When pension fund trustees are confronted with events they never imagined—so-called black swans—they need to be nimble. The turbulent and erratic economy is likely to continue to throw challenges at them.

by George M. Kraw, CEBS
Pension Funds—

Trustees know from the painful experiences of the past five years that economic change can come quickly, in unexpected ways.

The current challenges to multiemployer pension plans are especially frustrating for trustees who did all the “right” things before the market crash in 2008: diversifying portfolios, maintaining relatively conservative investment assumption rates of returns and following consultants’ recommendations about additional funding needs. As a plan lawyer and occasional trustee, it is a frustration I share. Recognizing the seriousness of the difficulties facing pension plans and developing strategies to address them are the first steps to fixing the problem. How to deal with difficult events in a turbulent, erratic economy will be the chief challenge for fund trustees going forward. Persistently high unemployment, artificially low interest rates, continuing difficulties in Europe, a slowdown in China and a decline in the number of union members in the U.S. private sector create investment, industry and institutional challenges for all Taft-Hartley pension plans. Down the road, inflation, problems with the dollar abroad that affect the economy at home, and regulatory changes that arrive with unintended consequences are all possibilities.

But random, unforeseen events may also determine success or failure for individual plan strategies. There is no computer simulation that could accurately predict 9/11 or the stock market crash of 2008. Financial fraud will occur so long as there are financial markets, but specific actors such as Enron or Madoff are impossible to foretell. Whether a particular scenario will arise and how it will then play out are beyond the ability of any professional manager to predict.

Hedge fund manager and academic Nicholas Taleb has written two books on the oversized effect of random events on investment returns. The second, more famous one, The Black Swan, takes its name from the European discovery of black swans in Australia in the late 17th century. Before the discovery, Europeans believed that black swans did not exist and they had no reason to believe that such swans would ever be discovered. Taleb used this example of an unexpected, unforeseen event to begin a reflection on the effects of randomness and complacency on success or failure. Among other things, this line of thinking sees black swan events as inevitable, just not easily predictable. The theory eventually arrives at a dim view of the ability of individuals to outthink the investment markets over the long term, a conclusion that made Taleb an outlier on Wall Street.

Taleb’s theory has three key points of interest for pension trustees:

1. Rare events have a large role in investment and enterprise success and failure.
2. Such events are difficult to predict, difficult to deal with and occur more frequently than is commonly believed.
3. Most people are blind to the risks these black swan events pose and continue with strategies that have worked in the past, but may not in the future.

The year 2008 and its aftermath drove home the difficulties of planning for the unpredictable. Trustees were not alone in their inability to foresee and manage events. Throughout the year, a series of financial blows, each increasingly harmful, struck the economy. In retrospect, the investment bank collapses, the failure of major mortgage lenders, the rolling stock market crash and the subsequent heart attack of the American economy seem inevitable. But it was not readily apparent...
to most observers or participants at the time. Some nimble, or lucky, investors made large amounts of money. Many more stood frozen, unable or unwilling to act.

In June 2008 at a financial conference in New York, I sat by the confident head of Chrysler, who chatted serenely about his company’s current operations and prospects. Less than a year later, the company was in bankruptcy and he was out of a job. Executives who spoke at the conference included the heads of Merrill Lynch, J.P. Morgan, BlackRock and Pepsi. While uniformly guarded in their outlooks, no one expressed serious concerns. Despite provocative moderators and the unspoken consensus that the wheels were about to come off of Lehman, there was no sense of urgency. No one was willing publicly to accept, much less predict, the possibility of the deep and long-lasting financial crisis that would follow a few months later when Lehman finally collapsed. In retrospect, this appeared to be not a matter of keeping up appearances and good poker faces, but an honest confusion about where the economy was heading.

If the best and brightest of U.S. finance and business were unable to see clearly the awaiting September disaster in June 2008, what are the trustees who oversee Taft-Hartley pension plans to do?

The difficult past decade of diminished investment returns and a stutter-step economy have made plans even more at risk to surprises. Pension plans generally approach the future with eyes fixed in the rearview mirror, expecting recessions and market crashes to be anomalies that work themselves out over the long run. That approach works well only as long as the present mimics the past. There are various issues involved in addressing random events that disrupt plan strategies. In the meantime, some factors to consider are:

- Conservatively financed plans have a better chance of surviving unexpected, negative events.
- A fund’s risk is directly related to the investment assumption rates driving its investment strategies; the higher the rate, the more risk the fund must accept and the more vulnerable it is to unforeseen events.
- The fund’s professional advisors are often closely aligned with past practices and strategies, which is fine when those practices are successful, less so when they are not.
- Boards of trustees themselves may not have the necessary knowledge or experience to deal with unexpected events.

When investment advisors in the wake of the 2008 crash speak of a new normal, it sounds disturbingly like the

**takeaways >>**

- Difficult events will continue to occur in a turbulent, erratic global economy, and fund trustees will have to deal with them.
- Most people don’t see the risks that random, unforeseen events can have. The strategies they have relied on in the past may no longer work.
- While nimble and lucky investors made money when the market dropped in 2009, others were unwilling to act.
- Pension plans are challenged with remaining solvent in an environment where low interest rates are pushing many plans to add riskier investments.
- Trustees need to understand the problems their plans face and the reports from plan professionals.
- The board may need to be expanded to add trustees with special expertise and insight.
“bad normal” of the 1930s, with high levels of unemployment, anemic growth rates and the risk of labor and social strife. But few were positing such a scenario in 2007, and pension plans at the time were not preparing for such an eventuality. I suspect that most of the advisors who thought carefully about such things anticipated nothing worse than the 1987 crash—and even saw that as unlikely—with the stock market and the economy recovering promptly.

Multiemployer pension funds especially have a long-term perspective and by their nature are conservative investors. Individual crafts, companies and industries wax and wane, the beneficiaries or victims of disruptive technologies and a changing economy. Union membership rates and plan demographics also are important factors. But while the funds can aspire to a 100-year outlook balancing all these factors, the more immediate problem may be a random event like the unforeseen 2008 stock market crash, the withdrawal of a key employer or an extended economic downturn.

Today, the hope is that government policies will eventually lead to economic growth, increase employment and provide the fundamental requirements for economic stability that are necessary for pension funds to prosper. This may or may not work out as planned, but for pension plans the more immediate challenge is remaining solvent in an environment where low interest rates are pushing many plans to add riskier investments that they would never consider in quieter, more complacent times. Traditional plan investment strategies (such as a portfolio of public equities and fixed income investments) may have left money on the table. But risk and volatility were clearer and returns were transparent. In these more difficult times, plans are being pushed by advisors and circumstances to adopt different strategies generally involving more private equity, where the operations are more complex, the responsibilities of the investment manager more opaque—and the plans more at risk to unforeseen events.

More than a decade ago, Andrew Grove, the then-CEO of Intel, wrote a book on business entitled Only the Paranoid Survive: How to Exploit the Crisis Points That Challenge Every Company. The exaggeration in the title neatly encapsulated Grove’s view that enterprises have to be ready for anything. Pension plans do not have the luxury of companies or industries to take a mulligan and restructure and reinvent themselves when unexpected events put them at financial risk. By definition the plans must be survivors to fulfill their mission. Paranoia and fear are not characteristics plan sponsors look for in trustees. But complacency—especially in unquestioned reliance on current advisors—has its own risks.

So what can trustees do when faced with unexpected challenges of events they may not have remotely imagined? The facts and circumstances of individual funds will determine what actions are appropriate for that particular pension plan, but four general rules apply.

1. As a trustee, make sure that you understand the problems your plan faces.
2. Demand reports from plan professionals that all trustees can understand.
3. Keep in mind that the interests of plans and their professionals may diverge at times of financial or operational stress, and act accordingly.
4. When appropriate, look to expand the board to bring on additional trustees who can provide special expertise and insight that current members may lack.

The conventional wisdom that today’s problems and rough spots will smooth out over time is a plausible scenario. But the more likely one is that as long as the United States and world economy remain unstable, pension plans will continue to confront frequent, unpredictable events that benefit some, destroy others and make mischief with forecasts and strategies. Present circumstances and current trends toward consolidation have resulted in fewer defined benefit plans. The surviving plans likely will be the most nimble, in solid industries, with strong union participation—and also be ones that recognize the role of uncertainty and randomness.