



Commentary – How Long is Long-Term

Randall Dodd
Financial Analysis Division
Monetary and Capital Markets Department
IMF

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OVERVIEW

The study employs an extraordinarily deep and detailed database to try and answer a very important question. This includes detailed information on the portfolios of Chilean pension funds and mutual funds and also a set of US mutual funds for comparison.

Despite the largeness of the database – over 7.5 million securities and almost one-half million observations – the conclusions don't quite add up to a definitive policy prescription. How big is big enough? Why don't a zillion data points reach a definite conclusion?



Premise

- Longer is substantially better

Their conclusions:

Descriptive:

1. Chilean PF surprisingly short-term – even by comparison to MF and US's MF

Analysis:

1. Not a supply problem.
2. Not opportunistic, i.e. waiting for buying opportunities
3. Not expected redemptions
4. Problem with managerial incentives.
 - lack of market discipline
 - flaws in regulatory framework
 - compensation structure



Shortcomings with the data:

1. The data on Chilean PF does not include their use of derivatives and is not adjusted for structured securities. This can significantly reshape effective maturity of portfolio.
2. How are foreign assets treated in PF – they are mostly hedged by rolling over short-term OTC fx forwards in Chile. Is this treated as short-term or long-term? What of structured notes with variable yield?
3. Maturity vs Duration in Chilean data:
 - Why is long-term variable rate more long-term than rolling-over short-term instrument?
 - how much is adjustable or variable rate yield vs fixed?
 - Is the variable swapped into fixed or vice versa?
4. The data on fixed peso and fixed UF pesos is recognized but the implications are not analyzed.
5. Data on short-term US MF shows a significant portion of long-term notes and bonds. Could these merely be the appearance of lending through reverse repo in which the collateral used to secure the loan shows up on the balance sheet as these notes and bonds? If so this is NOT long-term investment – just collateral.



Shortcomings with their analysis:

1. Analysis needs to directly consider the implications of DB and DC pension fund liabilities. DB need to match assets to long-term liabilities. DC liabilities are not different than MF – i.e. there are no liabilities but only redemption risk from competition.
2. The economic factor that is known to be present but does not ‘bark’ in their analysis is the role of the yield curve. If fixed peso yield curve is flat, then why move out along it to compete for investors. The sharpe ratios you calculate show small risk adjusted gains. Why take risk without return?
3. Is long-term market liquid so as to facilitate MTM reporting?
4. The data on fixed peso and fixed UF pesos is recognized but the implications are not analyzed. The difference does show up in average maturity of PF portfolios.
5. Cash may not be used opportunistically but if inflows all occur at the same time, they may all be managing or smoothing their purchases – otherwise proprietary trades are getting ahead of them



Shortcomings with their analysis:

6. Regarding redemption – issue is not the percentage of existing portfolio that is being added, but rather share of float in securities that are being purchased – and the timing of those purchases by other investors.
7. Regarding supply problem – they are buying up 30% to 40% of long end of UF bonds and nominal central bank bonds – although much less of Tesoreria – and that is a large share.
8. Claim that foreign assets expose PF to currency risk – in fact the vast majority of that risk is being hedged through fx forwards. And there are some interest rate options and swaps that allow hedging of interest rate risk.
9. Look at changes in weights over time. Appendix Table 1 gets to some of this, but a more complete tabular breakdown off portfolio over time – in which risks have changed – would likely shed light on PF strategies. (It's done for '98 events only, and could be expanded.)



Shortcomings with conclusions:

1. But what about problems with investor perceptions and incentives?
2. But market's high front-end fees also sharply reduces competition – should these be abolished by change in regulation?)
3. Many of these markets and many of the financial institutions lacked prudential regulatory requirements for conducting their operations.
4. Do not compare with DB plans – conspicuous by its omission



Suggestions for improvement:

1. Need to interview PF managers, as well as MF managers, to inquire about their thinking on this issue. It may not be scientific, but very likely to be informative.
2. Get even more data, or at least more detail for the data in order to improve accuracy of maturity or duration measurement.
3. Compare with DB plans.