



Over the next decade, the most successful pension fund investors are likely to apply a more dynamic (but still long-term) approach to investment strategy. This can apply to de-risking over time – that is allocating from equities to bonds – when the relative pricing is favourable. It can also apply to taking opportunities to acquire long-term investments at attractive prices, and it can involve selling long-term investments if prices are unattractive (as all investments have a price at which they no longer fit into a strategy).

Does a more dynamic approach to investment strategy really add value?



Determining long-term value

If you believe that long-term risk/return premia change through time – that is there are times when asset classes are extremely cheap and offer high prospective returns and vice versa – then an investment strategy that changes in the light of significantly shifting market conditions may be in the best interests of investors. For example, the long-term returns from equities can vary markedly, which means equities are genuinely risky – even for long-term investors.

Any dynamic asset allocation approach that seeks to get the best from a wide opportunity set of assets and improve portfolio returns, requires an assessment of current market prices relative to their long-term fundamental value. This requires a thorough understanding of long-run valuation measures and the fundamental drivers of markets. Keeping with our equity example, we can show, somewhat crudely, that the long-term expected real return from equities tends to be high when starting trend Price/Earnings (P/E) (a traditional long-run valuation metric) is low and vice versa.

Effective implementation

We believe, in principle, that a more dynamic approach to investment strategy will provide significant value for most pension funds. Such an approach should

be most beneficial if it is focused on identifying those market opportunities in which pension funds have an edge. For example, pension funds have a long time horizon and are therefore natural takers of illiquidity premia. However, we need to consider whether this can be achieved in practice. Few pension funds are currently able to apply their long-term investment principles and still act quickly – that is, use

their market understanding to identify and exploit good long-run investments that are available at attractive prices for relatively short periods. One solution to this is to adopt a disciplined process that uses a pre-specified set of market or economic conditions (for example, long-run valuation measures) under which a fund makes a change and sets up a framework for acting on this pre-agreed decision.

Figure 1 | Long-run US equity valuation



Source: AQR, GFD, Watson Wyatt

Figure 2 | The relationship between equity valuations and long-term stock returns

(Jan. 1927–current) P/E Range		Real stock market return in the next 10 years (1927–2007)			Next 1 year (1927–2004)	
Low	High	Median (Annual)	Worst (Total)	Best (Total)	Best (Total)	
5.2	10.1	10.86%	41.69%	465.25%	179.08%	
10.1	11.9	10.78%	32.60%	373.97%	83.04%	
11.9	14.6	9.96%	4.31%	314.13%	57.00%	
14.6	17.2	7.25%	–31.73%	353.31%	47.28%	
17.2	19.9	5.52%	–29.75%	299.19%	53.92%	
19.9	31.7	0.72%	–35.71%	137.15%	55.23%	
31.7	46.1	BEWARE!				

Source: AQR Watson Wyatt