Pension Fund Investment Governance - Real Choices for Trustees

by Ronan Smith

There is a generous choice of investment frameworks for pension fund trustees to consider for the governance of their funds, whether defined contribution or defined benefit. Along with my colleagues in Verus, I have spent much of the past three years studying the different types of Outsourced Investing model that trustees can use. We have been struck as much by the range of approaches that can be taken, as by the extent to which this field has evolved over the past few decades. Trustees sometimes feel a little bewildered by the complexity of these choices. I would hope, however, that some of the thoughts I have gathered together here, might make addressing questions about the right investment governance framework a little more digestible.

Historical perspective

A glance backwards through Irish pension fund history tells a story that helps to explain the various governance models used.

1. The Beginning - Single Balanced Manager

As professional asset management gained a foothold in pension fund investment in Ireland, the attraction for trustees was the high level of return that appeared to be available from people with expert access to high-return assets such as equities. Insurance companies had been the natural go-to people for typical pension funds. But medium to large funds, at that stage almost entirely defined benefit plans, began to see investment managers, some of which were owned by insurance companies, as the natural provider.

The competition for funds among investment houses led to a growing interest in measuring the performance of investment managers (and a painfully slow improvement in the methods used to do this). The key questions asked were about whether adequate returns were achieved and whether better returns might have been had elsewhere.

The natural stewards for this measurement and monitoring were the investment consultants, a function which commonly grew as an adjunct to the actuarial consultancy role but became quite distinct from it. Independent measurement of returns was carried out by consultants, often in the form of peer group comparisons. Manager selection was generally advised by the same consultants, who then carried out ongoing oversight of the investment managers for the trustees.

Typically, at the early stages of this period of

development (in Ireland from the 1960s to the early 1980s), investment managers ran 'balanced' portfolios covering all or most of the assets of the scheme. We can refer to this as the Single Balanced Manager approach.

2. Asset Allocation - Specialist Manager Approach

Techniques introduced by consultants to consider risk in terms of liabilities led to asset allocation being done under guidance of consultants.. The mandates issued to investment managers changed, removing much of the managers' discretion in relation to asset allocation. It was a short step from this to the introduction of specialist mandates, where managers were hired to manage a particular asset class or subset of an asset class in which they were regarded as having a particular skill. Trustees now had multiple managers (sometimes two, sometimes a handful, but in the case of some of the largest funds in the world, more than 60 managers directly contracted was not unheard of).The resulting structure was somewhat unwieldy for smaller funds but worked as a governance model for larger funds. The investment consultant played the critical role in policy formulation, asset allocation, manager selection and review, and oversight of the investment activities of the managers.

We can refer to this as the **Specialist Manager approach**.

Sometimes consultants and trustees recognised that specialist fragmentation was not economic but still wanted to diversify managers. They assembled two or more reasonably similar balanced managers to compete in 'real time' among each other by managing a portion of the fund. We call this the Split Manager approach. Clearly, the consultant maintains an oversight role where this governance model is used but not an asset allocation role.

3. The delegation of authority - Outsourced Investing

The key driver of step-change in this industry began in the 1980s. Very large funds in Holland and then in UK that were managing key investment decisions with in-house staff made a governance breakthrough. They took the entire implementation of investment policy off the trustees' table. Once they had done this for their own, they began selling the service – Fiduciary Management – to other, typically smaller, pension funds. This is the Fiduciary Management approach.

Then consultants made a breakthrough of their own. They turned their investment consulting relationships into investment management services. Rather than overseeing investment management provided by professional managers on behalf of the trustees, the consultants became the high-level investment manager. They leveraged their skill in assessing investment managers to decide upon and implement suitable mixes of managers for trustees. Some have built platforms designed to provide smaller schemes with affordable access to best-in-class investment management. These services are known by various names including Implemented Consulting and Delegated Consulting.

Just as consultants extended their services towards investment management, some investment managers, not to be left behind, have extended their services in the opposite direction – towards full investment solutions for trustees. Many of them self-style such offerings as Fiduciary Management although in some cases they do not include the full fiduciary service that traditional in-house managers originally developed.

All the methods that combine investment policy decisions with investment consulting or manager selection and investment management are best referred to collectively as Outsourced Investing. Outsourced Investing offers trustees of pension schemes, either defined benefit or defined contribution, a potentially significant enhancement to their investment governance. While outsourcing may not be right for all, it is difficult to argue that any fund over €15 million should not at least examine it carefully as a way to proceed.

What is available today

Trustees need to be to be familiar with the specific Outsourced Investment offerings available to them.

Although it is a relatively new development, we have identified at least eight providers of Outsourced Investing in Ireland and are aware of others who would provide the service if they saw an opportunity and others who are considering providing it.

Thinking about your scheme

Trustees need to consider the different governance models outlined above and assess their implications for the good governance of their own scheme.

What will constitute good investment governance will vary from scheme to scheme, depending principally on:

- **The scale of the scheme**
- **The experience and skills readily available to the trustees and the independence of those skills**
- **Specific service and choice requirements (in defined contribution plans)**
- **Funding issues (in defined benefit cases)**

Regardless of the specific issues in any case, however, formulating the right governance model for investments requires trustees to allocate responsibility, authority and accountability for each of the key phases of the investment process among:

- **The trustees themselves**
- **Investment staff**
- **Investment consultants**
- **Actuarial consultants**
- **Investment Managers**

Achieving rigour and full rationality in such an exercise is difficult. When it is done however, it will enable the trustees to assess which investment governance model works best for them.

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