for economies to grow and prosper, one during normal times and another during times of economic crisis. Should there be that sort of dichotomy in investment decision making also? I do note that the decision of when to switch, as it were, from classical principles to Keynesian and back is pretty fuzzy!

Are time and static asset allocation adequate? Do we need metrics for adjusting asset allocations that include increasing or decreasing likelihoods of "Black Swan" events, for someone's employment status, exposure to systemic risks, real asset risks, management risks, fraud risks, as well as the traditional purchasing power and "average volatility" risks that

most of our systems and practices are geared to plan with? Because all of these risks are obviously immeasurable (in terms of the future which is the only thing we can't know but can impact), is there simply a cash fudge factor we need to throw in for each of these factors? Would our clients tolerate, during the "salad" days, (when these fudge factors would be most important to put in), the drag on their lifestyles and performance that these factors would obviously apply? I think the sale of living benefits and guaranteed returns in annuities even in IRAs and qualified plans says there is a cost that people will accept. Of course I don't think that they provide the complete answer because I believe you increase the systemic risk to a client with each additional reliance on a financial asset guarantee.

Perhaps this is a good time for the Investment Management Section to really shine, as one of the very few places where financial advisors and representatives of all stripes can reside and discourse about the pragmatic ways that we can address portfolio risk and return with a very specific focus on the successful implementation or delivery thereof to clients in a way that increases their likelihood of financial success and their confidence in satisfaction with the providers of it along the way.

I have no doubt that we will recover from this disruption and probably with a great deal of market energy at some point, but I think it is valuable to study at length ways in which we might be able to reduce the cost of enduring it.

*Benjamin Baldwin III*

*To access the complete discussion, go to: <http://social.financialpro.org/financialpro/financialpro/eGroups/Default.aspx>.*

## Behavioral Finance

continued from page 2

often the S&P 500. They want to do better than the benchmark but they are afraid to stray too far from it. If they do much worse, they will lose their jobs. So they turn their funds into closet index funds.

At the end of the quarter, fund managers report their positions. It is embarrassing to hold a lot of losers and show the world, so fund managers will window-dress—sell their losers and buy winners just before reporting. This leads to a trading strategy described fully at [www.bloomingdalepartners.com/blog/articles/](http://www.bloomingdalepartners.com/blog/articles/).

### The Limits of Arbitrage

One of the key mechanisms to restore markets to rationality is arbitrageurs taking the other side of herding noise traders. Let's see if they can do their job.

Royal Dutch Petroleum and Shell Transport have the same cash flows and are one company. The stocks trade on different exchanges and often diverge as much as 35 percent from parity in price. A 30 percent divergence in 1980 took four years to correct.

Often there is no true arbitrage, where the same security can be bought elsewhere at a different price and a risk-free profit made, if you can wait long enough. So arbitrageurs have to make due with close substitutes. If the two securities do not come back into line, but actually continue to move out of line, the arbitrageur loses money. Most of the time, the arbitrageur is managing money for others. If he continues to lose money, investors will pull out and he will be out of business. Remember Keynes' words "the market can remain irrational longer than you can remain solvent." ●

*Gil Kreiter worked for seven years at Millen-*

*nium Partners, now a large hedge fund, starting as a quantitative analyst for a currency trading group. After four years, that group disbanded and he traded baskets of stocks hedged by future contracts. In March 2003 Kreiter started Bloomingdale Partners, LP, an investment partnership which buys a particular type of high-return loan with very low risk.*

*Kreiter can be reached by email at [Gil@BloomingdalePartners.com](mailto:Gil@BloomingdalePartners.com) or by phone at 888-600-8886.*

**INVESTMENT MANAGEMENT** is published online four times a year by and for Investment Management Section members. This newsletter is designed to provide a forum for ideas and topics pertinent to investment management. Statements of fact or opinion are the responsibility of the authors and do not represent an opinion on the part of committee members, officers, individuals, or staff of the Society of Financial Service Professionals.

**EDITOR** Dr. Greg Filbeck, CFA, FRM, CAIA  
Penn State University  
5101 Jordan Road  
Erie, PA 16563  
814-898-6549  
[mgf11@psu.edu](mailto:mgf11@psu.edu)

**CHAIR** Keith G. Burck, CLU, ChFC, CFP  
Alerus Securities  
15 Broadway N.  
Fargo, ND 58102-4978  
701-280-5031  
[kburck@alerusmail.com](mailto:kburck@alerusmail.com)

**STAFF  
LIAISON** Bill Drennan  
Managing Editor, Sections Newsletters  
Society of FSP™  
610-526-2559  
[bdrennan@financialpro.org](mailto:bdrennan@financialpro.org)

Copyright © 2009 Society of FSP™  
17 Campus Blvd., Ste. 201  
Newtown Square, PA 19073-3230  
Tel: 610-526-2500 • Fax: 610-527-4010  
E-mail: [newsletters@financialpro.org](mailto:newsletters@financialpro.org)  
Web Site: [www.financialpro.org](http://www.financialpro.org)



17 Campus Blvd., Ste. 201  
Newtown Square, PA 19073-3230

Address Service Requested

Non-Profit Organization  
U.S. Postage  
**PAID**  
Permit No. 5  
Boyertown, PA 19512

## Member Get a Member Contest

A special membership growth campaign for all Chapters and individual FSP members to recruit new members (regular and associate) is underway. Our goal is to recruit 2,000 new members across the country by June 30, 2009.

Rewards for individuals include deductions from 2009-10 National Dues (up to 100 percent) based on the number of new members recruited.

Rewards for Chapters include a nationally subsidized continuing education program valued at \$10,000.

For additional information and contest rules visit:  
[www.financialpro.org/membership/mgam/index.cfm](http://www.financialpro.org/membership/mgam/index.cfm).

## IN THIS ISSUE

### INVESTMENT MANAGEMENT

MARCH 2009

**Behavioral Finance Says  
Markets Are Inefficient**

**Insight into the Future of  
Pension Risk Management**

**Basel Committee on  
Banking Supervision Announces  
Enhancements to the Basel II  
Capital Framework**

**eGroup Eavesdropping**