Institutional Asset Management

Module 2, 2017

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Course description

This course uses a mixture of cases, lectures, and class discussion to examine how money is managed by organizations such as university endowments, pension funds, mutual funds, hedge funds, private equity funds, and banks. The course involves a mixture of finance and economics. It emphasizes the incentives professional money managers face within the context of the organizational structure in which they operate.

The course touches on numerous public policy issues, many of which are politically controversial and most of which are likely to continue to be important for years to come. A goal of the course is to provide students with a framework within which these public policy issues can be addresses in a useful manner.

Course requirements, grading, and attendance policies

The course grade will be based on the following: participation in class, regular homework assignments, in-class tests, and a final exam. Homework will be assigned every week. There is no textbook.

Class participation: Class attendance and participation are required. Each class several related financial concepts or theories will be discussed; students should review what they learned about these topics in other courses.

Homework assignments: Each week two short topics or one long topic will be discussed. The cases will be distributed in course packages or can be purchased on-line: http://web.hbr.org/store/index.php (search for cases using their numbers). Students will have to read cases and do short write-ups for each case/each class (2-3 pages per topic). Students have to answer all questions marked with stars. NOTE: Many readings represent official reports and documents, some of them are very long; as in real life, there is no need to read them line by line, rather those documents can be skimmed through but more important parts must be read carefully.

Case write-ups should be succinct and self-contained. Long write-ups are not necessarily good write-ups. Good business writing makes points in a manner that respects the reader's time. Typically, the answers to questions will not be heavily mathematical, but mathematical intuition will often be required to address some of the questions. Hard copies of write-ups should be handed in at the beginning of class. Students have to submit at least 5 out of 7 assignments. If students submit all 7 assignments, then the best 5 are counted towards their final grade. Students should be prepared to discuss and defend the ideas in their write-ups in class. For some questions, there is no "right" or "wrong" answer, in the sense that finance and economics professors themselves are likely to disagree about the answers to the questions. Students may talk to other students about the assigned questions, but each student should prepare a write-up individually, without looking at the write-ups of other students. Each student should list on the write-up the names of the other students with whom the student discussed the write-up.

In-class Tests: At the beginning of each lecture (except the very first one), there will be short 5-minute tests with several questions about material of the previous lecture. A goal of these tests is to help students not to fall behind on the material and to keep track of attendance.

Final Exam: A final exam is in-class and closed book. One double-sided cheat-sheet is allowed.

Grading: Grading is based on case write-ups (20%), in-class tests (20%), class discussion (10%), and a final exam (50%). Missing class is strongly discouraged. Case write-ups are graded on a scale with the following interpretation: 0=missing, 1=okey, 2=good; 3=great.

Plan

The course will cover several topics:

1. Asset Management Industry. Index Funds: Vanguard
2. University Endowments: Yale
3. Insurance Companies: Warren Buffett and AIG
4. Mutual Funds, Hedge Funds, Private Equity Funds: LTCM
5. Pension Plans
6. States as Asset Managers. Credit Programs: U.S. vs Russia
7. States as Asset Managers. Sovereign Wealth Plans: Norway, Russia, and Libya

Course materials

Below are topics and questions that we will discuss in class. I reserve the right to change the syllabus as the course progresses.

The schedule of classes follows. “Required readings” should be completed before class. Students should come to class prepared to discuss required readings. “Optional readings” are materials students may want to read before class or after class, but they are not required. They may be the subject of class discussion, but the discussion should presume that not all students have read them. They may also be the subject for make-up assignments. The “bedtime readings” are completely optional and include books students may want to read in the future, after the course is finished. They are included for general interest.

<u>For week 1, students have to read the material for week 1 topic, and submit the first write-up onto my.nes.ru before the first lecture on Thursday, November 2.</u>

Methodology

Students are expected to read material before the class, submit write-ups on assigned questions, and participate in class discussions.

Sample of Questions

Label each of the following statements as TRUE, FALSE, or UNCERTAIN. For each statement, justify your answer with a few sentences or a brief paragraph.

(1) David Swensen likes to invest in hedge funds because hedge funds managers use sophisticated mathematical models to extract value from less sophisticated investors trading in liquid markets.

(2) Warren Buffetts and AIG's derivatives strategies were similar in that both firms conceptually sold disaster insurance, hoping that a disaster would not occur.

Academic integrity policy

Cheating, plagiarism, and any other violations of academic ethics at NES are not tolerated.

WEEK 1 (THURSDAY, NOVEMBER 2): ASSET MANAGEMENT INDUSTRY. INDEX FUNDS: VANGUARD

REQUIRED READING:

H**BS Case "The Vanguard Group, Inc. in 2006 and Target Retirement Funds"(#9-207-129)**

Shlomo Benartzi and Richard Thaler, "Heuristics and Biases in Retirement Savings Behavior", 2007, Journal of Economic Perspectives.

THEORY: Portfolio Optimization, Separation Theorem, the CAPM, and Behavior Finance.

OPTIONAL READING:

Zhiwu Chen, Peng Xiong, and Zhui Huang, "The Asset Management Industry in China", 2014, Journal of Portfolio Management.

VIDEO: Jack's Bogle interview, www.youtube.com/watch?v=byNIu6e7Sbs

Questions for Write-Up, based on Vanguard case (1-2 pages):

1. The "100-minus-age" rule says that a person saving for retirement should invest in equities a percentage of assets equal to 100 minus the saver's age. For example, the "100-minus-age" rule implies that a 30-year old investor should invest 70% of assets in stocks and 30% in bonds. How close do Vanguard's life cycle funds come to matching the 100-minus-age rule? Is Fidelity closer?

2. *When do index fund managers trade? When do life-style and life-cycle fund managers trade? Do such funds tend to stabilize or destabilize markets, i.e. do they tend to buy or sell when prices go down?

3. *Would index managers have any reasons to keep some of their funds in cash?

4. *According to Jack Bogle, is Vanguard's approach to investing on behalf of its customers an economically efficient way to organize saving for retirement

5. *Would Rich Thaler agree that Jack Bogle's solution to organization savings for retirement will solve all issues?

6. *What is the difference between index funds and ETFs? What are advantages of ETFs over index funds? Would Jack Bogle think that ETFs are good vehicles for retirement savings?

7. *When assets are moved from actively managed funds investing on behalf of defined benefit pension plans to passively managed index funds used in defined contribution plans, does this tend to stabilize or destabilize returns on individual stocks? Or on the market portfolio?

8. *When assets are moved from passively managed indexed mutual funds to ETFs, does this tend to stabilize or destabilize returns on individual stocks? On the market portfolio?

WEEK 2 (THURSDAY, NOVEMBER 9): UNIVERSITY ENDOWMENTS: YALE

REQUIRED READING:

“Yale University Investments Office: February 2015,” HBS Case #9-812-062 (rev February 11, 2015).

Форум доноров, 2014, “Целевой капитал: Как его создать и что нужно знать о функционировании данной модели”

THEORY: Market Efficiency, Liquidity.

OPTIONAL READING:

Harvard Management Company (2010), HBS Case #9-211-004

Екатерина Шекова, 2014, “Целевой капитал и его роль в финансировании организаций культуры в России и США”
Sabrina Willmer and Tom Moroney, “The Secretive Hedge Fund That’s Generating Huge Profits for Yale,” Bloomberg Business, February 4, 2016.

VIDEO: David Swensen’s lecture at Yale, www.youtube.com/watch?v=wRdx7kVNQ_E

Bedtime Reading:

David F. Swensen, Pioneering Portfolio Management: An Unconventional Approach to Institutional Investing, 2000.

David F. Swensen, Unconventional Success: A Fundamental Approach to Personal Investment, 2005.

Questions for Case Write-Up (3-5 pages):

You should read this case carefully, and then prepare a brief write-up (no more than 800 words) which addresses the following questions:

1. *How would David Swensen define the efficient market hypothesis?

2. Does he believe in market timing for stocks, bonds, private equity, real estate, oil and gas? What specific features of private equity make market timing difficult?

3. *Consider a choice between the following two different hedge funds: (1) a fund run by former university professors who use sophisticated statistical algorithms to pick stocks based on public accounting and returns data using techniques found in published finance literature; (2) a fund managed by energy industry experts with engineering undergraduate degrees from prominent state universities (no graduate degrees) and with many personal contacts in the industry developed based on years of industry experience? Which fund would David Swensen probably like more?

4. *Did Yale get into trouble during the financial crisis? Has the financial crisis tended to vindicate Swensen’s approach to investing or suggest that another approach is needed?

5. *How do you think Swensen should compensate his own employees? How should Swensen himself be compensated?

6. *How much transparency should Yale demand from the funds it invests it? How would Yale prevent its hedge fund managers from “reaching for yield” or practicing financial engineering? Explain how having separate accounts would have been helpful to Yale’s hedge fund investments?

7. How should asset management companies adjust their strategies for dealing with issues of liquidity?

8. *Is the size of Swensen’s staff appropriate for the size of the endowment? How would the organization of the investment process for private equity need to change if the endowment were ten-times its current size? One tenth its current size? What recommendations would Swensen make about the asset allocation strategy of small university endowments?

9. *Would Swensen advise Russian endowments listed in the Donors’ Forum Report, e.g., NES endowment, to use the Yale model?

WEEK 3 (SATURDAY, NOVEMBER 18): INSURANCE COMPANIES: WARREN BUFFETT VERSUS AIG

REQUIRED READING:

Letter to Shareholders from Warren Buffett , February 27, 2009.

Financial Crisis Inquiry Report. Pay particular attention to the sections on AIG: "WELL BIGGER THAN WE EVER PLANNED FOR," pp. 243–244. "AIG'S DISPUTE WITH GOLDMAN: 'THERE COULD NEVER BE LOSSES,' pp. 265–274. CHAPTER 19: SEPTEMBER 2008: THE BAILOUT OF AIG, pp. 345–351.

Cunningham Lawrence, 2015, Intermediary Influence and Competition, Berkshire vs KKR

THEORY: Value Investing, Carry Trades, CDSs, and Black-Scholes Option Pricing.

OPTIONAL READING:

Last Berkshire-Hathaway Annual Report from www.berkshirehathaway.com.

Kathryn Judge, 2015, "Intermediary Influence"

VIDEO: Warren Buffett's interview, www.youtube.com/watch?v=FPkX7S5z5t0

Questions for Case Write-Up (2-3 pages):

1. *According to Cunningham, what is the main difference between Berkshire and KKR?

2. *Does Buffett believe that banks are more deserving of bailouts than other types of companies? Why or why not?

3. *What are the similarities between Buffett's strategies and carry trades?

4. *Explain similarities and differences between Warren Buffett's business model, AIG's business model, and Yale's investment strategy. Issues to consider include leverage, marking-to-market, hands-on management of companies, and perhaps other things (but save option writing for the next question).

5. *One type of business model involves writing out-of-the-money options and hoping to make a profit from doing so. Writing insurance is an analogous strategy. According to Buffett, is this the way Berkshire Hathaway makes most of its money? Is this the idea behind Gary Gorton AIG's strategy, according to the FCIC report?

6. *Compare Buffett's letter to shareholders for 2009 (published 2010), p.16 with the financial crisis inquiry report, pp. 243-244. What does Buffett think about AIG management?

7. *What does Buffett think is wrong with the Black-Scholes model? Is he correct?

WEEK 4 (SATURDAY, NOVEMBER 25): MUTUAL FUNDS, HEDGE FUNDS, AND PRIVATE EQUITY FUNDS: LTCM

REQUIRED READING:

HBS Case "Long-Term Capital Management, L.P. (A)" by Andre Perold, #200007.

Информационно-Аналитическое Управление, Федеральное Собрание РФ, май 1999, "Причины и последствия финансового кризиса в России конца 90-х годов"

THEORY: Leverage and Repo market

OPTIONAL READING:

David McClintick, 2006, "How Harvard Lost Russia"

VIDEO: Eric Rosenfeld's lecture, www.youtube.com/watch?v=i5KfP293MVQ
Carl Icahn's lecture, www.youtube.com/watch?v=HlfgQ4_7EYA

Questions for Case Write-Up (2-3 pages):

1. *How did LTCM make money? What are main characteristics of their strategies?
2. *What is the connection between repo market and leverage?
3. *Does betting on options have anything to do with momentum or value strategies?
4. *Why did LTCM collapse?
5. *Is the collapse of LTCM related to the Russian Crisis of 1998?
6. *Does typical hedge fund compensation usually seem to be lower of higher than typical mutual fund compensation? If so, why? Illustrate using some numeric examples.
7. *Why hedge fund managers usually have performance-linked compensation and mutual fund managers do not have it? Is there any economics-based explanation?
8. Why are "high water mark" formulas used in hedge funds but not in private equity? Under what circumstances would it be appropriate to use a private-equity-style compensation contract for a hedge fund? Under what circumstances would it be appropriate to use a "high-water-mark" style hedge fund contract for a private equity fund?

WEEK 5 (THURSDAY, NOVEMBER 30): PENSION PLANS

REQUIRED READING:

Алексей Кудрин и Евсей Гурвич, 2010, “Старение населения и угроза бюджетного кризиса”

Евсей Гурвич, 2011, “Принципы новой пенсионной реформы”

Douglas J. Elliott, “State and Local Pension Funding Deficits: A Primer,” The Brookings Institution, December 3, 2010.

THEORY: Immunization, Duration, and Portfolio Insurance

OPTIONAL READING:

Congressional Budget Office, “The Risk Exposure of the Pension Benefit Guaranty Corporation,” September 2005.

“A guide to Understanding the Pension Benefit Guaranty Corporation,” Congressional Budget Office, September 2005.

GAO, 2010, “TARP: Automaker Pension Funding and Multiple Federal Roles Pose Challenges for the Future”

Pew Foundation, 2013, “A widening gap in cities: Shortfalls in funding for Pensions and Retiree Health Care”

Latest PBGC Annual Report at www.pbgc.gov/about/annual-reports.html

VIDEO: Round table on pension reform: https://www.youtube.com/watch?v=5Bz9hxIK5gU

Questions for Case Write-Up (2-3 pages):

1. *To what extent, the levels of retirement benefits provided in the Russian Federation are similar to those in other countries?
2. *According to Aleksey Kudrin and Evsey Gurvich, what changes are necessary to make the Russian retirement system economically balanced and sustainable? Do you agree?
3. *What should be done to speed up the development of Russian pension plans industry?
4. *Is there a case to be made that corporate pension funds should invest only in bonds? To what extent does this case depend on risk and return considerations? What about tax considerations?
5. *If falling interest rates are good for bond returns, why might they be bad for the financial status of pension funds, which are heavily invested in bonds?

6. *If the pension plan invests in stocks, should the risk premium on stocks enter into a calculation of whether the plan is over-funded or underfunded, i.e., what discount rate should we use for discounting cash flows of liabilities?

7. *Conceptually, how are options involved in thinking about overfunding and under-funding? What role does the pension guarantor (like PBGC in the U.S.) play in thinking about firm's incentives to over-fund or under-fund its defined-benefit pension plans?

8. *Can pension plans insure their own portfolios? Are there any potential problems with this approach?

9. Consider a local pension plan (like pension plans of Puerto Rico or Greece) invested in risky assets to meet future pension obligations. Define a hypothetical insurance policy ("put option") which pays off the amount necessary to meet the future pension obligations if the risky assets in the plan fail to generate enough value to pay all pension obligations. Define a hypothetical ex post pension surplus ("call option") as the value left in the fund after meeting all pension obligations under circumstances when the fund generates more than enough cash flow to meet all obligations. What does put-call parity say about this?

WEEK 6 (THURSDAY, DECEMBER 7): STATES AS ASSET MANAGERS. CREDIT PROGRAMS: U.S. VS RUSSIA.

REQUIRED READING:

Deborah Lucas, "Credit Policy as Fiscal Policy," manuscript, November 15, 2011.

Алексей Кудрин и Евсей Гурвич, 2015, Государственное стимулирование или экономические стимулы?"

THEORY:

OPTIONAL READING:

IMF, 2014, "Russian Federation Fiscal Transparency Evaluation"

Yuri Romannikov, Individual Project, MiF 2015, "Measuring Russian Government Financial Risk"

GAO, 2010, "Financial Assistance: On-going Challenges and Guiding Principles Related to Government Assistance for Private Sector Companies"

VIDEO: Debbie Lucas' talk: www.youtube.com/watch?v=pib0Si9zNlg

Questions for Case Write-Up (2-3 pages):

Think of the government as if it were a "plan sponsor" supervising management of a large portfolio of financial assets, to some extent using in-house managers and to some extent using external managers.

1. *How do the risks in the U.S. government's portfolio compare with the risks in the portfolios of sovereign wealth funds? In particular, think about differences between "upside" (equity) and "downside" (debt) exposures?

2. *To what extent does the Fed look like a gigantic hedge fund? To what extent do you think that its objectives and management style might be different from a hedge fund?

3. *Compare TARP in the US to a large private equity fund. Do their objectives and management differ?

4. *Compare the Russian and US approaches to government subsidies. Think about their size, form, and organization.

5. *Should the Russian government provide credit to selective Russian companies or industries?

6. According to Evsey Gurvich and Alexei Kudrin what are the main reasons of slowdown of Russian economy? Do experts from Stolypin club agree with them?

WEEK 7 (WEDNESDAY, DECEMBER 20): STATES AS ASSET MANAGERS. SOVEREIGN WEALTH FUNDS: NORWAY, RUSSIA, AND LIBYA

REQUIRED READING:

David Chambers, Elroy Dimson, Antii Ilmanen, “The Norway Model,” October 11, 2011.

Елена Лебединская, 2012, “Роль нефтегазовых фондов в России”

Libya vs Goldman Sachs Case

THEORY: Principles of Financial Stability, International Finance

OPTIONAL READING:

JPMorgan, 2008, “Sovereign Funds Primer: A bottom-up primer”

Bloomberg, 2016, “The untold story behind Saudi Arabia’s 41-year U.S. Debt secret”

VIDEO: Knut Kjaer’s interview: https://www.youtube.com/watch?v=GywxDekc1bk

Questions for Case Write-Up (2-3 pages):

Think of the government as if it were a “plan sponsor” supervising management of a large portfolio of financial assets, to some extent using in-house managers and to some extent using external managers.

1. *What are the main public policy issues involved into thinking about how to set sovereign wealth funds?

2. *What are the differences between the “Norway model” and the “Yale model”?

3. *Should Norway use the Yale model? Should Yale use the Norway model? Are there reasons why Yale and Norway should use different investment models?

4. * Should Russia try to use the Yale model or Norway model, or try to develop its own approach?

5. *What are the main lessons for Russia to learn from the Libya vs Goldman case?