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Investment Income: Revenue Enhancement for Pension Plan, Foundation & Endowment Investors

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The Demand for More Income

Most liability-driven institutional investors are in a difficult position these days. Pension plans are faced with challenging regulatory and market conditions in the form of increased funding obligations. These reflect actuarial calculations that integrate regulations, assumptions, historical investment returns and expectations and projections for future investment results.

In a similar way, mission-driven, long-term investors such as foundations, endowments, building funds and other tax-qualified investment accounts must align their assets (short or long term) with their liabilities (minimum disbursement requirements, contractual commitments and program funding to fulfill their mission).

Whether funding a future retirement check for workers, providing tuition support for seminary students, delivering healthcare or meals for the homeless, the staff, trustees and managers of these asset pools are severely challenged.

There are three basic reasons:

1. They Pay Too Much

Various data generated from academic and commercial research has consistently shown that smaller investors underperform larger investors in both risk taken and returns generated. One of the biggest factors is that they pay fees significantly higher than their larger peers.

2. They Take Too Much Risk (or the Wrong Risks)

Many small and mid-market pension, foundation and endowment plans are served by vendors (insurance companies, banks, asset managers) that may not present the organization with a full or fair range of options. Often the staff and board members of the organization try to build investment policies and then implement them on their own. Finally, brokers, advisors or consultants may support the organization with information, advice, etc. to invest and manage the portfolio.

Inappropriate investment and asset allocation policies are often the result. The risk/return equation can only be maximized if the investor is well-informed, well-equipped and well-served by its advisor.

3. They Lack Access

Many small and mid-market institutional investors (and their advisors) are not aware of or able to access more sophisticated and easy to implement investment solutions. Enhanced strategies that produce increased incremental income, greater potential for growth and enhanced preservation or protection of principal are available with a little effort, expense and decision risk.

One Example

A well-recognized and proven strategy for investors is a buy-write strategy that involves the "overlay" of an option management program "on top" of an existing portfolio of equities such as the S&P 500 Index.

By selling (writing) options that allow the buyer to purchase the underlying securities at points well above the current market, the pension or foundation can realize an additional income stream from the options sold. Basically, they give up a portion of the portfolio's potential excess return above a given, predetermined point.

The Bottom Line

Would you give up any excess return on your index portfolio (say beyond +25%) in the next 12 months) in return for an additional income of 2% (net of management fees) on the portfolio? Many institutional investors have found this strategy to be valuable in meeting their corporate retirement and mission-driven investment objectives.

Next Month: More on Investment Revenue Enhancement

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