Setting a New Course: Institutional Investing After the Crisis

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As fears of a replay of depression-era economics begin to fade into memory, institutional investors have benefited from a sharp recovery across many financial markets. Rebounding markets have rewarded all types of investors, ranging from those who largely left their investments in place to those who opportunistically invested in depressed sectors. However, as institutional investors look ahead, the strong rebound of financial markets coupled with the prospects for a modest, and perhaps fragile, economic recovery is placing institutional investors in a difficult position to chart a course that will meet their needs over the next several years.

Many institutional investors have begun the process of comprehensively reviewing their investment strategies, managers, and processes to position their organizations for the long term. In light of this, we thought it would be helpful to share some observations on what is likely to be different about this planning process compared to ones in previous years. These observations are based on conversations we have had with our clients, as well as insights shared by senior investment officers within the various Prudential Investment Management businesses. While by no means inclusive of every issue, the following does capture many aspects of the environment in which institutional investors are operating today.

- **Franker conversations between CFOs and CIOs at companies sponsoring defined benefit (DB) plans.** The financial crisis and changes in accounting and funding regulations have made corporate finance executives and business leaders far more aware of the risks posed by DB plans and other benefit obligations. Many corporate plans are evaluating what risk they can truly bear in their DB plans in light of the risks posed by their core businesses such as revenues and profits that are highly sensitive to the broader economic environment. As a result, finance executives are working more closely with CIOs and other investment professionals to review the risk profile of DB plans and other benefit funding vehicles. In turn, CIOs will need to set realistic expectations with management teams for future returns for potentially more conservative investment portfolios and the resulting implications for contributions and pension expense. At the same time, while adopting less risk within portfolios can reduce volatility, it may not be a realistic option in the near-term for plans with significant funding shortfalls.

- **Greater focus on managing liquidity.** The sharp loss of liquidity at the height of the financial crisis, particularly across some asset classes that turned out to be far less liquid than expected, left many institutional investors scrambling to meet benefit payments and forced some to make inopportune investment decisions to increase liquidity. Going forward, plans will need to manage their portfolios much more carefully to ensure sufficient liquidity at all times, particularly during stress scenarios, which may impact the allocations to illiquid investments such as private equity. Plans may also have to consider a larger strategic allocation to cash, rather than counting on the sale of presumably liquid investments to meet short-term obligations. Finally, concerns about liquidity are altering the investment approach of managers of alternative products as investors renegotiate terms to gain greater access to their assets going forward.

- **Importance of keeping an eye on the destination.** The funded status of many corporate plans is certain to improve substantially in the near future either because of market performance or increased required contributions. The question for plan sponsors is what steps they will take to protect their funded status when it approaches 100%. Few plans are likely to take the same level of risk that they did in the past at this funding level. Investment committees may need to prepare to take the appropriate actions to reduce risk when funding levels improve significantly. Investment committees may also need to put in place the policies and processes that would enable plans to react more quickly to temporary market conditions, such as sharp swings in interest rates, which could provide attractive, but short-lived, opportunities to hedge liabilities.

- **Early look at new approaches at some public plans.** Public plans have far greater flexibility in funding their plans than corporate plans that must quickly address funding shortfalls through increased contributions. As a result, many public plans have not fundamentally altered their investment strategy and approach over the last year. However, similar to corporations, public entities face the challenge that aggressively invested plan portfolios are almost certain to suffer at the same time that revenues fall sharply due to a slowdown in economic activity. Underfunded public entities without mandated caps on changes in contribution rates must often choose between raising taxes and reducing public services to meet funding shortfalls. This raises the question of whether public plans should continue to manage pension portfolios primarily to maximize long-term returns, or whether plans should gradually shift to portfolios that better protect funding status during future economic downturns. Public plans may also need to revisit long-term return assumptions, which can materially impact contributions and investment strategy.

- **Importance of evaluating new risk management approaches.** Institutional investors have been aggressively and appropriately strengthening risk management processes in the wake of the financial crisis, particularly to better protect against tail-risk scenarios. Investors are systematically evaluating a more diverse set of risks within their portfolios and conducting thorough stress case analyses based on these new assumptions. Managers are being asked to provide far greater transparency into their investments and processes to enable institutional investors to assess the risks inherent in various strategies and to have a deeper understanding of risk across their entire portfolio. Finally, in addition to efforts to comprehensively identify and measure risk, investors are also considering implementing a range of derivative or insurance-based strategies to reduce risk.

Investment Outlook

Of course, institutional investors are balancing a focus on long-term planning with near-term investment decision-making. Though not exhaustive, the following are some of our perspectives across financial markets for investors as they enter 2010.

- **Equities are positioned to deliver attractive long-term returns.** Even after rebounding strongly from lows reached in March, domestic equity markets are still at valuation levels that roughly match their historical averages. As a result, today's domestic equity markets provide more favorable investment opportunities than have existed for most of the last decade, when valuations were far higher. Based on relative valuation, returns over the next five to ten years can be expected to be close to historical averages, though near-term returns will be less certain given the expected slower growth of the U.S. economy. For investors who are comfortable with the higher volatility of emerging markets, the long-term outlook is better than U.S. equities, driven by stronger fundamentals in these economies.

- **The short-term outlook for equities is much more mixed.** Current valuation levels and the likelihood of a mild recovery make the short-term outlook for equities far more uncertain. Cost-cutting and inventory restocking may boost earnings and stock prices; at the same time, a sagging recovery may limit gains or trigger a correction. Any correction will probably be more severe in emerging markets, particularly given the higher relative valuations achieved in these markets during the recent rebound. The best protection for equity investors in this environment will be to focus on the highest quality companies that have strengthened their competitive position during the downturn and that have minimal external financing needs, in case capital markets tighten again. The likelihood of a smaller set of "winners" in this economic environment than in the past may provide an advantage to active managers. Recent widening in the dispersion of performance between the best performing and worst performing groups of stocks is another indication that this environment may favor active equity investors of all types, whether fundamental or quantitative.

- **Despite recent appreciation, there are select opportunities within public fixed income.** Institutional and other investors continue to steadily direct assets towards fixed income, and, in response, spreads across all products have narrowed significantly. This trend is unlikely to reverse given the significant amounts of cash residing in money market funds earning negligible yields. In particular, select long-term high quality corporate credit opportunities should remain attractive, in part simply because a growing number of DB plans are likely to increase

their allocations to such securities to partially hedge benefit liabilities. Senior high quality structured products also offer attractive yields despite continued credit challenges. Underpinning the positive outlook for many fixed income securities is the muted forecast for near-term inflation given the vast amounts of unused productive capacity in most developed economies.

- **The light at the end of the tunnel for real estate is approaching, but still some distance away.** While continued uncertainty clouds the outlook for real estate investing, evidence is building that we are reaching the bottom of the cycle. Although spreads have tightened considerably across residential mortgage-backed securities, the outlook for these securities remains uncertain since it is unclear what will happen when and if the government unwinds its extensive support of this sector. New origination and securitization of commercial mortgages stopped in 2007 and is yet to restart, leaving many properties with limited options to refinance loans coming due. The cumulative gap between available and needed commercial mortgage refinancing through 2011 is expected to be substantial. This environment will create attractive opportunities for lenders who can carefully choose properties, negotiate favorable terms, and secure senior positions. However, attractive distressed lending and buying opportunities will be more difficult to come by than one might expect as banks proactively renegotiate loans for many financially challenged properties with reasonably secure income streams. Equity investors can benefit from already sharply reduced asset prices that will persist for some time because of growing vacancy rates and the expected slow growth in employment. Investors should act carefully during the bottoming process, as property prices may continue to decline during the first half of 2010. Investors also need to carefully target the most attractive geographies and property types. For example, growth in new households and tighter residential mortgage underwriting standards bode favorably for multi-family rental housing. However, office and hotel properties are likely to perform weakly until the recovery is further along.

- **Private placement lending has been resilient.** As with past recessions, the financial crisis has demonstrated the attractiveness of private placement lending for institutional investors. Private commercial loans and bonds have historically performed well during recessions, in large part because lenders had put in place loan covenants that allowed them to quickly react to, address, and, in many cases, receive compensation or favorable positioning with a borrower facing credit deterioration. In addition, during the height of the financial crisis, the traditional disadvantage attributed to private placement lending, i.e., lack of liquidity, became less of a relative disadvantage, as many public fixed income investments were illiquid. While issuers of private debt represent a relatively narrow part of the capital markets, they offer investors the benefit of further issuer diversification in addition to the opportunity to earn higher returns than other credit investments of similar risk.

The financial crisis has fundamentally, and potentially permanently, impacted institutional investors' approaches and strategies. Institutional investing is entering a new, more complex phase where considerations such as protecting funded status and maintaining sufficient liquidity are going to play a much larger role in investment decision-making. The challenge will be to balance these considerations with the need to retain sufficient flexibility to react appropriately to the opportunities across markets.

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