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Pension Fund Evaluation –

Europe's new directions for solutions to old age problems

The pension fund industry has become a major topic within the European financial world. In the not-too-distant past, the task of providing income in retirement was often taken for granted; the equity bull market seemed in a permanent state of grace in which defined benefit (DB) schemes could flourish without excessive maintenance, and investment decision-making was relatively low on the list of priorities of many pension trustee boards. However, recent market uncertainties, and their impact upon several highly visible pension fund shortfalls, have served to demonstrate that laissez-faire approaches are unlikely to work in the long-term.

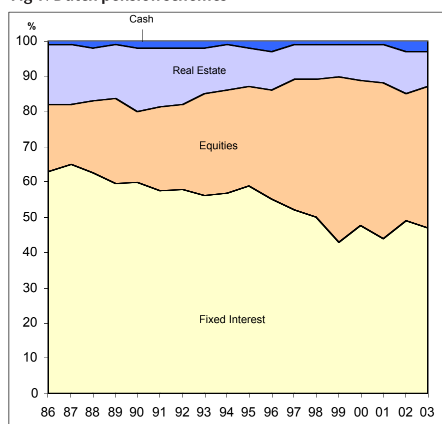
As European governments struggle to cope with pension reform programmes in light of declining birth rates and increasing life expectancy, and pension fund trustee boards grapple with short-term balance sheets and long-term liabilities, all we seem to know for sure about pensions is that nothing is certain. However, where uncertainty exists, opportunities exist for companies and managers willing to cast aside preconceptions about money management within the pension fund context.

Whither the corporate pension? As retirement provision, or the lack thereof, increasingly becomes a visible issue throughout Europe, politicians have begun to intervene on behalf of workers questioning their employers' commitment to their pension covenant. For example, within the Dutch environment, the introduction of the Financiel Toetsingskader (FTK) regulations in 2006 will require the move to mark-to-market valuation of both assets and liabilities, and funds will need to meet obligations with respect to continuity, solvency and minimum tests.

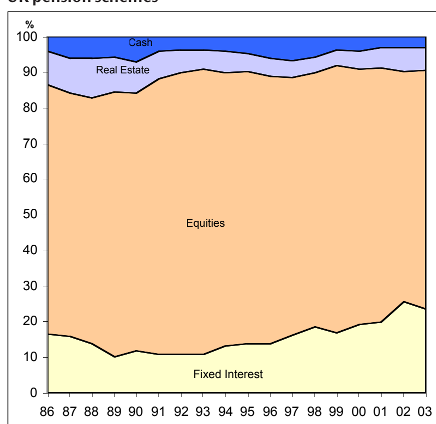
In the UK, the new Pension Protection Fund is being created as an equivalent of the Pension Benefit Guarantee Corporation in the US. Pension trustees in the UK have been strongly encouraged to follow the investment decision-making principles set out in 2001 by the Myners report, but so far compliance is voluntary. Indeed, a recent report by the UK Department for Work and Pensions, outlining whether the Myners principles have been successful in bringing about change, has showcased many of the gaps between best practice and reality.

On average, the UK pension trustee board devotes fewer than four hours per year to investment matters. Larger schemes have greater resources for managing change and have generally been more progressive in accepting change, but the Myners report suggests that many trustees who believe their schemes to be in complete compliance with the principles have much work still to do. Asset allocation revisions have typically taken the form of predictable responses to changing markets, rather than adoption of the fundamental changes recommended by Myners. Performance monitoring of investment managers has been better implemented than the equally rigorous suggestions with regard to performance evaluation of investment consultants and the trustees themselves. Many schemes' trustees rely very heavily upon their consultants and advisors, with only 15% of them having overruled a consultant's recommendation during the two-year period of the review.

Fig 1: Dutch pension schemes



UK pension schemes



New products and services are rising to meet this challenge. For example, the WM Company has recently collaborated with Standard & Poor's to develop a new suite of services for pension fund trustees. These exist to better facilitate relationships between trustees and the scheme sponsors and to allow the trustees to better manage the pension process.

The Myners' principles should be similarly relevant throughout Europe, where many countries - notably France and Italy - have been slow to foster corporate pension schemes. No one solution to the pension conundrum exists; different countries must actively plot their own courses, just as each pension fund must take into account its own individual circumstances to make effective decisions. But a number of common factors should drive the assessment of pension fund circumstances, among them efficiency, effective stewardship and consistency.

In the current climate of widespread pension fund deficits, the efficiency of the entire pension fund management process is under increasing examination. Such scrutiny should not be limited to investment management, as it may have been in the past, but also encompass all decisions made by pension board trustees, as well as the inputs used for these decisions. If a pension fund is in deficit, all costs such as fees and transaction levies - whether direct or through inefficient implementation - are ultimately borne by the sponsor, thereby increasing the deficit that the sponsor has to make good. The indiscriminate use of multiple managers across the same active mandate, in which any added value generated by one manager is likely to be diversified away, is a classic example of inefficiency: paying active management fees to get index performance is muddled thinking. Objectives must always be matched to implementation.

As trustees gain power and a measure of independence from their sponsors, they will increasingly be required to demonstrate professional and comprehensive approaches to the stewardship of their assets. With power comes the responsibility to use it wisely. Legal scrutiny of decisions with a view to determining, with hindsight, whether trustee decisions were appropriate will likely become more commonplace. Trustees will need to proactively and, if necessary, publicly defend their members' rights. In the UK, the recent attempted takeover bid of WH Smith by the private equity firm Permira foundered because the WH

A New Challenge

by Michael S Walsh,
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Smith pension board asserted itself on behalf of its members – this has been widely viewed as an exception rather than the norm. Going forward, this may well become a yardstick against which other trustees are measured.

Consistent decision-making involves a logical progression of actions, with each decision supporting the next. For example, if a sponsor has a low tolerance for contribution rate changes, the asset structure should not involve investing predominantly in equities. A fund must not be at odds with itself; internal contradictions only serve to decrease transparency and tend to propagate further poor decision-making.

The question of asset allocation brings the above issues into strong relief. Myners suggested that greater resources should be devoted to asset allocation decisions and to serious consideration of the full range of asset classes; in practice, what should this mean? Looking at existing asset allocations among European pension funds, UK pension funds have historically favoured the higher potential returns of equity investments, whereas the continental preference has been to avoid significant equity investment and emphasise fixed income much more strongly. The Dutch example (see figure 1) shows a heavy exposure to domestic (now Euro) bonds. The more conservative Dutch approach to strategic asset allocations is reversed when considering the management of the assets, particularly with regard to their willingness to accept active equity risk.

The bias to bonds within Dutch pension plans was beneficial during the recent period of bear equity markets. Figure 2 shows that over the three years to end 2003, Dutch funds produced better returns than their UK counterparts whilst taking less risk. However, any view on the respective efficiency of UK and Dutch funds on a risk/reward basis should carry two important caveats. Firstly, pension funds involve long-term investments. The lower market risk of bond investing is associated with lower potential returns.

Secondly, and more importantly, analysis of investment efficiency should always be secondary to the primary goal of achieving a level of return sufficient to cover one's liabilities at a reasonable cost. After all, what is the point of a DB pension fund? It exists to pay the pensions promised to scheme members upon retirement. Risk-adjusted returns do not pay pensions. All major investment decisions within the pension-management process must work with a common rationale to this end, and within that conclusion resides the framework for assessing the success or failure of such decisions.

Managing fund returns has historically involved setting some form of strategic benchmark. Formerly, in the UK, this benchmark was a set of peer group returns; in recent years, index-based customised benchmarks have become the norm as they have always been in the rest of Europe. Target returns are expressed in terms of compliance to or outperformance of an index, often with risk constraints on downside performance. Underlying this framework is the assumption that the decision to allocate resources to this benchmark is correct and will generate returns sufficient to meet the liabilities at acceptable cost. Then the asset manager's task is to add value against this benchmark.

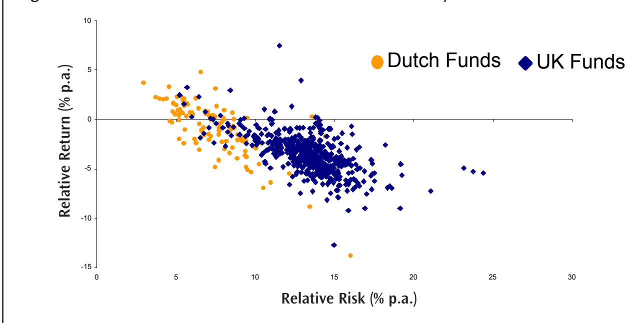

Fig 2: Absolute Risk Return for Dutch and UK Funds over 3 years to end 2003

It has become clear, however, that analysis of pension fund returns has disproportionately focused upon the investment manager's role in the process. In one sense this is understandable, as the manager commands the highest fees in the process and will naturally attract the most scrutiny. But ultimately, the primary driver of fund performance is the strategic asset allocation decision of the pension board. Many problems have arisen because the benchmark itself contained unmanaged risk not because the manager strayed outside its given risk allocation. The risk of a benchmark should be explicit. It's all very well measuring daily performance levels, but if the 20-year view is going wrong, the daily measurements are pointless.

The good news is that because the emerging regulatory framework has thus far concentrated upon transparency rather than uniformity of process, ample scope exists for creative thinking. The Dutch and UK examples show that there is no one solution to the pension puzzle – the only requirement of a correct answer is that it must enable a scheme to meet its commitments. This realisation carries within it the seeds of a revolution for the asset management industry. Conventional benchmarking cannot fully marry a pension plan's asset growth to the growth of its liabilities. If the ultimate goal of a pension fund is to grow assets to meet its liabilities, simply outperforming or performing in line with a strategic benchmark is not sufficient in and of itself.

This simple insight opens the way to new approaches to pension fund management, and indeed asset management in general. The proper pension fund benchmark has long been related to the liabilities of the fund – the closeness of this relationship is what is now under review. The challenge for asset managers is to find a role that helps this process evolve. Also, until these ideas can be communicated effectively to the boards of pension fund trustees and/or their investment consultants and advisors, the aforementioned revolution will remain stillborn.

So far, the response of the asset management community has been twofold. Firstly, there has been debate about the possibility of awarding a mandate that includes varying the strategic policy of the fund. Essentially, this would allow the manager to manage the fund in such a way that positions were being taken against the liabilities rather than against a market index. One element of this approach would be to award the mandate for a longer period than is common at present. Another key point would be that an explicit benchmark would not exist as such in the current manner. These reasons may limit the speed of uptake with trustees.

This also provides a challenge for the performance measurer, as the manager is not only managing the assets but also effectively insuring against the possibility of movement in the liabilities. Therefore the individual decisions of the manager will have to be analysed from this viewpoint, rather than the constrained return maximisation as at present.

Secondly, there is an approach to explicitly define a minimum risk benchmark and either match this or attempt to add value against it. This benchmark can be constructed from bonds or swaps and will approximate the liabilities as closely as possible. (We must accept that there is no perfect match available at present.) The challenge for the asset management industry is to produce products that allow this benchmark to be created without the trustees themselves having to be closely involved in the world of derivatives. This product would then become the core holding for the pension fund and would deliver the required return to match all or part of the liabilities. For example, the liability matching portfolio could replace the index tracking funds within pension funds. Additionally there would be scope for specialist managers to be employed to add value around this core holding – hence this has been described as bond plus investing.

These new approaches require new methods of performance measurement. Trustees have many difficult decisions to make. To facilitate their decision-making they require quality, independent management information and, where relevant, advice. Naturally they still want - and are required - to have an evaluation of their decisions.

Without clear yet comprehensive measurement and evaluation of all decisions, trustees will be reluctant to fully embrace these new concepts. WM is committed to helping ensure that the techniques required are developed to aid the trustees in discharging their responsibilities.

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