Monitoring delegated investment management

In an advisory model, the plan sponsor typically monitors each of the underlying investment managers in the pension fund's portfolio against an appropriate benchmark. How do plan sponsors create a framework to assess a delegated manager?

A delegated model assigns hiring and firing of underlying asset managers and the monitoring of mandates to the delegated manager. The plan sponsor oversees the delegated manager.

Measures of success

A thorough assessment of a delegated manager is both qualitative and quantitative, and can be achieved by using a balanced scorecard of hard and soft measures of success. A plan's funding level progression, typically a key plan sponsor focus, is a potential hard monitoring metric, as is progression against the journey plan.

Figure 1 provides some metrics for a balanced scorecard. These metrics create a framework for plan sponsors to assess their own decisions and those made by their delegated managers. How measures are used in an assessment, however, should be customized to the individual client's needs.

Benchmarks for quantitative monitoring

In the delegated management industry, we typically see two types of performance benchmarks: performance relative to liabilities or a comparator portfolio (typically a low-governance equity bond portfolio or a diversified composite based on market indexes). The key benefits and drawbacks of each type of benchmark are shown in *Figure 2.*

We feel performance relative to liabilities is the better measure of success, as it is consistent with the plan sponsor's objective; however, there is merit in simultaneously using other measures, as they can provide meaningful information that performance relative to liabilities does not easily show.

When comparator portfolios are used for monitoring, we believe they need to be updated as the pension fund's circumstances and risk profile change through time.

Performance attribution

While performance measurement allows the plan sponsor to understand whether the investment objectives are being met and if the underlying managers are achieving their targets, the plan sponsor also needs to understand how a delegated manager's skill in various areas has contributed to the overall performance.

We feel performance attribution analysis helps the plan sponsor to better understand why a pension fund's return is different from the fund's benchmark, whether relative performance reflected a delegated manager's skill and which decisions added value. *Figure 3* shows how comparing total pension fund performance against a number of comparators can disaggregate this performance figure and identify performance drivers.

Figure 1. **Sample balanced scorecard**

Risk	Metrics
Business	▪ Stability of the delegated manager's business ▪ Staff turnover ▪ Staff training, professional qualifications and experience
Return	▪ Performance against objectives and suitable benchmarks ▪ Performance of managers within the portfolio ▪ Forward-looking measures of return
Investment process	▪ Clarity of investment process ▪ Research resource and track record in innovation and thought leadership ▪ Cost awareness and control
Risk management	▪ Is the level of risk taken within the mandate guidelines? ▪ Is the level of return appropriate for the level of risk taken? ▪ Is there an appropriate risk-monitoring framework in place? ▪ Forward-looking risk analysis
Implementation efficiency	▪ Speed of implementation ▪ Errors made and appropriateness of process for dealing with errors ▪ Appropriate internal controls
Service delivery	▪ Quality of strategic advice ▪ Plan sponsor training/education ▪ Communication ▪ Responsiveness
Conflicts of interest	▪ Appropriate process for identifying and managing potential conflicts of interest ▪ Full transparency
Transparency	Does the manager provide enough information to allow the plan sponsor to understand what changes have been made, the rationale for these changes and what value has been added?
Proactivity and innovation	▪ Best-in-class manager selection ▪ Dynamism and flexibility ▪ High-quality investment ideas

Figure 2. **Comparing benchmarks**

	Liabilities	Diversified composite	Equity/Bonds
Benefit	Consistent with the plan sponsor's overarching objective	Shows if the manager has added value through relative asset class views and manager selection	Shows if diversification and complexity have added value
Drawback	Market returns likely to dominate attribution	Not necessarily consistent with the plan sponsor's objectives/ pension fund's journey plan	Not necessarily consistent with the plan sponsor's objective/ pension fund's journey plan

Figure 3. **Example: 12-month performance attribution**

Imagine a pension plan with a delegated mandate objective of liabilities +3% per annum.
Assume the following returns were achieved:

	Actual portfolio return (% per annum)	Liability benchmark return (% per annum)	Equity/Bond portfolio at same risk (% per annum)	Diversified comparator
Absolute return	**5.5%**	**3.0%**	**2.5%**	**3.5%**

For illustrative purposes only

Did the delegated manager meets its objective?

The pension plan has probably fallen behind its journey plan by achieving liabilities of +2.5% over the last year against a target of liabilities +3% per annum. The funding level would have improved by slightly less than is required to meet the pension plan's long-term goals.

If we then look at where value was delivered, *Figure 3* shows what we could see from this form of attribution.

In this example, taking investment risk was not particularly well rewarded. The equity/bond portfolio delivered a lower return than liabilities; however, a diversified portfolio was beneficial, delivering 1% of additional return over and above the equity/bond portfolio. Then there was a further 2% of added value from the delegated manager's active asset allocation and investment manager selection decisions.

In a challenging market, we feel these results are considered very productive, despite funding progress slightly trailing longer-term expectations.

Figure 4. **Example: Added value**

	Actual portfolio return (% per annum)	Liability benchmark return (% per annum)	Equity/Bond portfolio at same risk (% per annum)
Relative return	**–0.5%**	**+1.0%**	**+2.0%**
Did taking risk add value?	✗		
Did diversity add value?		✓	
Did asset allocation/manager selection add value?			✓ ✓

Performance comparisons and reporting variations

Comparing the performance of different delegated managers is very difficult, as the type and level of reporting provided varies considerably. This reflects different provider approaches to the portfolio management and the unique nature of each delegated mandate.

For example, consider the following: In a given year, pension plan A achieves a return of liabilities +2%, and pension plan B achieves a return of liabilities +3%. Surely pension plan B achieved a better result.

But what if we now told you:

- Pension plan B hasn't achieved its return target of liabilities +3.5%, and is behind its journey plan.
- Pension plan A has outperformed its return target of liabilities +1.2%, and consequently, its funding level increased, and it reduced risk and its reliance on the sponsor company.

Which achieved a better result?

We would also question the merits of comparing performance across providers. It is possible to compare the performance of multiple investment managers against a market index, but delegated management is more nuanced, as the best objective is plan specific and can vary considerably (e.g., performance relative to the plan's journey plan, liabilities and an equal risk comparator portfolio). This can also incentivize delegated managers to attempt to outperform each other rather than focus on the individual plan's objectives.

While a useful comparison of pension fund performance across delegated providers is difficult, if not impossible, to achieve, on a like-for-like basis, we think it best to compare managers across a range of metrics that should drive success relative to a client's specific objectives; the range of criteria in *Figure 4* is a good starting point.

In conclusion, we believe plan sponsors need to establish a framework for monitoring their delegated manager that is consistent with the objectives of the manager and plan sponsor. Delegated managers should provide the plan sponsor with adequate information and training, so there is understanding of what drives the manager's performance. The plan sponsor should also be aware that comparisons across delegated managers are difficult and interpreting comparisons require care.

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