

5 key considerations when implementing third-party investment management

Within a delegated mandate, a customized investment strategy is developed for each pension plan, with various implementation options available to plan sponsors.

Investment strategy can be implemented in different ways. We look at this from three perspectives:

- The choice between pooled funds and customized implementation
- Liability hedging implementation
- Accessing diversity

Historically, investments in specialist mandates, particularly in hedge funds and private markets, were satisfied by fund of funds. They provided access to diversified and specialized investments in niche asset classes for governance-constrained investors. In fact, some delegated mandates use fund of fund solutions to implement investment strategy.

Bundling investments into pooled funds

Typically, the overall investment strategy uses a number of different asset classes and/or different investment managers. A delegated manager may combine some or all of these into bundles and create pooled funds populated with the delegated manager's highest conviction ideas.

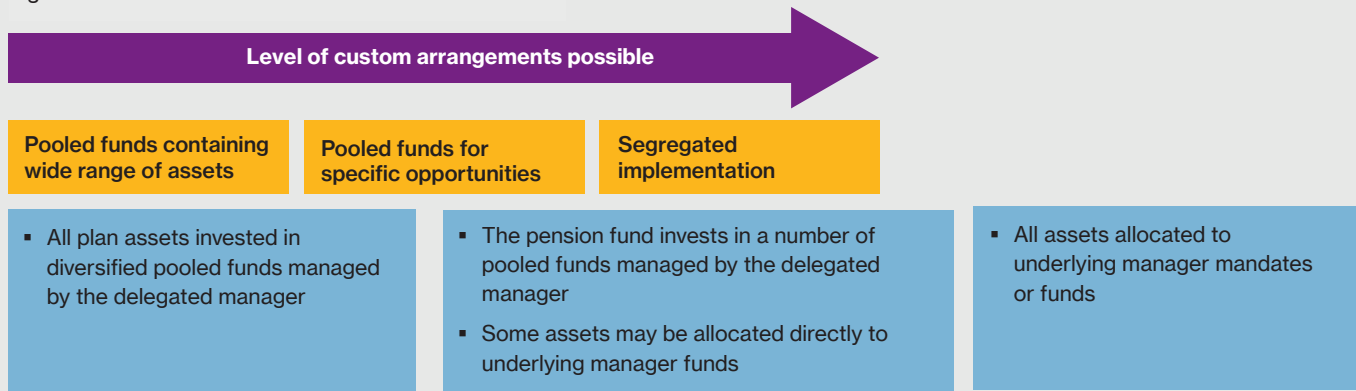
At one extreme, all a pension fund's invested assets could be combined into one bundle. Alternatively, a number of different bundles could be created for sub-portfolios (e.g., different asset classes). A pension fund would then hold units in these different pooled funds managed by the delegated manager.

It can be difficult for small pension funds to access a diverse range of ideas, but pooled funds can make these opportunities more accessible. We believe a large number of pooled funds help create more asset allocation flexibility though potentially a very large number of underlying investment managers, as each fund employs several managers to ensure it is differentiated on a stand-alone basis.

Fully customized implementation

Alternatively, fully customized implementation enables the delegated manager to reach separate asset manager agreements on the client's behalf and to tailor the eventual portfolio to the plan's particular needs (*Figure 1*).

Figure 1. **Access to customized investment solutions**



For illustrative purposes only

When deciding whether to select a pooled fund or a customized portfolio, we believe plan sponsors should be mindful of:

1. Investment beliefs and restrictions

Investors should first consider their mission and investment beliefs, and the extent of risk specific to them. At the onset of a delegated mandate, the plan sponsor should consider any beliefs that need to be reflected in its investment arrangements (e.g., if the plan sponsor does not believe in active management in a particular asset class).

2. Access to opportunities

Either a pooled or a segregated approach should offer the same access to opportunities; however, plan sponsors should be aware of the range of different funds that are available.

Some delegated managers already operate funds that cover the major asset classes, but a delegated mandate should make new opportunities accessible. The plan sponsor should understand the flexibility that each of the funds has in investing in new opportunities.

As an example, following the credit crisis, there were a number of opportunities to lend to distressed companies. If several of the pooled funds in the pension fund's portfolio had the discretion to allocate to sub-

investment-grade credit and chose to do so, a higher-than-intended exposure to riskier credit for the pension fund could have resulted.

3. Portfolio construction and management

We believe a delegated manager needs to ensure a portfolio is sufficiently transparent so a plan sponsor can confirm that assets reflect overall investment objectives. We feel this can be accomplished by providing clear data and an understanding of risk and return, the managers' style, concentration of positions, liquidity and leverage – both at an individual manager and the portfolio composite levels. The impact of any portfolio changes can then be assessed not only against risk and return objectives, but also against other risks and implementation issues (such as liquidity), and the plan's investment beliefs and/or restrictions.

4. Costs

Fees and costs can materially influence a pension plan's outcome. The level of fees will vary depending on implementation. A pooled fund may have both administration costs and underlying manager fees; however, the large size of a pooled fund may allow a delegated manager to negotiate more favorable investor fees, potentially bringing costs down. We believe transparency of fees and costs to the plan sponsor is also important, particularly investment and delegated

manager fees and expenses embedded in any pooled funds.

5. Liquidity

Liquidity describes the cost and ease of selling an asset. While the liquidity of underlying fund managers is largely dependent on the asset managers, a delegated offering's structure can also impact liquidity.

When a fund of funds is used, additional liquidity considerations surface that are dependent on the delegated manager's terms or the funds used. Where a pension fund already has some assets that it does not want to sell, moving to a delegated mandate using a fund of funds could force a sale if these assets cannot be transferred to the pooled fund. Similarly, if the plan sponsor was to change the delegated manager in the future, then a new delegated manager is unlikely to hold investments in a competitor's fund. The entire portfolio might have to be disinvested and commensurate costs incurred.

Implementing liability hedging solutions

Liability hedging solutions have largely the same implementation considerations as for return-seeking assets, but plan sponsors also need to consider:

- The level of and ability to control leverage – a custom arrangement makes it easier to control
- Whether active management should be included within the liability hedging portfolio or not

Ultimately, the plan sponsor needs to be comfortable with the delegated manager's approach to liability hedging and the various controls it applies when considering implementation. This should be established at the outset of a delegated mandate.

The approach to diversity

Diversity is not a new concept for pension plans. While seemingly simple, the definition of diversity is multi-layered. Most simply, it is investment in different asset classes. Since assets are not perfectly correlated, if one asset class experiences poor returns, then a pension fund with diverse holdings may suffer a smaller loss.

Genuine diversity?

Constructing a portfolio that includes uncorrelated strategies that deliver their returns from similar drivers may not provide the required diversification during times of stress. Instead of relying on modeled risk, which is based on assumptions for risk, return and correlations, we believe asset owners should recognize uncertainty and understand the fundamental drivers of

Figure 2. Sources of investment returns

Risk premium	Investors are rewarded for bearing the risk of:
Equity	Being lower down the capital structure in the event of corporate default
Credit	Debt issuers defaulting on their bond obligations
Illiquidity	Holding an asset that cannot be quickly or cheaply sold
Insurance	Providing protection against extreme losses
Term	The uncertain return and mark-to-market volatility of taking duration risk
Currency	The risk that the purchasing power of the currency falls due to a currency crisis
Skill	A manager, previously considered skillful, underperforming its benchmark

We believe delegated management should allow pension funds to really diversify in a way that goes beyond investing in a number of different funds or providing an alternative means of investing in mainstream asset classes.

return and what risks they are being rewarded for taking. *Figure 2* shows what we believe to be the key drivers of return. Many asset classes access more than one of these key drivers.

A number of pension plans have invested in a range of different funds, which have helped to reduce modeled risk. Even so, many continue to rely heavily on equity risk premium. We believe delegated management should allow pension funds to diversify in a way that goes beyond investing in a number of different funds or providing an alternative means of investing in mainstream asset classes. An example of a seemingly diverse portfolio is shown in *Figures 3 and 4*. *Figure 3* suggests a portfolio spread across a range of assets.

On closer inspection, the majority of risk arises from the allocation to equities. The 50% allocation to different types of equities contributes to over 80% of the risk.

Instead of relying on asset classifications, we feel a diversified portfolio that balances exposure to different risks has a better chance of reducing risk.

A large number of delegated management options are available to plan sponsors. Both the benefits of a customized option and the simplicity of a fund approach should be explored. Of course, with some delegated managers, it may also be possible to benefit from both by combining fund investments with a custom mandate.

Figure 3. A seemingly diverse portfolio

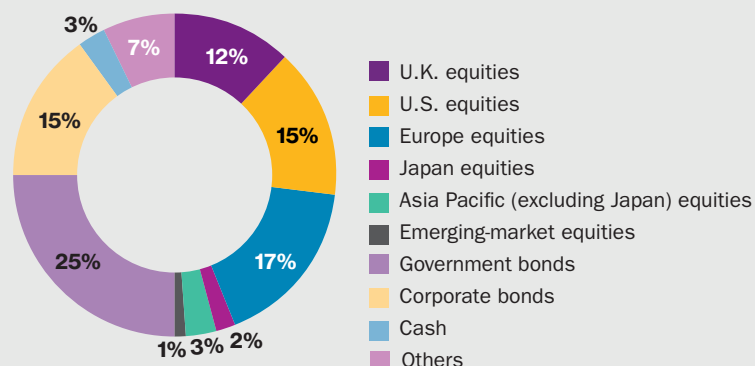
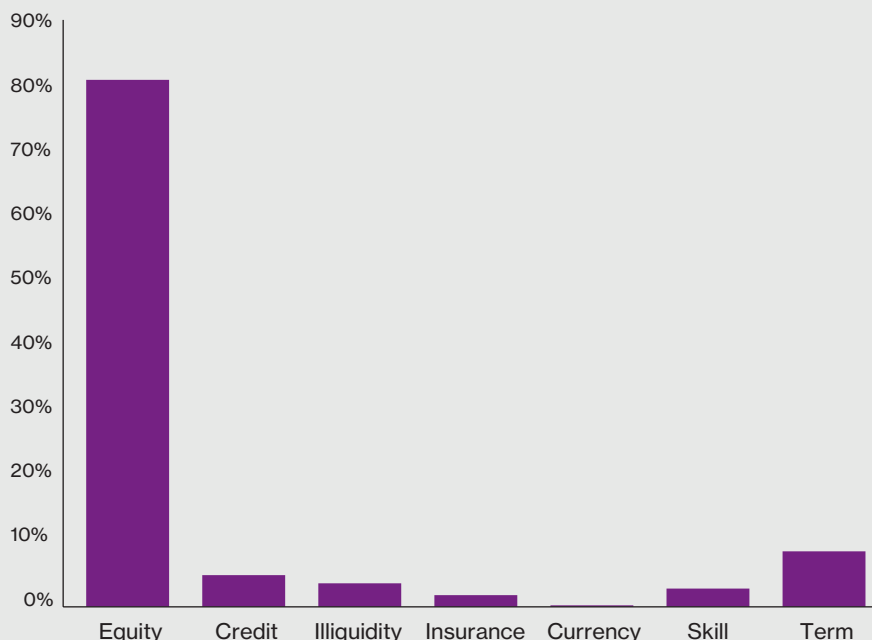


Figure 4. A different perspective on diversity



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