



Rudi Bogni

# Religion and Asset Management

So who shall we banish to the desert bearing the sins of the financial markets?

**W**hy do I risk blasphemy by linking religion and asset management? On one side I do so, because both address fundamental security needs of humankind, religion in the emotional sphere, asset management in the material sphere. On the other side I choose this parallel because both are about basics and I strongly believe that we need to go back to basics in an attempt to filter out all the background noise, of which the specialists produce volumes. Insiders perhaps do not deliberately intend to confuse us, but are nevertheless most successful at achieving opaqueness.

Religions are wonderful at building a mental order that focuses on the essentials. Give me the Ten Commandments any time, or at least some of them, and free me from the Justinian code, the Napoleonic laws, the FSA rulebook and the US securities legislation.

I long for the day when a sanctioned equity trader will bring his or her case to the European Court of Justice, on the basis that it is against natural law to expect any human being to perform a task which no human can; the memorization of all the laws and regulations covering the simple task of trading equities.

Religions and asset management have very



*And lo, immediately after did the mysterious disappearance of the village's grass cease, and so too the appearance of the strange raisin-like pellets that didn't taste like raisins ...*

compatible objectives and very similar hygienic precepts. Most religions aim to create enough capital of good deeds to save the soul of the believer for a radiant after-death existence, most main-stream asset managers, managing life assurance or pension funds, aim to accumulate enough future capital or annuities to ensure a dignified late stage of life for the beneficiaries.

Religions have rules to steer you away from the evil deeds that will lose you your soul, asset management has asset allocation to prevent you from gambling away your capital. In both cases empirical rules dominate thinking, and scientific evidence is occasionally brought on to reinforce the main case, but it is deemed a useful, but not essential foundation.

Such a state of affairs has collided, sometimes violently, with prevailing Western thought of the last century, strongly biased towards placing science at the core of beliefs and of policy making. It has collided straight on in totalitarian regimes, where optimism for the future of humanity could only be based on the potential of science to redeem the failures of the present. It has collided in a more nuanced way in Western democracies.

The rise of the new century however has seen the disillusioned masses attracted by the mantras of new small avant-gardes. The mantra of the New Jerusalem for the Christian fundamentalists, the mantra of the jihad for Muslim extremists, the mantra of hedge funds' and private equities' uncorrelation for the pension fund trustees.

There is something of the unavoidable in all this. People need simple beliefs to hang on to. Simple answers are a necessary staple for every day's psychological intake; questions are a luxury, a digestive for the psychically well fed or the adrenalin for the doubting minority. Science suffers from a terrible original sin: it provides answers which are often partial, not total, every answer throws up new questions and its practical applications are often disruptive before they become constructive.

Let me now consider the basics of fiduciary asset management, the function of capital accumulation performed on behalf of life assurers and pension funds trustees, unfettered by specialist or technical considerations, which in my view cloud the essential problems.

The core is an undertaking to pay a group of individuals, large enough to be statistically significant, a lump sum either at a pre-determined date in the future or at occurrence of a specific personal event, i.e. death. Alternatively a pre-determined annuity will be paid to one or more beneficiaries. When I say pre-determined I do not necessarily mean that the exact figure or the number of the annuities must be known upfront, but that it can be modeled using actuarial tools for all reasonable scenarios.

In contractual terms the member of such a group foregoes present individual purchasing power in exchange for a future claim, which he or she expects to be satisfied.

There is nothing so far, except perhaps prudence and experience, which says that such schemes, whether private or public, should be funded.

Indeed there is much of a free lunch argument

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that a government in charge of a country with high and indefinite expected population and economic growth should run unfunded schemes. There could even be a yet untested regulatory arbitrage argument that support for a private scheme could be in the form of a guarantee from a suitable vehicle in an unregulated territory.

If however we keep it simple and more acceptable to today's environment, a funded scheme will need to accumulate enough capital to meet the profile of its maturing liabilities year after year.

Would it not be wonderful therefore if accommodating governments were to issue matching financial instruments of investment grade rating, that is matching both in terms of maturity and of interest in relation respectively to the liabilities

and the desired rate of capital accumulation?

The more I read these days, the more I see hints, even from market observers, that this utopia is not only desirable, but it is just waiting to happen.

Little thought seems to go in to the fact that demographics have a different impact on assurers' and pension liabilities on one hand and budget deficits on the other; even less thought to the political constraints to growing long term budget deficit financing or to the fact that rates set by an expanded interest rate curve may not necessarily match required capital accumulation rates, as supply may not meet demand.

If utopia does not rule, then asset allocation does. Diversification ought to mean an improved level of return for a given level of risk, never mind the evidence that the positive impact of diversification is increasingly diluted. New asset classes ought to mean decreased correlation;

never mind evidence that when markets react to major undesirable events correlation rises or that claims to low correlation may be the fruit of different accounting and evaluation techniques, which are likely to change, or that the behavior of managers of different alternative classes may be converging at good speed.

Life could be really tough for our asset manager, if the future beneficiaries could take time out from choosing the latest 4WD or planning that holiday in the sunshine and ask some really probing questions.

Luckily he or she (the future beneficiary) has got those trustees and regulators to do the worrying for him or her. And here come the statutory capital requirements and the checklists to tick



## The multiplication of bread and fish was an once-in-a-lifetime symbolic occurrence, not a daily event



and the certifications to and from the auditors to sign and all the related mystical paraphernalia on which faith-based management is resting.

And if that was not enough, he or she has got the financial journalists worrying about how the state is going to afford all those increased liabilities with no-one willing to foot the bill, while at the same time leaving enough space for the establishment of those new private schemes that will transfer responsibility for future generations' dignity in old age from the public purse to the private individual.

The smarter ones have pointed out the fact that dignity will be assured by keeping up with wage development and cost of "life-style", not with cost-of-living, a measure smartly engineered by governments, whether of the right or of the left, to reflect the increased cost of keeping the lumpen-proletariat alive, but not necessarily happy.

This wholesale transferring of worrying from those directly concerned to some proxies reminds me of the practice in some Mediterranean villages of hiring unrelated widows to cry and scream, pulling their hair, for a dear departed. The choreography is fascinating; whether that helps the soul of the loved one it is matter of opinion.

I promised you I would stick to basics. The fundamental basic in my view is that developed economies demographically weakening, closed to immigration and with modest productivity increases will see asset managers bid up the price of available financial assets and bid up relatively even more those assets which come close to fitting their liability profile or that help in the optimization of regulatory capital modeling.

That would not be a problem if those same financial assets could sustain the required yield at the higher level.

But that might require an even higher level of faith than believing in life after death. After all it is true to no-one yet has returned to tell us that there is an after life, but no-one has come back to tell us that there isn't.

There are instead lots of people about to tell what happens to yields when financial assets val-

ues get inflated

The obvious alternative would be to consider the whole universe of financial assets, including those arising from developing countries with a higher rate of growth and productivity increase and possibly stronger demographics.

Just a series of small problems: are such assets available and freely accessible in large enough quantities? Are they of similar risk characteristics? More importantly has anyone taken a look at the demographic profile of China yet??

I suspect that we shall go on hoping and dreaming for a long time. Perhaps economic growth and productivity will miraculously pick up and solve our problem, perhaps demographics will alter drastically in less than generation; perhaps technology transfer from the developed to the developing world will trigger a new global economic miracle. Perhaps pigs will fly.

If not, something will have to give: the multiplication of bread and fish was an once-in-a-lifetime symbolic occurrence, not a daily event.

It is true that in a demographically weakening society one builds less new schools and, if lucky less new prisons, but one also builds more retirement homes and the cost of education per head increases, while that of health-care per head simply explodes.

Developed societies will have to choose between an expected high level of dignity and care in old age for the middle classes, which think they have paid for it and therefore legitimately earned it, and other imperatives, such as solidarity for the under-classes and the needy, who may not have any such claim. How such conflicting demands will be met will determine not only future social cohesion or lack thereof, but also the demand and supply of various asset classes and their price.

To demand that asset managers rely less on obsolescence-bound empirical rules and more on well-grounded research is fair; to demand that they multiply daily bread and fish is folly.

It may be good for temporizing politicians to pretend that they can do so and to set the regulators on them, when they fail in their attempts to do so.

It is however strangely akin to that construction of Old Testament religions: the scapegoat.