VERUS
ADVISORY LIMITED

Investment Governance Using Benchmarks

Ronan Smith, Verus

15 Sept 2021

Benchmarks and Targets

Benchmarks are tools for assessing success in investment management. So, however, are target returns. We need, therefore, to be clear about what each of these means.

Benchmarks

When an investment manager takes on a mandate, they often specify or agree a reference index. This may be a published stock or bond market index reflecting the type of securities which are included in the mandate. It might be a cash return, property index return or other asset class index, depending on what the portfolio is designed to invest in. Generally, benchmarks are published and therefore constitute an independent reference for comparison with the returns of the investment portfolio. In some cases, no such published benchmark exists and a bespoke benchmark may apply, constructed internally by the manager but with a loss of independence. Many portfolios are managed by reference to complex, or blended, benchmarks: these are weighted combinations of ordinary benchmarks, where the weights should be agreed or specified when the mandate or fund is set up.

Depending on the style of investment management, active or passive, the manager may be charged with trying to generate higher returns than the benchmark over time, either before or after costs, or may be expected to match the return of the benchmark as closely as possible. All passive (indexed) investment portfolios are managed with explicit reference to the relevant benchmark. The benchmark constituents are studied by the manager as part of the investment process.

Some active managers also pay close attention to the index constituents and take conscious positions, relative to the index, explicitly attempting to overweight likely winners and to underweight likely losers. Others ignore the benchmark or refer only casually to its constituents, but measure their performance against it. Yet others do not use a benchmark at all.

Target Returns

The mandate or fund objective may sometimes specify a margin by which the manager is expected (over some stated period) to beat the benchmark's return. This is a target return (consisting of a benchmark return plus expected margin). By way of example, a global equity fund may have a benchmark consisting of the MSCI World Index, Total Return, with Net Dividends Reinvested, expressed in euro. The manager may have an objective to surpass the return on the benchmark by 2% per annum over 3-5 year rolling periods, before investment management fees. The target return is, in this instance, MSCI + 2% (gross of fees) per annum.

A passive manager of a global equity portfolio will have a target of MSCI (gross of fees) without any margin. In the case of the passive manager, the mandate may also include a target level of tracking error, the risk of being different from the index. Risk is another dimension of benchmarking portfolio performance.

Absolute return funds attempt to generate returns from various sources. The manager attempts to find and change these sources over time as part of the mandate. The target for such funds is usually expressed as cash plus a significant margin (often 4% or 5% per annum or, for absolute return fixed income, about half of this). The cash element will be specified as some form of cash index or interbank reference rate. That cash return, formally, is the benchmark for the fund. But the key element of return is the margin that can be generated over cash.

This highlights the importance for trustees of focusing on targets rather than benchmarks in the course of reviewing investment performance. The relationship between portfolio returns and the benchmark itself does provide information about the types of risk being taken by the manager, but to answer the key question of whether the manager has achieved their objective, investment returns must be compared, for all funds, with the appropriate target return.

Issues with the use of benchmarks and targets

Verus has raised issues with clients over recent years concerning deficiencies in the use of benchmarks by investment managers. The Pensions Authority's draft Code of Practice requires explicit consideration of investment performance and details the use of objectives, performance benchmarks and return targets. It will be crucial for trustees to control and influence the use of benchmarks and targets in the portfolios they are responsible for governing. There are three key ways in which we have observed benchmarks or targets being misused and which trustees need to ensure do not adversely impact outcomes for their investments. These are: inconsistency, inaccuracy and retrospection.

Inconsistency

We have observed cases where the same fund reported two different target returns to different clients at the same time. While both targets would not have been visible to either board of trustees, trustees should ensure as far as possible that providers are using proper methods and processes to ensure that benchmarks and targets are consistent.

Inaccuracy

There have been cases where benchmarks were selected by investment managers that do not reflect the universe accurately from which the manager is expected to generate returns, according to the mandate. This can happen when the wrong 'version' of an index is selected (there are many versions of each index, depending on such factors as: currency of quotation, hedging, inclusion of dividends, and allowing for an element of taxation in those dividends) or when an unsuitably constructed index is chosen, such as an index that is not investable because a significant element of its market capitalisation is not listed and available for investment, or is restricted by regulation. It can also arise when inappropriate weightings are used in blended benchmarks.

We have also seen examples where the manager has failed to distinguish accurately between a benchmark and a target. Performance has been reported for all funds held by a scheme with comparisons against a benchmark in all cases. Applying this method meant that the performance of absolute return and similar funds was shown in comparison to cash only, a rather easy benchmark to beat! Clearly, such a fund should be compared to its target or, where there is a target range, its benchmark should be considered to be the lower end of that range. This anomaly highlights the importance, in our view, of always reviewing investment performance primarily against its target, rather than its benchmark.

Retrospection

When a fund is initially selected by trustees for inclusion in the scheme, either defined benefit or defined contribution, the trustees will have agreed to the benchmark that will apply to the fund and, usually, what target return will apply. The appropriate benchmark for a fund or mandate may have to change subsequently. For example, the original benchmark may use an index which becomes unavailable, such as Libor/Euribor; or the investment strategy may become inappropriate or sub-optimal and will have to be replaced with another strategy that will be better reflected by a different benchmark; or the target margin may be found to be unattainable due to changed market conditions and may have to be reduced: there are many reasons why benchmark or target changes may be required.

Usually, this involves changing the benchmark or target for a fund in which the trustees are only one of a number of investors. The fund in question may be marketed widely, possibly in different jurisdictions and possibly to different types of investor. The manager may need, quite reasonably, to give effect to a required benchmark change for the fund that will apply equally to all investors and will not generally be in a position to use different benchmarks with different clients. As an investor in the fund, the trustees' right to information about the change will be determined by the terms of the prospectus or equivalent documentation and could in some cases be quite limited. However, as the party appointing the investment manager using the fund, the trustees need to preserve their own control over the governance process, and to determine what is the best way to assess the performance

of their manager. They should, therefore, when appointing the investment manager or by subsequent amendment, ensure that whenever benchmark changes are required:

a) The manager provides full details of the proposed change well in advance of implementation;
b) The manager provides a full explanation for the need for the change and why the proposed new benchmark or target is the most suitable (for the trustees);
c) The manager allows the trustees sufficient time to consider whether the change is appropriate and to make alternative arrangements if it is not;
d) The trustees give full consideration to any change in the effectiveness of their investment oversight arising from the proposed change;
e) The trustees and the investment manager agree a date for implementing the new or amended benchmark.

Trustees should embed these requirements in their process in the soon-to-be-required Statement of Investment Process.

We have observed changes to benchmarks being implemented without the knowledge of trustees. The first time the trustees will have observed the change will be when the new benchmark is used in an investment report. Sometimes not only is an effective date for the new benchmark not agreed in advance, but it is not even disclosed after the event. Accurate and advance introduction of agreed benchmarks and targets is an intrinsic element of the investment process and trustees have an obligation to ensure that this remains so.

Ronan Smith
15 September 2021