

# Optimising returns the key to success

Richard Newell talks to Hideo Kondo about the 'rigorous manner' in which he and his team manage the pension fund of Dainippon Ink

**D**ainippon Ink and Chemicals (DIC) is one of Japan's most diversified chemical companies and the core of the DIC Group, which comprises approximately 230 subsidiaries and affiliates worldwide, including Sun Chemical Corp. A leader in the global market for printing inks, organic pigments and performance resins, the company was founded in 1908. It is publicly traded and has over 25,000 employees and sales exceeding \$8.5bn a year.

The DIC Pension Fund was established in 1975 and has assets of ¥107bn, or a little less than \$1bn. It is seen as one of the more progressive pension funds in Japan, with an active global equity exposure, including emerging markets and alternative strategies. It is also working with third-party providers to devise cost-efficient rebalancing techniques.

Hideo Kondo, Dainippon Ink's asset management director, says, "We manage our pension fund in a very rigorous manner with a small staff. Our approach to managing our fund is somewhat non-traditional." By this he means that the fund adopts a relatively aggressive investment approach by Japanese standards and has a sophisticated risk budgeting approach, attempting at all times to optimise returns for a given level of risk.

After the fund had been running for almost 30 years, a number of structural changes were made. Kondo explains: "By 2004, with the fund managing a defined benefit plan, together with the government pension obligation, we decided to review its workings and attempt to manage the aftermath of the so-called 'perfect-storm' years of 2000-02."

The DIC pension fund was changed to a cash balance plan (CB), after returning the government pension obligation to the government. Kondo says this was necessary, "in order to meet the current low yield conditions (10-year yield below 2%) and the lower expected return circumstances for the long term". The new CB plan adopts the variable yield in a range of 2-4%, determined by the five-year average yield of 20-year Japanese government bonds. Currently 2% is applied to the pension.

**T**he traditional assets, bonds and equities, are weighted fairly evenly - 55% fixed income, 45% equities. The equity investment style is largely active, being a mix of enhanced index and satellite holdings. Strategic benchmarks are the Topix for Japan and MSCI-kokusai (ex-Japan). However, actual benchmarks to be applied will depend on the underlying managers' styles. For the purpose of diversification, emerging equity, small cap equity and alternative assets are allocated. Dainippon's alternative universe embraces hedge funds, private equity and real estate.

The plan's expected return is 3%, so Kondo says, "We target to earn 3.5% to cover fees."



DIC is a global leader in the market for printing inks

The bond element is 50% passive and 50% active. Of the 55% of the portfolio allocated to bonds, 35% is allocated to Japanese bonds and 20% to non-Japanese bonds, with a 100% yen hedge in place. The average duration is five years plus. The strategic benchmarks are Nomura BPI for Japan and Citi Government Bond ex-Japan.

Of the equity portion, emphasis is placed on value as the investment style for core holdings. The 45% overall allocation splits 20% into Japanese equity and 25% global equity, including emerging equity. Kondo says, "the emerging equity component and our private equity exposure is expected to capture the growth of the economy and the corporate earnings growth". Within the active portion of the fund, the bond, equity and currency components are able to take short positions.

Although running a small team of in-house investment professionals, the DIC pension fund retains control of 43% of the invested assets. Kondo says, "The asset management department provides the investment guidelines to each asset manager and reviews them quarterly. From their view of the market conditions, we do a rebalance of the managers' exposures on a quarterly basis. Every month we check the balance of the managers' allocations and review the risks contained in the portfolio."

With exactly half the portfolio assets invested globally, the team uses a variety of methods of finding and monitoring its external managers. The manager selection process results from three

key factors, the first being managers who initiate visits to the company themselves. The second source is recommendation from asset consultants. The fund uses two consulting firms, Mercer on the asset management side and Diwa Fund Consulting on the liability side. The third are recommendations from the fund's appointed manager of managers. Dainippon have three managers of managers retained at present: Nomura Funds Research and Technologies Co, HC Asset Co and Mitsubishi Corporation Capital. All of the investments are handled by fund management firms or the trust banks in accordance with Japanese regulations. The fund does not have a licence to invest directly. Strategic review is carried out every four to five years, to determine the strategic portfolio with ALM analysis.

The fund does make use of quants in risk management and investment, but Kondo says, "we keep the balance in favour of the judgemental managers and only use quant managers to a limited extent." It does not employ approaches such as short extension or 130/30, because its asset mix includes market-neutral funds in the equity class selection.

**K**ondo advises institutions that are just beginning to look at managing their risk better to "consider what kind of risk they want to take and diversify that risk with a view of the short term and long term based on the economic cycle. Then closely monitor the risk and, if needs be, rebalance the risk allocations. By risk in this context, I mean systematic risk and asset manager risk."

What lessons has Kondo-san learned from his experience of investing through different market environments? He says, "Over time, we have learned how to observe the market risk which we take in the portfolio and how to rebalance when required." One of the approaches the fund has adopted in this regard is the rebalance optimisation product AlphaEngine, produced by US company MCube. The product is promoted in Japan by Sony Corporation's retired chief investment officer Masakazu Arikawa.

AlphaEngine is web-based software that is suitable for small-scale, resource-constrained investors. It allows them to evaluate a broad range of investment strategies for any asset class, currency portfolio or group of external managers and use these strategies to guide ongoing portfolio decisions. It can be easily customised to analyse a specific portfolio structure, benchmarks and policy constraints. The net impact to most funds is higher returns, better governance through transparency in decision-making, effective risk management and cost savings.

Kondo says he was impressed to discover the MCube staff "not only understood my vision, but were easily able to capture the fund structure in their software. More important, I am able to leverage their capabilities as we explore the potential benefits of improving returns and risk management through the dynamic asset and currency allocation approach that they have pioneered."

Arikawa says of the DIC pension fund team, "They are very innovative and progressive, and immediately understood how we can work together to help improve returns and risk management without increasing staff."