Assessing asset manager performance—evolving new techniques

Report on a roundtable for industry professionals

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Introduction to the Issue

Managing financial performance and risk over the long term has always been a central task for pension funds. Recent work by regulators and others has made clear that trustees have a duty to consider environmental, social and governance ('ESG') issues, in so far as they have a financial impact over the long term. Trustees already use relatively sophisticated methods or investment consultancy products to guide their initial appointment of asset managers, and these are largely designed to assess how well managers will perform over the long term and can take into account their effectiveness at monitoring environmental and social factors. However, once they have hired an asset manager, trustees still tend to revert to simple quarterly comparisons with a benchmark when assessing ongoing performance, and thus whether the asset manager should be kept or fired. Naturally, this encourages short term decisions by the manager, and thus a loss of focus on environmental and social factors. This may in turn lead to a loss of value over the long term.

Hence there is a question as to whether and how trustees (of both defined benefit and defined contribution funds, but not specialised ethical funds) can assess and manage their asset managers more effectively. This is likely to involve both quantitative and qualitative techniques. One aspect of this question is how taking into account ESG issues fits within this wider process. Some funds, such as the Environment Agency Pension Fund, have used alternatives to portfolio valuation, but can funds with lower levels of commitment and resource move in this direction? If so, what is the best, feasible alternative to portfolio valuation, and how can we create trust in it?

Report on the Event

A roundtable to discuss these issues was held on 13 March 2017, attended by representatives of 13 Pension Funds, and 6 advisory and asset management firms. It was hosted by the Pensions and Lifetime Savings Association.

Following a welcome from Luke Hildyard of the PLSA and an introduction to the meeting from Charles Seaford of CUSP, there were four five-minute talks from participants:

First, Stuart O'Brien outlined the legal position. Pension fund trustees have a fiduciary duty to act in the best interests, normally understood as best financial interests, of beneficiaries, balancing returns with risk and using an appropriate time horizon. The chances of a fund achieving its financial objectives—and by the same token the risk of it not achieving these objectives—will be at least partly driven by the performance of the asset managers it selects and the fees they charge. It follows that trustees need to have a view on the likely future performance of any manager they select and on whether this justifies the fees charged and need to exercise due care when taking this view. Trustees will also need to consider whether the incentives and mandate they provide for their managers are likely to enhance or detract from performance.

If trustees accept that in principle ESG risks could be financially significant, they have a duty to take them into account in their investment decision making. Given that they delegate stock selection, and in many cases engagement with corporate management, to their asset managers, "taking them into account" will largely refer to how they select, mandate and incentivise those managers.

It follows that using quarterly benchmark performance is not necessarily the best way of fulfilling fiduciary duty.

Mark Mansley then described his approach to asset manager performance assessment (as CIO of the Environment Agency Pension Fund). This involves the use of both quantitative and qualitative methods. The quantitative methods cover cash flow, ESG metrics and some other metrics which may be leading indicators of good long-term performance. These metrics are developed by the asset managers themselves, and so as a pension fund client he has to be satisfied that the manager's choice of metrics is adequate as well as being satisfied that its performance against these metrics is adequate.

Qualitative assessment is also needed. This is partly because the metrics don't tell the full story. For example, sometimes a manager may create an exposure, e.g. to oil, but this may be acceptable if the manager is aware of the longer-term risk and is likely to exit in time. More generally, judgment is often needed to interpret metrics because the evidence for their predictive power on their own is not that strong. Indeed, in some areas, for example governance, it is difficult to reduce what matters to a number.

He also remarked that while quarterly performance was not the most important factor in re-appointment decisions, *consistent* under-performance would weigh heavily: you had to have a very good reason to ignore this.

Marisa Hall presented the methodology offered by Towers Watson to its clients. This involves both qualitative and quantitative techniques. The qualitative techniques include reviewing the people, their investment ideas and the systems in place for implementing these ideas. It also included an assessment of how likely any competitive advantage created by these features was to endure. Quantitative analysis provides the basis for challenge and dialogue between client and asset manager, and includes analysis of the impact of fees on net returns, risk profile, performance and drivers of performance. She emphasised, however, that good performance was a function of a good long term relationship between asset owners and asset managers—underpinned by trust, an investment of time on both sides, and an exchange of value.

She also presented some of the evidence that using quarterly performance metrics was a poor way of assessing future performance, certainly in isolation, and that changing asset manager on the basis of one quarter's poor performance was likely to destroy value.

Leon Kamhi of Hermes Investment Managers confirmed that Hermes focused on, and reported on the 'holistic returns' that is to say outcomes for clients that go beyond the financial and include the impact of its decisions on society and the environment. These decisions have an impact on the world today, but also on the world as it will be in the future, when beneficiaries retire, and thus on the real value of their retirement incomes. and that these were good leading indicators of financial performance. Hermes therefore has a set of proprietary tools for achieving and measuring this.

The discussion that followed led to the conclusion that there were two tasks to be undertaken if effective assessment of asset managers was to become more widespread:

- Technical work on the development of metrics and other tools that would enable funds to assess performance without recourse to quarterly performance against a benchmark: while there are some metrics (as the speakers testified), there is certainly room for more work, particularly of ESG metrics that can be shown to be good leading indicators of financial performance. This work is taking place anyway within consultancies, asset managers and bodies such as the Institute of Actuaries.
- Creating a consortium or partnership between small to medium sized funds that would help them use such tools and products that already exist or are developed so as to avoid falling back on quarterly benchmark performance as a method of assessment. Many schemes lack the expertise and confidence to use the metrics—as was emphasised by the speakers, their use requires judgement, and in any case they are part of a mixture of quantitative and qualitative techniques which may be too resource intensive for many small schemes. In principle they can ask their investment consultants to provide it, but they may not be able to specify a suitable, cost-effective assessment product, either because they lack the knowledge or because they lack the market power.

Report on follow up activities

A consortium or partnership would probably need to be sponsored by a trade body such as the PLSA itself, or perhaps the AMNT (Association of Member Nominated Trustees). The question was whether the interest expressed during the meeting could translate into action. Charles Seaford had conversations with both organisations after the event and presented a 'straw man' proposal for a package that might facilitate this to AMNT members. This could include a guide to existing assessment approaches and passive products, when to use which approach and what advice to ask consultants for under what circumstances, how to do qualitative assessment, what this means for those developing metrics and assessment tools, and a process for collective purchasing where appropriate. In the event neither organisation wished to take an initiative in this area. It seems likely that any consortium or wider uptake of techniques will depend on creation of stronger incentives for trustees (and their trade bodies) to take action, in other words further changes to the law, and continuing consolidation in the industry.