

NEW TERRITORY

ADAM MICHAELS of Lane Clark & Peacock gives a consultant's view of targeted returns and whether they will achieve their objectives

Do you believe that targeted return products better link the fund manager's objectives with those of the trustee, compared with the current index benchmark approach?

MICHAELS: Very much so, if the manager's objectives are related to an appropriate liability benchmark. Of course, this depends on the expected volatility of returns around the tracking error not being too high.

Under the traditional approach, the investment manager could outperform their benchmark and yet the pension scheme's funding position could worsen (for example, if the level of real long-term interest rates falls). The manager's objectives are often not well aligned with the trustee's objectives.

Under a "target return" or "liability-driven" approach, the mismatch between the manager's benchmark and the assessed value of the liabilities can be reduced, better linking the manager's objectives with those of the trustees.

This will require the framing of a suitable liability benchmark.

Do you think that targeted return objectives should be based on absolute return objectives or should they be liability-related – i.e. bond-like?

MICHAELS: Where the mandate relates to all of the scheme's assets, then the benchmark should typically be liability-related. Targeting an absolute return, or one that is linked to RPI, would not protect the scheme's funding position from falls in the level of real long-term interest rates.

Actuaries typically assess the value of pension benefits with reference to the price of long-dated bonds, which means that the most obvious strategic benchmark is a bond-based benchmark of suitable duration.

However, there may be situations where a mandate that targets an absolute return would be suitable:

- Where the trustees are happy to accept the interest rate risk.
- As a part of the overall portfolio, providing diversification.

One of the issues faced by trustees thinking about adopting a target return approach given current market conditions is that this may involve locking in to the current low yields on



bonds. Where the trustees believe strongly that long-term interest rates are going to rise, it may make sense to adopt an absolute return target, rather than a bond-based target. This would be on a tactical basis, with a view to adopting a bond-based target once yields are more favourable. This would enable the scheme to benefit from a fall in the assessed value of the liability if interest rates rise. The views of the corporate sponsor will also be important here.

In this case, the trustees must understand the risk posed by further falls in long-term interest rates. Trustees may feel that this is a risk that they cannot accept.

Does delegating both strategic and tactical asset allocation decisions to the fund manager involve a potential conflict of interest for the fund manager to steer allocations towards high fee asset classes?

MICHAELS: It could do – certainly care is required. One would not want to feel that investment decisions were being driven by motives other than performance.

There are a number of ways in which this conflict can be managed:

- By retaining oversight of significant investment decisions, such as changes in the strategic asset allocation.
- By agreeing in advance the fee payable for

a given level of target return over the liability benchmark.

- By ensuring that the remuneration of the relevant investment team is directly related only to the performance of the target return products managed and not to the success of other areas of the business.

Having a performance-related element to the fee can help to align the manager's interests further with those of the scheme.

There is also the potential for conflicts related to the purchase of derivatives such as swaps. Many fund managers are affiliated to an investment bank and it is important to ensure that best execution terms are obtained.

Are today's targeted return products credible or do you feel they need more time to develop a track record?

MICHAELS: In my opinion, some products are theoretically credible.

Some fund managers can provide examples of successful performance over short periods. However, there is currently no body of hard statistical evidence to show that the products in the market will achieve their objectives.

Few managers have been managing liability-driven investments for three years or more, and it will take time for a track record to develop; the market is still in its infancy. There is a very wide range of possible

solutions, which will make it difficult to analyse performance. The various pension schemes adopting this approach will have a range of requirements, in terms of:

- The liability benchmark.
- The required level of outperformance over the benchmark.
- The balance between manager risk and market risk.
- The constraints imposed.
- The approaches the trustees are comfortable with.

Until a sufficiently large number of schemes have adopted these approaches, it may be difficult to find a large body of performance figures that are relevant to the specific approach envisaged.

However, trustees can clearly look at the manager's track record in the underlying asset classes used in the overall solution.

It may be possible to look at simulated performance figures for the proposed solution. Indeed, the manager is likely to have done this in developing the solution, which means that the solution is highly likely to have achieved the target return over the last few years!

How difficult will it be for trustees to quantify return and risk measures for targeted return mandates?

MICHAELS: The concept of performance relative to a liability benchmark is very similar to that of performance relative to an equity- or bond-based benchmark. Indeed, the liability benchmark may be defined in terms of an index of bonds. Care must be taken where the liability benchmark is defined in terms of swaps, since swap prices are not well defined.

The monitoring of performance for target return approaches should not be fundamentally any different to that for traditional approaches.

It is always difficult to assess retrospectively the risk that has been taken. Risk is a measure of the variability of returns, and only one realisation of the range of realisable returns is observed.

Looking forward, it is possible to assess the expected return and risk for some approaches. However, this assessment will be dependent on a number of assumptions about the underlying investments and their interaction. Other approaches, for example those which involve significant tactical asset allocation decisions, may be harder to assess prospectively.

It is worth noting that providers of performance measurement services may require additional payment if they are asked to report on the performance of swap contracts, for example. ●

Adam Michaels is a consultant at Lane Clark & Peacock

The questions which both Adam Michaels and Peter Scales (opposite) answered were set by Hewitt Associates

TARGETED RETURNS

LPFA's Peter Scales believes trustees and advisers must develop a longer-term approach to targeted return mandates

Do you believe that targeted return products better link the fund manager's objectives with those of the trustee, compared with the current index benchmark approach?

SCALES: One of the difficulties in talking about targeted return mandates is that they are imprecise in terms of the asset components and can be subject to the individual style of the manager selected or product chosen – this can also be an advantage and a reason why these products are becoming popular or fashionable. The point is that by specifying a targeted return, this can be related to the actuarial return expectation or the rate by which liabilities will increase.

To that extent, this can be said to be a better link to the trustees' objectives since the investment return should be an integral element of the funding strategy. If a return can be set to meet a funding shortfall over time, why bother with index benchmarks? However, such freedom is not always welcomed by the traditional fund manager who values the comfort blanket of a benchmark and can bring risks that are less easy to evaluate.

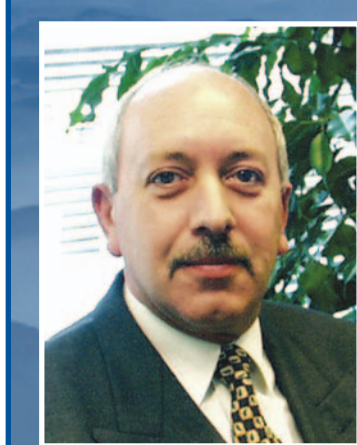
Do you think that targeted return objectives should be based on absolute return objectives or should they be liability-related – i.e. bond-like?

SCALES: In setting up the structure for the LPFA mandate, we first considered a liability-related return, preferring index-linked gilts plus 3pc. However good a proxy this might be for liabilities, the one thing that pensions don't do is go down. Of course, index-linked gilts can go down as well as up, and absolute returns became more attractive to our thinking as a target.

In the end, we selected RPI + 5pc as our target, accepting that this would influence the types of assets selected and could well mean a more volatile ride over time.

Does delegating both strategic and tactical asset allocation decisions to the fund manager involve a potential conflict of interest for the fund manager to steer allocations towards high fee asset classes?

SCALES: I'm not sure I accept the implication that there is a potential conflict of interest, but it has to be accepted that higher returns require more active management, the use of more expensive investment vehicles, and come with a greater risk budget. That said, trustees can specify controls on the assets used, must monitor activity, and should review transaction costs and fees. One option is to set the performance target net of fees, or operate a set fee structure, performance-based or not, which ignores the asset structure used.



■ Scales: "better link"



IN IT FOR THE LONG HAUL

Are today's targeted return products credible or do you feel they need more time to develop a track record?

SCALES: I believe they should be credible for they can demonstrate they will do rather than on past performance. I know that sounds obvious and it is difficult to ignore the past completely and put your faith in something new and different. This places a greater onus on the trustees and their advisers to understand the product and the process that will deliver the expected returns over a reasonable period of time. As I said previously, part of the baggage is greater volatility in the short-term and we must develop a longer-term approach to this type of mandate.

How difficult will it be for trustees to quantify return and risk measures for

targeted return mandates?

SCALES: The calculation of returns should be self-evident for all but a few asset classes, as there are well established protocols for measurement. In some areas, like private equity, this may be more difficult for funds hanging on to the quarterly treadmill of performance measurement. As I've said, trustees need to accept a much longer-term approach to valuing returns, which links with the actuarial assumptions and funding strategy, and not to other funds.

Evaluating risks is a crucial element of the targeted return mandate and must involve discussion with the selected manager. The risks of volatility and mismatch with other asset choices in the fund are manageable by understanding the structure of the mandate and manager strategy.

Inevitably, the answer lies in determining what the trustees won't accept, rather than choosing the asset allocation, to set parameters for the manager. These would include forbidden assets or products, e.g. hedge funds perhaps, pork bellies; low exposure limits on, say, pooled vehicles or unit trusts, leveraged loans, high yield bonds, commodities; maximum exposure limits on, say, quoted equities, cash; and limits on the use of derivatives, which is an article in itself!

You may ask after reading this whether I am really talking about a targeted return mandate or an unconstrained benchmark. It is the outcome that defines the purpose. Trustees need to generate a particular return – managers are mandated to deliver that return. ●

Peter Scales is chief executive of the London Pensions Fund Authority

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