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Non-Traditional (Unconstrained) Benchmarks

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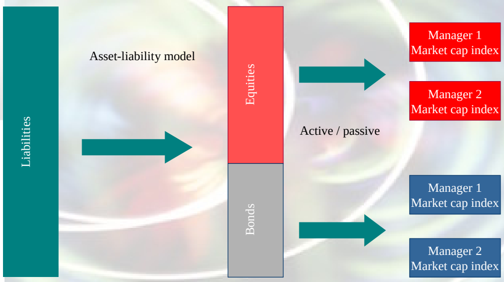
What is a non-benchmark mandate?

- Wide term that refers to many approaches
- Any mandate not heavily influenced by a market cap index in the equities
  - Unconstrained
  - Index-aware
  - Absolute return
- The investment managers are given freedom to invest in their best ideas
- Having a benchmark that is not investable forces the manager to think about fundamental best ideas
- This is not a debate about benchmarks but about behaviour

The current model….

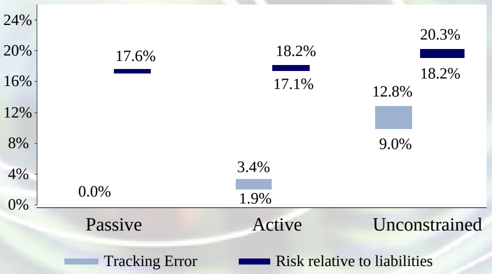


What is missing?

- Index is key driver of performance regardless of style of management
  - Trustee boards are indirectly taking a number of investment decisions
  - Business risk is key driver for managers
  - Relatively small deviations from the index
  - No protection in downside markets
- Highly concentrated mandates in some regions
- Mandate benchmarks bear little resemblance to pension fund liabilities
- Only one type of risk is being taken….market risk
- Passive management is seen as the low risk option – it is NOT!

What is the real risk?

Inter-quartile ranges based on 5 years' analysis



Why would you go down this route?

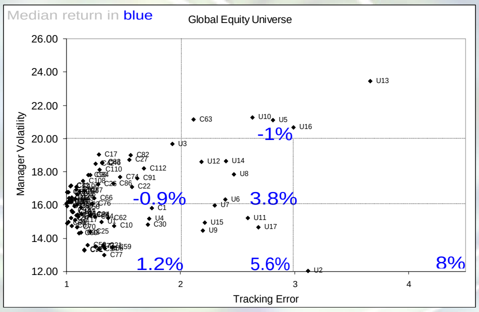
- Way of trying to get better management and alignment to scheme objectives within existing asset classes
- Trying to influence manager behaviour…not creating a new "benchmark"
- But one of the drivers of manager behaviour is the benchmark – if it wasn't there would not be a debate
- Think about how you want your manager to behave then think about how best to achieve this
- There is a discussion about what the manager should invest in if they don't have conviction…….
- ….but setting an investable benchmark to measure managers on the basis of what they should do if they don't have conviction is not the right starting point

What do you get in practice?

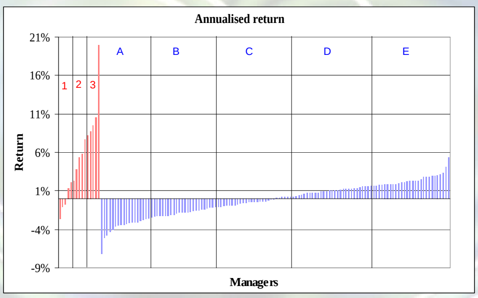
Sample used for comparison:

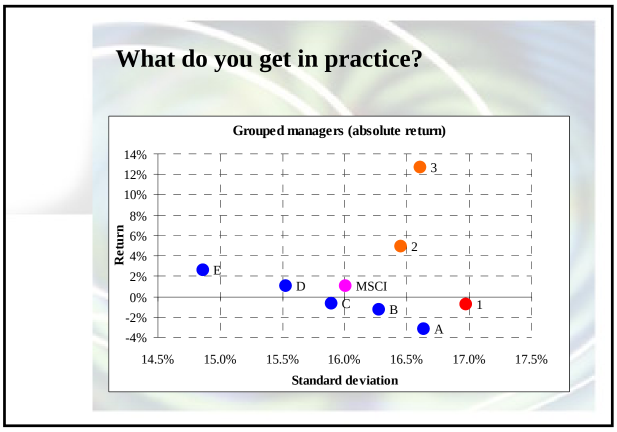
- **Universe = MSCI World**
- **Period : 30/04/2001 – 31/03/2006**
- **Returns are net of fees**
- **16 Unconstrained managers (grouped 1,2,3)**
- **126 Core managers (grouped A,B,C,D,E)**
- **Example portfolio : 50% Eq + 37.5% FI + 12.5% ILG**
- **Liability proxy : 70% ILG + 30% FI**

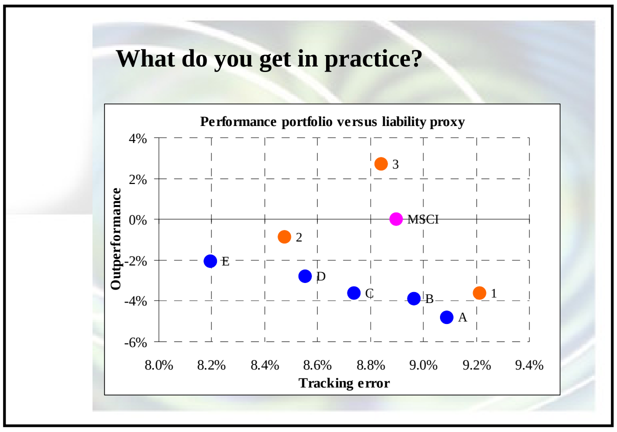
What do you get in practice?

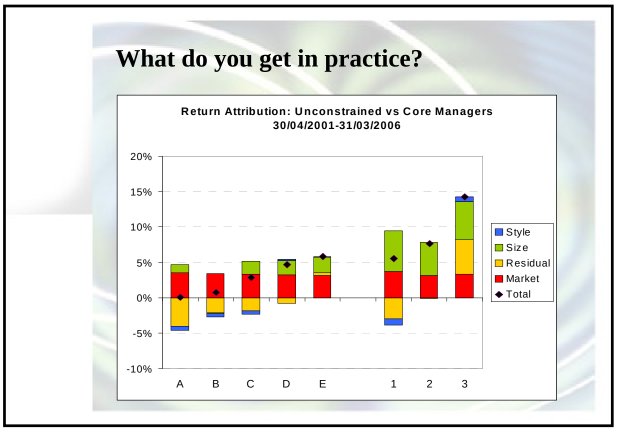


What do you get in practice?

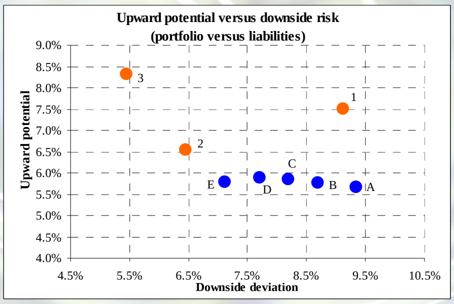



What do you get in practice?
Grouped managers (absolute return)
Return
14%
12%
10%
8%
6%
4%
2%
0%
-2%
-4%
14.5%
15.0%
15.5%
16.0%
16.5%
17.0%
17.5%
Standard deviation
E
D
MSCI
C
B
A
1
2
3


What do you get in practice?
Performance portfolio versus liability proxy
Outperformance
4%
2%
0%
-2%
-4%
-6%
8.0%
8.2%
8.4%
8.6%
8.8%
9.0%
9.2%
9.4%
Tracking error
3
MSCI
2
E
D
C
B
1
A


What do you get in practice?
Return Attribution: Unconstrained vs Core Managers
30/04/2001-31/03/2006
20%
15%
10%
5%
0%
-5%
-10%
A
B
C
D
E
1
2
3
Style
Size
Residual
Market
Total

What do you get in practice?



Implementing “non-benchmark” equity mandates

- Time horizon not a key objective in its own right
- Implementation depends on your starting point
  - Number of managers whose natural style is more “unconstrained” - what you see is what you get
- Trying to change behaviour of existing manager more complex
- Some Options for benchmarks
  - Comparison with randomly generated distribution of returns from available universe of stocks
  - Equally weighted index (in regional market)
  - Absolute return objective
- Absolute rather than relative risk controls

Monitoring issues

- Attributing and analysing performance must be manager specific
- Using the index as a yardstick of performance is not a problem…provided it then doesn’t force a change in behaviour of both the client and the manager
- Understand drivers of performance and risks being taken
  - Absolute volatility
  - Contribution to total volatility of 10 most volatile instruments
  - Contribution to total return of 10 highest returning positions
  - Factor analysis