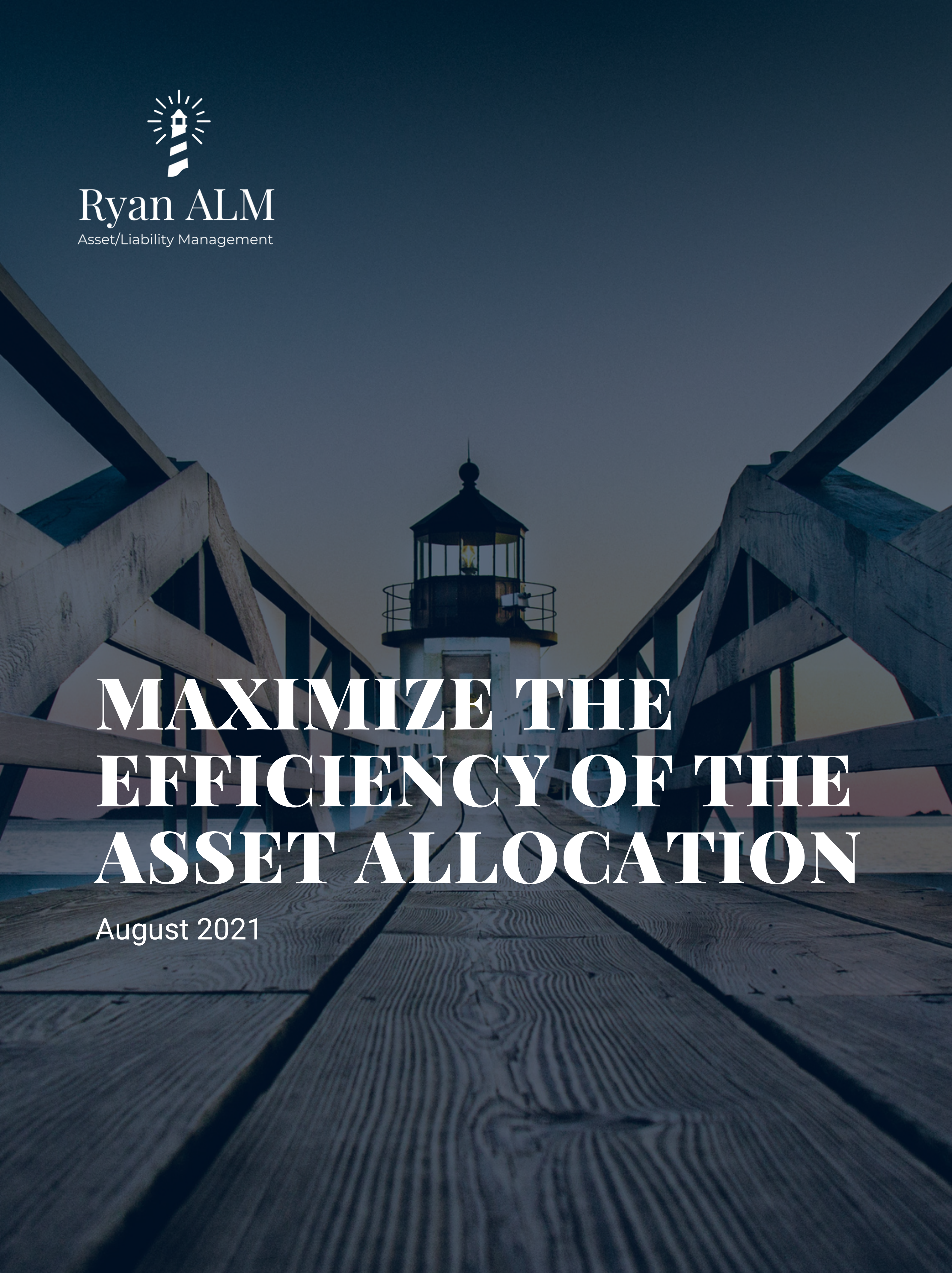
Ryan ALM
Asset/Liability Management



MAXIMIZE THE EFFICIENCY OF THE ASSET ALLOCATION

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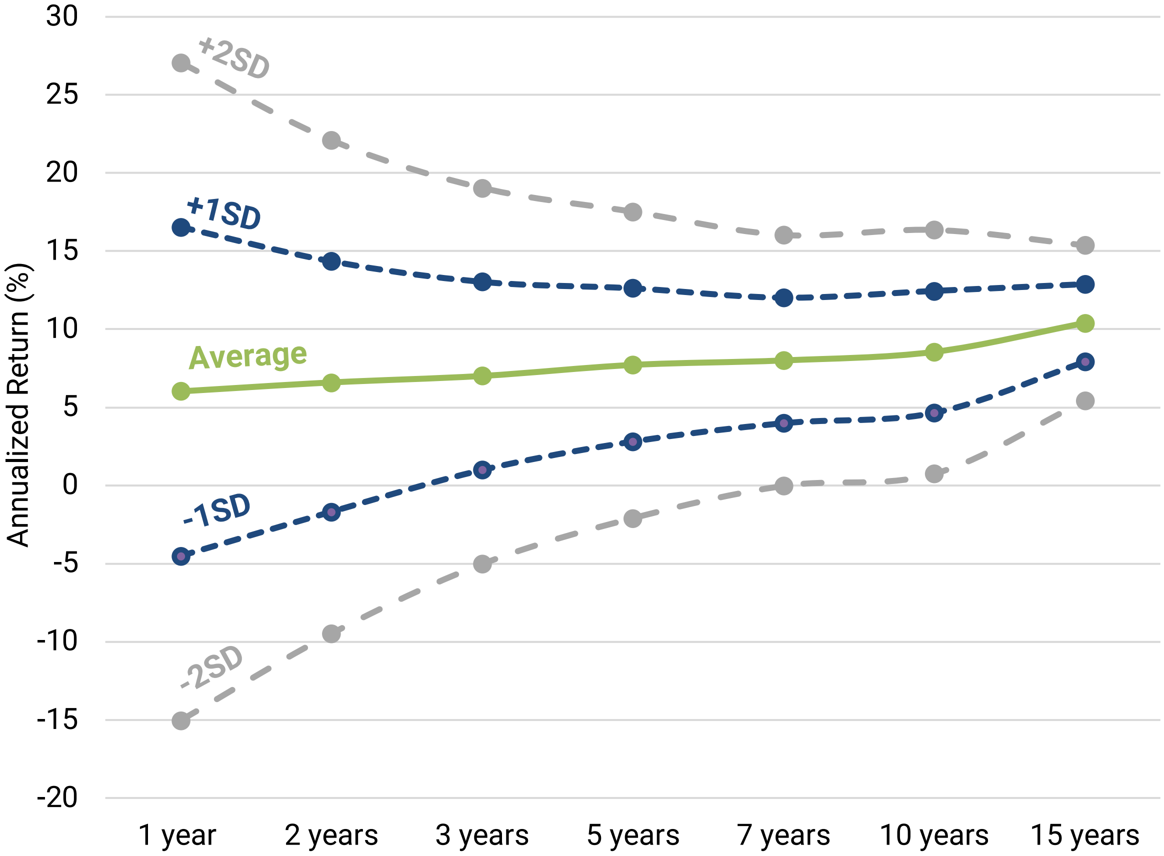
Maximize the Efficiency of the Asset Allocation

Russell Kamp, Managing Director

There is a lot of volatility in a normal asset allocation in short time frames. We've seen this unfold dramatically in a number of cases during the last couple of decades. At Ryan ALM we are guiding pension clients to adopt a cash flow driven investing approach (CDI) that can significantly reduce the volatility associated with a traditional asset allocation.

Buy More Time

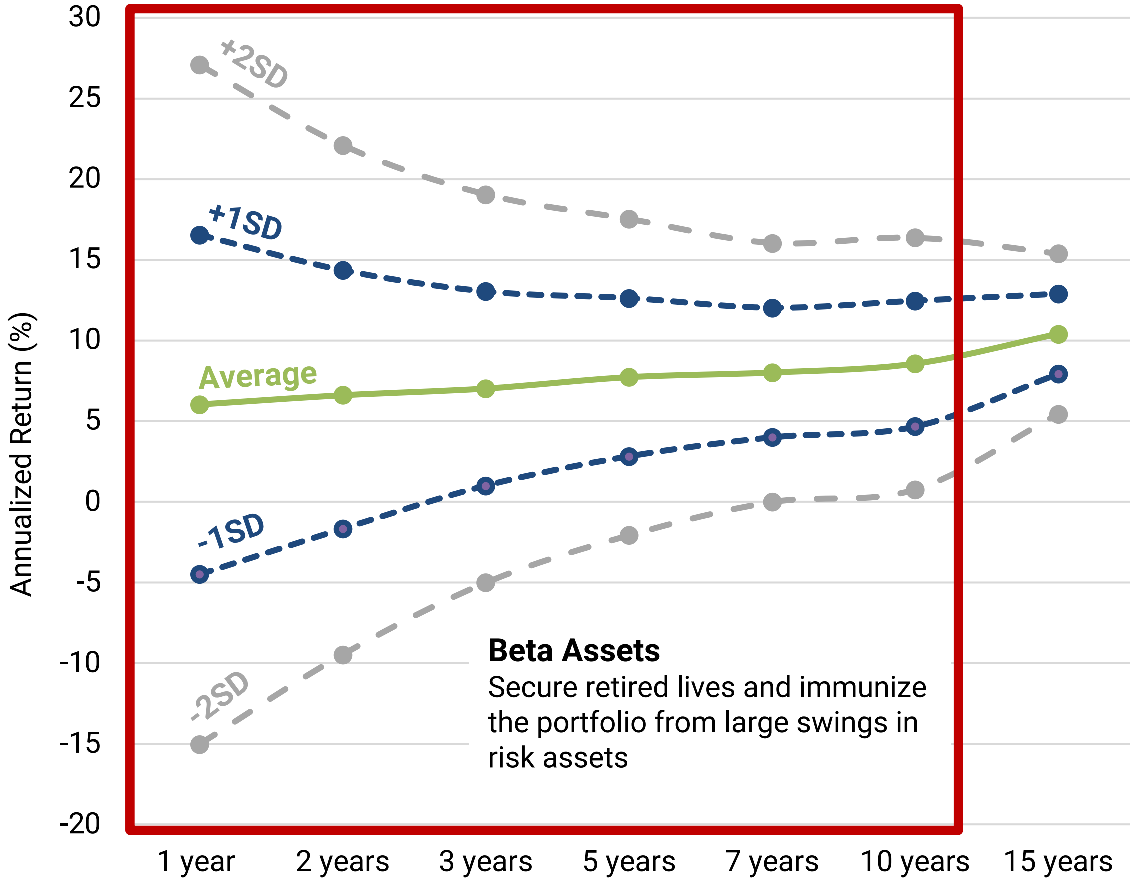


Source: Ryan ALM, Inc.

As the graph above reflects, the Ryan ALM asset allocation (5% cash, 5% international equities, 55% domestic equities, and 35% bonds) has produced an average 1-year return for the last 20 years (monthly moving average) of 6.03% with a 1 standard deviation (68% of the observations) of +/- 10.5%. A 2 SD observation would have that average 6% return showing a 95% confidence band of +27% to -14%. You can drive a couple of semis through that gaping hole!

I suspect that no plan sponsor would ever tolerate hearing their consultant remark that **"your fund was down 12.5% during the last 12-months, but don't worry, as it isn't statistically significant"**. Our primary goal is to get plan sponsors securing the promised benefits net of contributions for the next 10 years. If we can use the current bond and cash allocation to accomplish this objective, we can significantly reduce the volatility inherent in this traditional asset allocation.

Beta Assets

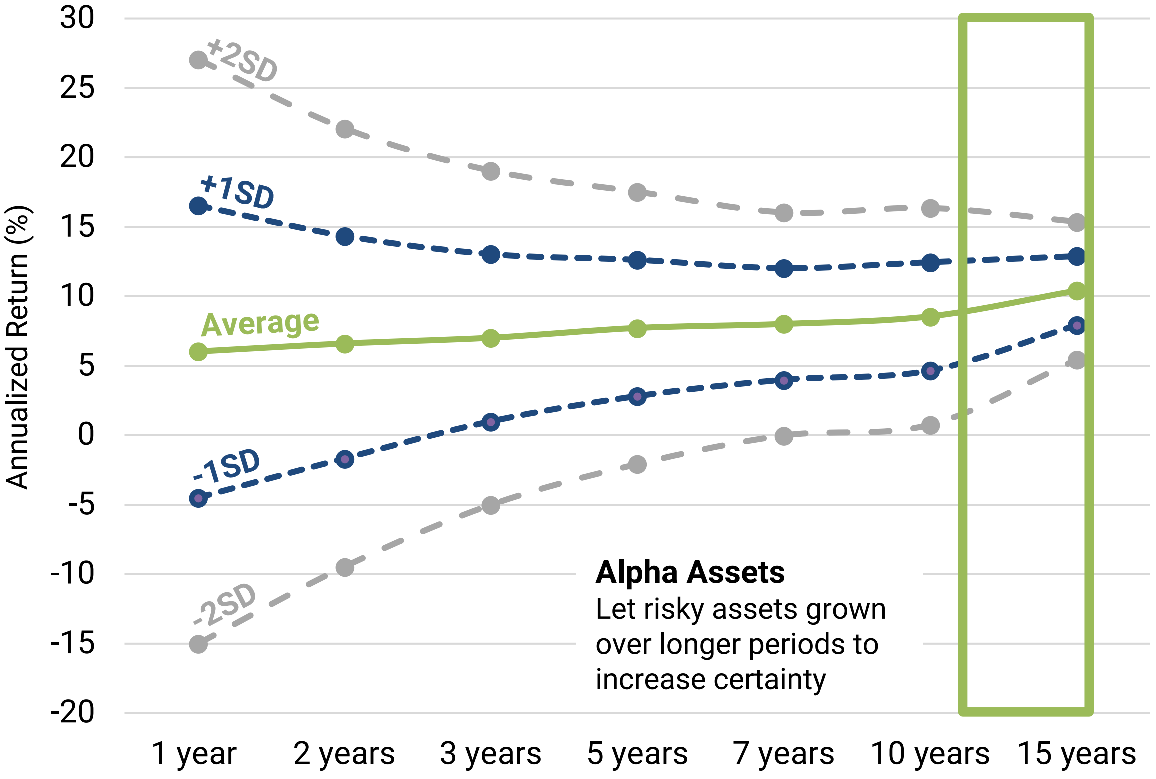


Source: Ryan ALM, Inc.

As the chart above highlights, by separating the assets into two buckets – beta (the red square) and alpha, we can secure the promised benefits through a CDI implementation that extends the investing horizon for the alpha assets that now have time to grow unencumbered. In a traditional asset allocation, all assets are on hand to fund benefits net of contributions. During periods of market turmoil, liquidity may not be as abundant as usual and often assets are sold at less than ideal times. This forced selling exacerbates the underperformance experienced by the fund.

As you also see by the graph above, extending the investing horizon has substantially lessened the volatility through time. Where a 1-year period had a 1 SD observation of +/-10.5%, a 1 SD observation for the 10-year period is only +/-3.9%, which significantly enhances the probability of success for the plan. In our asset allocation example, the average 10-year return during the last 20 years was 8.55%. Thus, a 2 SD observation of the results would have a 95% confidence band of 0.75% to 15.35%: far more tolerable than living with the volatility of a 1-year horizon.

Alpha Assets



Source: Ryan ALM, Inc.

The alpha assets (highlighted by the green box) that presumably have a liquidity premium associated with them now have the time necessary to grow without being disturbed. Furthermore, the alpha bucket can invest in all sorts of assets other than traditional fixed income assets that are too highly correlated to plan liabilities. This process should result in much more stable contribution expenses and funded ratios. As the plan moves through time, it is highly recommended that the sponsor and their consultant contribute the necessary amount to keep the beta bucket defeasing the next 10-years of plan liabilities.

As we move through this incredible period for markets many participants are naturally worried that their promised benefits may be at risk. For those plans that have adopted a CDI approach such as ours, sponsors can safely tell their participants not to worry as their promised benefits are secured for the next 10-years. Furthermore, plans don’t have to worry about raising liquidity to meet those net benefit payments, as the cash flow from the CDI portfolio will be there every month to meet the next month’s payments. Don’t you think that your participants want to hear such a message?

Ryan ALM's mission is to solve liability driven problems through low cost, low risk solutions.

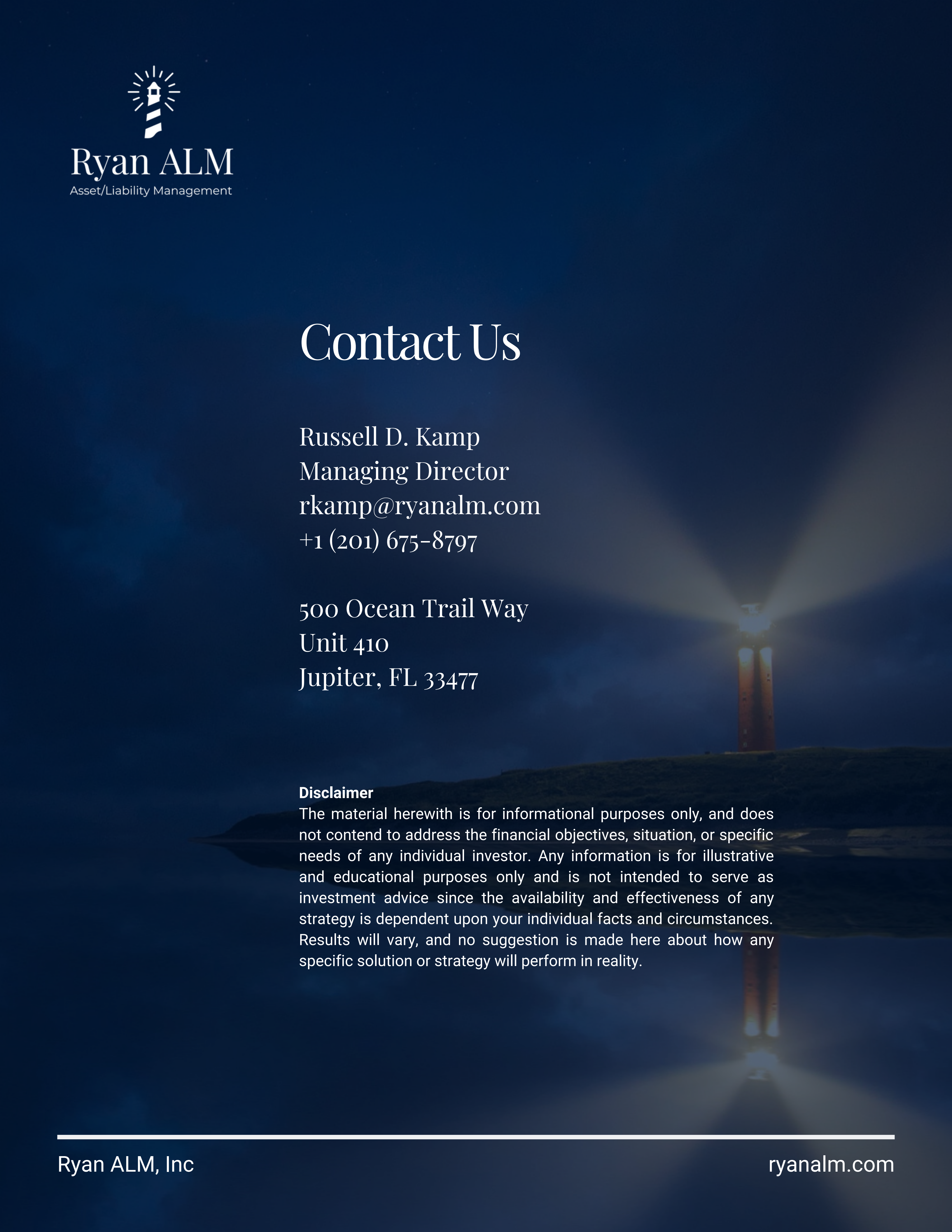
About Ryan ALM, Inc.

Ryan ALM was founded by Ronald J. Ryan, CFA on July 12, 2004 as an Asset/Liability Management firm. The firm builds a turnkey system of proprietary synergistic products designed to measure liabilities as a Custom Liability Index (CLI) and manage assets to the CLI as Liability Beta Portfolios.

Ryan ALM is unique in having its own proprietary Index company named ALM Research Solutions, LLC. This company builds both custom and generic bond indexes. Such indexes range from Custom Liability Indexes to ETF Indexes.

Our Liability Beta Portfolio™ is our proprietary cost optimization model that "cash flow matches" clients projected liability benefit payment schedules at the least cost using investment grade bonds. It is back-tested since 2009 showing a consistent cost savings of 8% to 15% or more. Our LBP best represents the core portfolio of a pension plan.

Our team has been recognized for our expertise and results including Ron Ryan having won the William F. Sharpe Index Lifetime Achievement Award.



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