

How to set objectives when delegating investment management

As pension plan objectives evolve over time, so should the objectives of a delegated mandate.

A delegated investment management agreement between a plan sponsor and manager should include mutually agreed upon mandate objectives and operating guidelines, and a framework for monitoring performance against the objectives. We believe a regular review enables the mandate to evolve with the pension plan and any change in circumstances through time.

Delegated management looks to combine advice tied to strategy (can't be delegated) with portfolio implementation (can be delegated). Mandates are ideally structured with this in mind. As an example, the level of pension fund risk needs to reflect the plan's objectives. The plan sponsor understands these objectives best and should retain investment strategy decisions.

We believe the manager should have sufficient flexibility to decrease risk when appropriate, or to rebalance to a strategic benchmark when market conditions are favorable.

Risk also changes over time. Required return and the level of risk needed changes as a pension plan matures and moves along a path to fully funded status and self-sufficiency (*Figure 1*).

Setting the manager's objective

Measuring a portfolio's performance against a benchmark (e.g., the pension plan's liabilities) can help with monitoring, but we don't believe this should be the delegated manager's objective, as the required level of outperformance changes over time.

Instead, the delegated manager can manage to a journey plan (the path that outlines how the plan sponsor intends to meet the plan's long-term funding objective). This frees the plan sponsor to concentrate on (with advice from the delegated manager and other advisors if appropriate) setting the plan's long-term objective, the time horizon and the initial balance between risk and return, as well as determining how the balance should change through time.

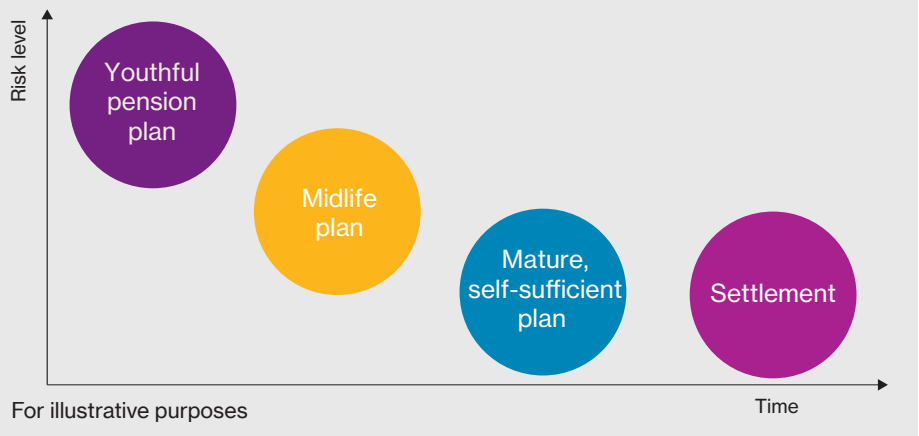
The delegated manager then implements and manages a portfolio in line with this plan. This may seem similar to mandates that are structured with a target outperformance or funding level, but there are some subtle yet important differences. Managing to the journey plan may offer several potential advantages over other objectives we have seen.

Managing to a journey plan

We believe managing to a journey plan should be completely consistent with the plan sponsor's ultimate objective, as it outlines how the pension plan hopes to reach its funding objective. This further aligns the interests of the manager and the plan sponsor. We feel it allows for better investment risk management, as risk does not need to be increased simply to adhere to a documented return target. In our opinion, the flexibility created allows for more efficient portfolio management, as there is no obligation to increase risk when it may not be appropriate, or rebalance to a strategic benchmark when market conditions are not favorable. For instance, assume a delegated manager had a +3% per annum return target for liabilities. If the market rewards risk taking and results substantially exceed this target, forward-looking expectations will likely be lower than anticipated in the current investment strategy (e.g., liabilities at +2.6% per annum). A contract to target liabilities at +3% will, however, force the delegated manager to continue targeting liabilities at +3% per annum, and it may add to risk at exactly the wrong time.

Rather than reacting to a change in its forward-looking return assumptions, we feel managing the journey plan recognizes these nuances and gives the manager flexibility to adjust the portfolio. Of course, when granting a delegated manager additional flexibility, it is important to have checks and balances in place. This is commonly achieved by using upside and downside triggers around the central journey plan. Triggers facilitate real-time

Figure 1. **Evolving objectives of pension plan**



decision making and implementation to allow the pension fund to help take advantage of de-risking opportunities as they occur and ensure that the pension fund does not deviate too much from the journey plan.

This process represents some evolution in mandate design. *Figure 2* describes common delegated mandate specifications and their implications.

Perhaps the most important aspect of structuring a delegated management agreement is setting controls around risk, and mandates should be designed with required risk constraints, such as a range around tracking error, absolute volatility or value at risk. In addition to risk controls, *Figure 3* outlines some of the guidelines and controls that are frequently incorporated in delegated management agreements and some factors that a plan sponsor may wish to consider.

In summary, we believe care should be taken when structuring a delegated management agreement, and a plan sponsor should work closely with the manager and advisors. Delegated mandates involve a significant transfer of authority, and a plan sponsor should be comfortable that the mandate's structure allows the manager sufficient flexibility to manage the portfolio using the breadth of skills and resources at its disposal while remaining consistent with the plan sponsor's objectives. The interests of the delegated manager and the plan sponsor should also be clearly aligned and allow for efficient portfolio management.

The delegated investment manager should be managing the portfolio with a view to an evolution in objectives and should understand and be able to explain the constraints that might be imposed in the future by portfolio construction decisions made now.

Figure 2. **Common delegated mandate specifications**

Types of objective	Description	Implications
Asset allocation benchmark	Delegated manager implements a portfolio consistent with an asset allocation set by the plan sponsor	Delegation largely involves manager selection and de-selection, with some active asset allocation
	Plan sponsor specifies individual market indices against each asset category	Changes to asset allocation benchmark agreed by the plan sponsor
	Some discretion to vary asset allocation; liability hedging parameters are specified	Process required to ensure that the asset allocation benchmark remains consistent with the plan sponsor's objectives
	Risk restrictions reference the extent of risk allowed relative to the benchmark and possible liabilities	
Total return mandate	Delegated manager targets a certain return, typically in excess of liabilities	Greater delegation by varying asset allocation to achieve target
	Mandates tend to specify which asset categories may be utilized, but there will not be a set allocation as above	Process likely to be to maintain target return, which in some cases could lead to counterintuitive rebalancing
	Risk restrictions need to be consistent with the return target and relative to liabilities	
Journey plan mandate	Plan sponsor sets return profile over time, possibly including funding-level triggers to change profile	Overall level of risk and return remain under plan sponsor control
	Delegated manager manages to the agreed journey plan (glide path) but also takes into account actual progress versus the journey plan	Funding-level triggers agreed by plan sponsors allow a dynamic de-risking process consistent with the journey plan Delegated manager reporting on risk and return becomes key

Figure 3. **Sample delegated mandate guidelines**

Guideline	Sample specifications
Permitted asset classes and exposure limitations	<ul style="list-style-type: none"> Allowed asset classes Minimum and maximum allocations to each permitted asset class
Diversification	Maximum allocations to direct investment in individual securities, investment managers or pooled funds
Liquidity	Specifications may include a pre-agreed allocation to cash or time frames within which a certain proportion of the plan assets may be redeemed
Foreign currency exposure	<ul style="list-style-type: none"> Limits on how much unhedged foreign currency exposure is allowed Instruments that are allowed for hedging currency risk
Liability hedging	<ul style="list-style-type: none"> Minimum and maximum interest rate and inflation hedge ratios Instruments that can be used for liability hedging
Dynamic de-risking framework	How the manager should adjust the portfolio in the event that the plan's funding level moves outside pre-agreed expected funding-level ranges
Permitted financial instruments	What financial instruments are allowed
Leverage	<ul style="list-style-type: none"> Whether or not leverage is allowed If leverage is to be allowed, limits as to how much
Use of derivatives	Whether or not derivatives can be used in the portfolio and for what purposes, for example, risk management (currency hedging, liability hedging)
Pension-fund-specific restrictions	For example, plan sponsors that wish to restrict investment in the industry in which their sponsor operates could specify such restrictions

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