Investment Performance: The Responsibility Borne by Pension Fund Trustees

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In the UK, pension funds play a major role in the traded securities market. However, the implications of the independence to which such power can lead have probably not been fully recognised. To a great extent, the commercial pressures are such that trustees are rarely fully informed of the extent to which they can, and probably should, ignore short-term pressures.

For a typical pension fund, there are a variety of good reasons for pre-funding future promises and intentions. Initially, the contributions and investment income exceed benefit outgo, leaving a balance to be invested. Even if the layman cannot easily grasp the scope of the potential long-term liabilities, they are no less the real for that.

Generally, a UK pension fund is set up under trust, so that trustees, individual or corporate, bear responsibility for running the operation. This must involve monitoring their likely assets and liabilities, in order to be sure that the benefits can be provided.

So far as long-term liabilities are concerned, this is left to the actuary, who will advise on alternative funding strategies, and how that selected can best be tackled. However, in many cases, the trustees feel that they understand the investment process, and that the assets are of no concern to the actuary.

In fact, the assets are only being accumulated against the background of long-term liabilities. Therefore, as most actuaries would agree, it makes a great deal of sense to tackle assets and liabilities together.

In practice, I do not think that very much has actually been done in the UK along these lines, despite a lot of lip service. Indeed, I am not at all sure that all investment managers specialising in pension fund work always take account of the long-term nature of the liabilities against which the assets are being accumulated. For example, for some members, prospective pension fund benefits may not even commence being paid for decades.

The first point, then, is that the assets of a pension fund are normally being accumulated within a specific context. More particularly, the trustees of a pension fund have a much longer time frame, within which to plan, than say commercial unit trust managers. This must be carefully borne in mind.

Given the above, it seems to me that most trustees would regard it as prudent to arrange for the 'performance' of their assets to be monitored by an independent advisor. One can imagine circumstances in which trustees could be held responsible for not having done so. In any event, being monitored may, should it be needed, remind the investment manager that the client is not totally uninformed.

Further, the disclosure requirements of the Social Security Act 1985 may be relevant, in that such information may have to made available to members (although this is not yet certain).

It should be mentioned that, whatever method is adopted for monitoring 'performance', this will be far easier for marketable securities (or units in funds so invested) than for traditional insurance policies. However, for insured arrangements, I would submit that trustees should periodically review the investment return enjoyed, in order to satisfy themselves that the arrangements are economically efficient.

The question to consider is how best to monitor the asset 'performance'. There are now a few major monitoring services available. While they are not all the same, their similarities are, in my view, more significant than their differences.

What they all have in common is that the results are based upon 'market values'. At best, this is merely an approximation. At worst, however, this can lead to results which are severely misleading, for the following six reasons.

1. 'Market values' are not always well defined.
2. For some classes of asset, such as gilts, if held to maturity, the figures are of no relevance whatever.
3. 'Market value' is subject to fluctuations, frequently severe, over short periods. Therefore, it is not at all appropriate to regard 'market values' as any indicator of what might be described as a 'store of value'. The conclusion must be that the 'market value' can provide virtually no useful information as a predictor of the all-important long-term future.
4. High end-point 'market values' lead to the apparent conclusion that the investment manager has done well. However, this ignores two points, the first being that further contributions will purchase less than previously, which should not be regarded as good news. Secondly, if the 'market value' falls, then the investment return 'disclosed' must have been too high, and hence an unreliable planning basis. Even if it increases, it is no more reliable, because the figure disclosed would have been too low.
5. No account is taken of 'risk', which is difficult even to define, let alone tackle.
6. Finally, on a technical point, the 'time-weighted return' commonly published is an artificial concept, and is not actually a return which is achieved on the fund.

In short, 'market value' is the unit of measurement for short-term speculators, and not for prudent investors charged with meeting long-term liabilities. If any investment performance criteria could be

shifted away from the current heavy reliance upon volatile 'market values', then this should release investment managers from unjustified, but commonly experienced, short-term pressures. In itself, this may enable longer-term investment decisions to be taken, which is probably economically desirable. This was actually recently suggested by a Director of the Bank of England.

The second main point, then, is that the 'performance' services generally provide information which is largely irrelevant to trustees of pension funds.

It is quite understandable that few trustees would consider themselves capable of coherently framing what they intend to achieve by monitoring 'performance'. If, however, they were asked, and could give the answer, then I think that the following should be acceptable to them. They would like to know what rate of return could reasonably be regarded as maintainable on their portfolio, over a very long period, regardless of short term price movements. This is what I call the 'locked-in return'.

The above led me to frame an alternative to the 'industry standard', which, in my view, satisfies three aims.

A. It avoids the six problems referred to above.
B. It is practical.
C. It indicates what level of investment return may reasonably be regarded as 'locked-in' over a long period.

Suppose that we thought we knew, in advance, the average rate of return, which could be achieved over a long future period. Then the 'true initial value' of the assets could be assessed, using this 'knowledge'. If we were correct, then, over a long period, under the same approach, the Fund figures would fall into pattern. This is why I postulate that the return so determined would be 'locked-in', regardless of short-term market fluctuations. As, of course, we cannot be certain of the future, we have to make the best estimates we can, to be reviewed from time to time.

Such an approach may appear to be both highly theoretical, and extremely subjective. However, in my view, there is nothing wrong with theory, if it leads to practical results. Further, and more importantly, the approach appears to be far more robust, and far from subjective, as I had originally feared.

The approach was first publicly aired in October 1983[1] since when two further articles have been published.[2,3] This article is an attempt to distil those three technical articles into layman's terms.

One analogy I have found useful is the engineers' concept of 'noise'. If one has a signal of some sort, it may be pure, or it may include some interference, otherwise called 'noise'. My point is that the returns commonly published can be thought of as signals, which have to be interpreted with great care, in order to detect what is meaningful and what is not.

To illustrate the concept with a couple of figures, over the six years 1979–84, it has been published that the 'average UK pension fund' earned a return of 20.6 per cent per annum (excluding property). Using my alternative criteria, I estimate that a return of 14.0 per cent per annum may be regarded as 'locked-in' over a long future period, the remainder being 'noise'. This may indicate the degree to which the commonly published figures on investment returns can be misleading, if merely taken at face value.

My alternative approach, which is comparatively new, has not yet been accepted as valid by those engaged full-time in pension fund investments, either as managers or measurers. Nevertheless, I hope that the above may incline trustees to consider, very carefully, what they are told about such matters. In particular, the achievement of apparently poor 'market value' returns is not necessarily against the trustees' best long-term interests, and vice-versa.

Finally, the views expressed above are my own and should not be attributed to my partners.

References

(All by the Author published in 'The Investment Analyst')

1. 'The Long-Term Analysis of Investment Performance' [TIA 70,22 (October 1983)].
2. 'Long-Term Investment Returns Revisited' [TIA 73,17 (July 1984)].
3. 'Monitoring Investment Performance For Long-Term Investors' [TIA 80,21 (April 1986)].