Editorial

Introduction to the special BMI issue on the occasion of the EDHEC Risk Institutional Days in Monaco, December 8-9, 2010

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At EDHEC Risk Institute we are delighted to be introducing an editorial partnership with *Bankers, Markets & Investors* on the occasion of the EDHEC Risk Institutional Days 2010 in Monaco, and all the more so in that EDHEC Risk and *Bankers, Markets & Investors* share a common philosophy, namely distributing cutting-edge academic research in finance with a focus on practical applications and without compromising on the quality of the work presented. Our particular thanks for this special issue go to Jean-François Boulier, Editorial Committee President.

EDHEC Risk Institutional Days 2010 will feature an indexation and passive investment conference focusing on new forms of indices and benchmarks; a global institutional investment conference presenting the results of EDHEC Risk research on themes of major interest to institutional investors; two innovative seminars: the advanced portfolio construction seminar and the private wealth management seminar; and the PhD forum, where EDHEC Risk Institute PhD in Finance students will give presentations on their specialised research topics.

In the first of our articles in this special EDHEC Risk Institutional Days issue, Lionel Martellini, Scientific Director, and Vincent Milhau, Research Engineer, EDHEC Risk Institute, drawing from the research chair on dynamic allocation models and new forms of target date funds supported by UFG-LFP, address concerns that target date funds, which aim at providing investors with one-stop solutions to their life-cycle investment needs, have been sub-optimal in proposing a deterministic decrease in equity allocation over the life of the fund. The EDHEC Risk researchers suggest that a parsimonious set of life-cycle investment benchmarks can be designed which could serve as relatively accurate proxies for a whole range of retail investors' optimal long-term investment strategies.

In a survey of the asset-liability management practices of European pension funds, supported by AXA Investment Managers as part of the "Regulation and Institutional Investment" research chair at EDHEC Risk Institute, Samuel Sender, Applied Research Manager, draws attention to weaknesses in the risk management practices of pension funds – only a minority, for example, manage accounting risk and sponsor risk. We recommend that pension funds favour rule-based strategies over discretionary ones, because rule-based strategies are compatible with economic capital and prudential risk-based regulations.

The emergence of sovereign wealth funds as a major financial force was particularly noticeable during the financial crisis. In his paper, Bernd Scherer, Professor of Finance at EDHEC Business School, looks at macroeconomic risk management for oil stabilisation funds in Gulf Cooperation Council countries, a subject that is being studied at EDHEC Risk Institute as part of the Deutsche Bank research chair on "Asset-Liability Management Techniques for Sovereign Wealth Fund Management." Professor Scherer's recommendation is that investment guidelines for oil stabilisation funds should stress the necessity to invest in assets with negative correlation to oil price movements to protect the total wealth of an oil exporting economy. As a result, Professor Scherer's paper considers that the optimal allocation for a sovereign oil fund can be quite different to that of a traditional institutional investor.

The paper by Felix Goltz, Head of Applied Research, and Lin Tang, Research Assistant, EDHEC Risk Institute, analyses the current state of exchange-traded fund (ETF) usage based on a survey of European professional ETF users. We find that the ETF industry is in a phase of increasing maturity as ETF users are now making intense use of such instruments across a range of asset classes and taking advantage of advanced trading mechanisms and more complex forms of ETFs. Despite this increase in maturity, ETF users are still demanding more product development and most intend to increase their exposure to ETFs in the future. This research was supported by the Amundi ETF "Core-Satellite and ETF Investment" research chair.

Finally, Abraham Lioui, Professor of Finance, EDHEC Business School, and Laetitia Drusch examine corporate social responsibility (CSR) in France to assess the impact of CSR on corporate financial performance. Their empirical evidence confirms previous findings arguing that stock market rewards for CSR are hardly observable at the aggregate level. Looking at CSR dimension by dimension, however, provides some encouraging results as to the reward by the market of such activity.

We wish you an enjoyable and informative read of this special issue of *Bankers, Markets & Investors* and hope that you will continue to follow the research published by Bankers, Markets & Investors and the research produced by EDHEC Risk Institute in the months and years to come.

Abstracts

Towards the Design of Improved Forms of Target-Date Funds 6

Lionel MARTELLINI and Vincent MILHAU, EDHEC Risk Institute

In an attempt to address the concern over financially illiterate individuals being increasingly responsible for investment decisions related to retirement risk, the financial industry has started to design dedicated mutual fund products known as target date funds. These funds, which aim at providing investors with one-stop solutions to their life-cycle investment needs, typically propose a deterministic decrease of equity allocation until a date called the target date of the fund. This approach, however, has been found inconsistent with the prescriptions of standard life-cycle investment models (Viceira and Field, 2007). In this paper,we characterize in closed-form the optimal time- and state-dependent allocation strategy for a long-term investor preparing for retirement in the presence of interest rate and inflation risks and a mean-reverting equity risk premium. We confirm that existing target-date fund products are the wrong answer to the right question, and the opportunity cost involved in purely deterministic life-cycle strategies is found to be substantial for reasonable parameter values. Perhaps surprisingly, we also find that even reasonably fine partitions of the set of investors and market conditions, only marginally more complex than current partitions solely based on time-horizon, allow for substantial welfare gains compared to existing target-date fund strategies. Our results have important practical implications since they suggest that a parsimonious set of life-cycle investment benchmarks can be designed, which could serve as relatively accurate proxies for a whole range of retail investors' optimal long- term investment strategies.

Why Pension Funds Should Favour Rule-Based Strategies over Discretionary Ones 26

Samuel SENDER, EDHEC Risk Institute

This article is based on a survey of pension funds, their advisers, regulators, and fund managers representing assets under management of around €3 trillion. Asset and liability management (ALM) is a dual challenge: liabilities must be covered and performance must be generated. In addition, pension funds must respect their minimum funding ratios by insuring risk away. The survey suggests that pension funds make insufficient use of relevant techniques and prefer discretionary methods to rule-based ones, even though discretionary decisions involve the risk of delays. The lack of risk-adjusted performance measurement may lead to sub-optimal decisions being taken again and again.

Macroeconomic Risk Management for Oil Stabilization Funds in GCC Countries 36

Bernhard SCHERER, EDHEC Business School and London Quant Group

The existence of oil stabilization funds as the largest category of sovereign wealth funds relies on oil prices as a main source of macroeconomic risks for oil exporting countries. Given the often contingent spending policies of oil stabilization funds (accumulate wealth when oil prices are rising and spending wealth to support the local economy when GDP is shrinking) it is important to understand the magnitude and importance of oil price shocks relative to other sources of macroeconomic risks. Using the Bernanke and SIMS approach we establish oil price innovations as short and long term the most important economic drivers of local GDP for Gulf Cooperation Council countries (GCC). Investment guidelines for oil stabilization funds should therefore stress the necessity to invest into assets with negative correlation to oil price movements to protect the total wealth of an oil exporting economy. Using a Bayesian VAR we project the impact of different oil price scenarios on local GDP and hence the likely growth of oil stabilization funds. Under the pessimistic scenario (40% drop in oil prices from their 2009 level and 5% drop in global GDP over 2 years) a short 2 year contraction of about 10% per annum (in nominal USD terms) of Sovereign Wealth Fund (SWF) assets is anticipated. In 2011 SWF growth is likely to be back to pre crisis levels. Under a more optimistic scenario (10% drop in oil prices over two years) SWF will experience a two year period of zero growth with strong growth thereafter.

French Corporate Social Responsibility: Which Dimension pays More? 47

Laetitia DRUSCH, Mazars, France, and Abraham LIOUI, EDHEC Business School and Risk Institute

We use a sample of 148 events related to corporate social responsibility (CSR) to assess the impact of CSR on corporate financial performance. There is considerable heterogeneity in market reaction to different dimensions of CSR. Not all dimensions offer a positive reward; some yield a negative and even statistically significant impact on the firms' stock returns. One main conclusion of this study is that Socially Responsible Investment is not an excuse for passive management. There is still room for timing and stock picking within the Socially Responsible universe of stocks.

Focus on...

The State of Development of the European ETF Industry after a Decade: Evidence from the Demand Side 57

Felix GOLTZ and Lin TANG, EDHEC Risk Institute

The European market for exchange-traded funds (ETFs) has experienced tremendous growth in the past decade. This paper analyses the current state of ETF usage based on a survey of 192 European professional ETF users. We find that the ETF industry is in a phase of increasing maturity as ETF users are now making intense use of such instruments across a range of asset classes and take advantage of advanced trading mechanisms and more complex forms of ETFs. As further signs of increased maturity, ETF users have clear views of the ETF types they prefer and have started using ETFs as a tool to gather information about asset markets in addition to using them as an investment tool. Despite this increase in maturity, ETF users are still demanding more product development and most intend to increase their exposure to ETFs in the future.