Setting Briefs For Investment Managers

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History of setting briefs

- Fully discretionary
- Expect to beat inflation over “long-term”
- Little measure of skill of manager

“How is my manager doing vs. others?”
- Beat average of peer group objectives
- Peer group became asset allocation benchmark
- Index or peer group within each asset class
Problems arose

Asset allocation decisions became relative
   No longer “fully discretionary”

Today - Specialist Briefs

Trustees set strategy
   Asset allocation decision by trustees
   Different manager for each asset class
   Index benchmark for each manager

Specialist briefs - problems

Index “hugged” by managers
   Business risk to managers
Index seen as construction benchmark
   Intention: performance benchmark
“Risk” seen as underperformance of index
   Below index seen as bad as absolute loss
Specialist briefs - problems

Stock concentration – 12% in Vodafone
From a manager who didn’t like it
Asset allocation implies stock weighting
BP (3%) vs Exxon (0.2%)

Present and Future

“You get what you measure”
So measure the right things:
Objectives of fund manager should…
…line-up with objectives of trustees

Investment Objectives of Trustees

Long-term:
  Meet pension payments
Short-term:
  Increase funding level
  Low risk of reduction in funding
Present and Future

Liability matching
Liability-plus
Unconstrained – specialist
Unconstrained – “new discretionary balanced”

Liability Driven Investment

Liability matching

Provide liability information to manager
Asked to determine asset benchmark…
…that is near-match to liability cash-flows
Manager tracks that benchmark
Benchmark adjusted as liabilities accrue

Current Membership Profile

[Histogram graph showing age distribution of members]
Membership Profile in 10 Years' Time

Membership Profile in 20 Years' Time

Liability Driven Investment

Liability plus

Benchmark is as before
Objective is to outperform benchmark
Active positions from any asset class
   Hedge fund overlay(?)
Liability Driven Investment

Trustees may only match part of liabilities
pensioners only
half of full liability profile
Require high returns from rest of assets

Unconstrained - specialist

Manager asked to produce “high-returns”
Risk is negative returns
Expected not to hug index
Objective may be:
RPI plus 4%
Outperform median stock

Unconstrained – New Balanced

Discretion to determine asset class weights
Objective to produce positive returns
Needs to show skill in asset allocation
Few have been able to do so
Potential Problems

Long-term view from trustees…
…and managers
Does not mean trustees “buy and hold”
Performance is not the only trigger to replace a manager