Delegating investment management: Here are the skills needed

Pension funds evolve over time, so it is important that a delegated investment manager has the full suite of skills and capabilities to work to any set of objectives.

At the highest level, plan sponsors strive to have sufficient assets available to meet the pension promises. Exactly what this means in practice changes over time. In fact, this has changed remarkably over the last two decades as we have moved from a purely long-term approach to an increasingly mark-to-market approach driven by legislation and accounting standards.

The youthful pension plan

Although now rare, in the past pension plans were more commonly open to new entrants with participants earning additional benefit accruals with each year of employment. The time horizon created was to all intents and purposes infinite and replenished with new entrants to pay contributions, which indirectly paid pensions.

In this type of plan, a sponsor may adopt an approach akin to an endowment fund with objectives set in real terms (e.g., risk and return targets relative to inflation). A long-term investment horizon can be sought, and the plan can outperform shorter-term investors that may find they are forced sellers when short-term market shocks occur.

The midlife pension plan

Over the last few years, an increasing number of pension plans have been closed to new members – and in some cases, to new accruals for current active members. With no increase in membership and no new benefits earned, this is a fundamental change. Gradually, as the time horizon for payment of the liabilities shortens, management of this liability assumes greater importance, eventually dominating the investment strategy.

Many pension plans acknowledge this trend with well-defined journey plans (also known as glide paths) that state their long-term funding objectives expressed relative to liabilities. Pension plans will also define the time horizon over which they expect to achieve their objectives and their acceptable level of risk.

We feel the importance of implementing this framework increases as the pension plan's liabilities mature and there is less room to maneuver if investment performance is poor.

The mature, self-sufficient pension plan

Some pension plans are fully funded on both a going concern and solvency basis. At this stage, assets may be invested mostly in fixed-income and other low-risk assets (relative to liabilities), as it is highly probable that benefits can be provided without recourse to the sponsor.

During early self-sufficiency, cash-flow management and liquidity tend to be less of a concern than mark-to-market management, as cash flows may only be 1% to 2% of assets each year. The focus is on managing mark-to-market interest rate and inflation risks. Diverse, return-seeking assets will still have scope if they have sufficient liquidity. Indeed, we feel liquidity management becomes increasingly important as a pension plan transitions through the self-sufficiency stage.

As benefit payments become a material draw on assets, the focus moves to cash-flow management. Bonds are held because they will generate cash flows that can help match the yearly predicted pension fund outflow.

Settlement

Ultimately, it may make sense for a pension plan to transfer all the assets and liabilities to an annuity provider and wind up the plan. This represents the end of the life of the pension plan, and the annuity provider pays the benefits.

It is important that the delegated investment manager can build a path to settlement in the portfolio management offering and has the resources to monitor the market to identify suitable opportunities.

Figure 1. **Skills needed to manage a pension plan through time**

		Youthful pension fund	Midlife pension fund	Mature, self-sufficient pension fund	Settlement
Context-driven strategy	Understand the pension plan's liabilities and design appropriate investment strategy		✓	✓	✓
	Understand the sponsor's position in relation to the pension plan	✓	✓	✓	✓
	Understand the pension plan's longevity risk exposure		✓	✓	✓
Portfolio construction	Ability to research different asset classes in detail and identify attractive opportunities	✓	✓	✓	
	Ability to research a wide range of asset managers across different asset classes and select the best managers	✓	✓		
	Expertise in hedging interest rate and inflation risk		✓	✓	✓
Implementation	Ability to implement the chosen investment strategy	✓	✓	✓	✓
	Expertise in settlement transactions			✓	✓

Potential steps to this end could include the purchase of an asset that matches a particular set of cash flows. Under this scenario, the pension plan retains ultimate responsibility for meeting its liabilities but manages them through a very secure cash-flow-matching asset.

We believe it is essential that the delegated manager is aligned in the objective to reach settlement so opportunities aren't missed, or worse still, the portfolio is too illiquid or costs make a transaction prohibitive.

Long-term partnering with a delegated manager

Clearly, a delegated manager needs to be able to construct a suitable portfolio that meets the plan sponsor's immediate objectives. But objectives can change rapidly (e.g., the funding level materially improves, accelerating the journey plan, or new legislation expedites the transition from a midlife to a mature pension plan).

It is vital that the delegated investment manager can identify these changes and work with the plan sponsor to help redefine objectives. Similarly, the portfolio's management should reflect evolving objectives, and the delegated manager should understand and be able to clearly explain how current portfolio construction decisions could create future constraints. For example, early in the journey plan, a private equity allocation may look attractive, but if the plan's life cycle is suddenly accelerated, and settlement activity looks attractive, a pension plan may not be in a position to take advantage of this opportunity.

We believe a true delegated investment manager partners with a plan sponsor to fill governance gaps over the long term, transitioning through the phases of a pension plan's evolution. Plan sponsors need to test this tenet and ensure the partnership remains effective as the plan evolves or if circumstances change. *Figure 1* shows the necessary key objectives and skills at each stage.

Delegating responsibility can help a plan sponsor access relevant skills that often don't all exist within a single entity. We believe a delegated manager with diverse skills can bridge the governance gap and improve the chances of meeting a plan sponsor's long-term objectives.

Delegating responsibility can help a plan sponsor access relevant skills that often don't all exist within a single entity.

About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has 45,000 employees serving more than 140 countries and markets. We design and deliver solutions that manage risk, optimize benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas – the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

willistowerswatson.com/social-media

WTW-NA-2019-WTW301647

willistowerswatson.com

Willis Towers Watson