Performance League Tables

Great for football, a step backwards for fiduciary management

November 2014
Overview

Fiduciary management is now an established investment and governance solution having had a strong presence in the UK pensions market for over 5 years. However, perhaps due to its perceived complexity, there remains a number of misconceptions around this approach. One such topic is that of performance league tables; there have been calls by some in the industry to use these for fiduciary management.

In this latest paper we discuss why we believe fiduciary management performance league tables would be inappropriate and even misleading. We draw upon examples and illustrations to support this view.

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Performance league tables are not suitable for fiduciary management

Fiduciary management is now an established solution to the many challenges facing UK pension schemes. However, perhaps due to its perceived complexity, there remains a number of misconceptions around this approach. One area frequently discussed is, unsurprisingly, performance; not just in terms of is it delivering results, but how can it be measured and compared between providers.

Our Fiduciary Management Survey 2014 once again confirmed that performance and track record remains the leading quality indicator when selecting a fiduciary provider (see chart to right).

This is often an area that trustees, rightly, want to understand more about and see real life examples of results. As part of this, there have been calls within the industry for performance league tables for fiduciary providers, to help trustees compare and select providers.

However we strongly believe that such performance league tables for fiduciary management would not only be inappropriate but that it would also be misleading. In the rest of this paper we outline exactly why we have this view.

Are league tables ever suitable?

Performance league tables are suitable for products, where the participants have similar investment objectives and are compared against similar benchmarks. For example, there are industry wide performance tables for each product / fund type such as FTSE UK equities or MSCI World with relevant targets, such as +2% p.a. These show the funds available in that particular area and their performance as well as the median for those managers (ie for a specific universe of funds). This is appropriate as each have very similar objectives and investments, and are essential very similar products just with different lead fund managers at the helm.

The CAPS survey is another example. Pooled fund providers will include the performance of their various funds in this survey with an objective of beating the median or upper quartile return. This can lead to a herding mentality where the provider is only interested in outperforming the other providers rather than concentrating on each scheme’s unique objectives and most importantly achieving risk-adjusted returns that are commensurate with the risk tolerance of the particular scheme.
Fiduciary management is not a product

Fiduciary management is a bespoke solution, not a product and therefore a performance league table would be inappropriate and misleading. There are so many variations within fiduciary solutions, as well as different investment objectives and unique liability benchmarks which drive them, that it means no two solutions look the same. And just as the solution in place will be tailored to each schemes’ unique needs, thus the expected returns would also be unique.

For example, a scheme with an investment objective of liabilities +0.5% would have a very different growth / matching split and asset allocation compared to a scheme with an investment objective of liabilities +4% which may also have a strategic underhedge. The solutions in place would be designed specifically to meet those objectives, taking into account any parameters and risk preferences set by the trustees at the outset. The second scheme would likely have a higher allocation to growth seeking assets and perhaps more in equities or hedge funds compared to the first scheme.

Indeed, at the end of the year, if the first scheme in this example achieved a return of liabilities +3% you would actually expect the trustees to be concerned about this performance. Were additional risks taken to achieve it? Has the fiduciary provider actually broken any parameters set and was there any mis-alignment of interests that encouraged them to over deliver by this extent rather than reduce the risk / returns in order to successfully meet the +0.5% objective over liabilities.

Even clients with much closer investment objectives will have very different looking solutions. As shown in the diagrams below, a liabilities +3% solution will look different in terms of its allocation to a liabilities +4.7% solution.

Client A

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**Size:** £250m  
**Investment objective:** +3.0% p.a. over liability benchmark

Client B

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**Size:** £500m  
**Investment objective:** +4.7% p.a. over liability benchmark
More than a headline return

There’s also another layer to our rationale. Not only do fiduciary solutions and each schemes’ unique investment objectives vary significantly, but it’s also important not to judge a provider on just a headline performance number.

Using an analogy to illustrate this point – it’s like choosing between two cars and saying that the fastest one is the best car to buy and so purchasing that one. This is misleading as you need to look at more than just the high level top speed data. When selecting a car, buyers would first consider what criteria they are looking for in a car and use this to determine which is best for them. For example, the buyer may actually want a car with a strong safety record and the best mileage (mpg). Thus top speed isn’t a key driver of their decision and shouldn’t be looked at in isolation to make a decision.

It’s the same with trustees and fiduciary management; when choosing a provider, trustees shouldn’t just look at the headline performance number from a sample client but should also look beneath this and consider the overall solution, as well as the providers’ business, amongst other considerations (discussed in our previous papers).

Looking at the headline number alone does not illustrate if the client has underperformed or outperformed their bespoke liability benchmark, what happened to their funding level and even if they did outperform, whether they met their investment objective (e.g. liabilities +2% p.a.).

An example is shown in the table – at first glance client A (or provider A) looks like they’ve had the best performance with total returns of +10.5% p.a. versus the other client at +3.5% p.a. However, when you start to delve beneath this number you can see that the bespoke liability benchmark also has much different returns and client A has a much larger investment objective versus client B. So while the headline numbers are very different, as are the relative outperformance of +3.2% p.a. and +1.1% p.a., actually the risk-adjusted returns are identical. Both clients have outperformed their bespoke liability benchmark and improved funding levels, without taking on too much risk to achieve it. Looking at the headline returns alone would be very misleading.

<table>
<thead>
<tr>
<th></th>
<th>Client A</th>
<th>Client B</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total return</strong></td>
<td>+10.5% p.a.</td>
<td>+3.5% p.a.</td>
</tr>
<tr>
<td><strong>Benchmark return (liabilities)</strong></td>
<td>+7.3% p.a.</td>
<td>+2.4% p.a.</td>
</tr>
<tr>
<td><strong>Target (Investment Objective)</strong></td>
<td>3.0% p.a.</td>
<td>1.0% p.a.</td>
</tr>
<tr>
<td><strong>Relative return (Outperformance)</strong></td>
<td>+3.2% p.a.</td>
<td>+1.1% p.a.</td>
</tr>
<tr>
<td><strong>Risk-adjusted returns</strong></td>
<td>1.14</td>
<td>1.14</td>
</tr>
</tbody>
</table>

It is very important to understand where the returns have come from and what levels of risk the provider has been taking. Have all the returns come from one big bet (a view or position) or have they been delivered through a number of contributors.

Ultimately, it isn’t just the headline returns that should be considered, nor the risk-adjusted returns, but also the drivers of risk and return before determining what is best for your needs and requirements.
How should performance be measured?

So, if performance league tables aren’t appropriate, how should fiduciary management be measured and providers compared?

It is important to understand at the outset what success looks like so that along the journey trustees can assess if the fiduciary manager is delivering what they promised, in the way they said they would do it. In order to do this, and effectively monitor their fiduciary provider’s performance, it is essential to delve beneath the headline numbers.

Fiduciary management solutions, by their very definition, are bespoke and so it is near impossible to compare directly the headline performance of different providers on a consistent basis. The different hedge ratios, target returns, growth / matching split, benchmarks, timeframes and fees deployed by providers for their clients mean that looking at (and comparing) just the headline number has little meaning and gives a limited picture.

Therefore the best way to measure performance, and the most relevant for trustees, is to look at this versus their unique investment objective. The real focus is improving funding levels and by assessing performance in terms of outperformance versus bespoke liability benchmark and investment objective (eg liabilities +3% p.a.) this is more relevant than looking at returns versus an industry benchmark which is not specific to their scheme.

68% of respondents to our survey agreed as they said they’d prefer to compare the success of their solution versus their unique investment objective (see chart), as opposed to versus an industry benchmark or other fiduciary solutions. This is a strong statement against league tables for fiduciary management and highlights that trustees understand the unique nature of a fiduciary solution.

Measuring success or failure

Source: Aon Hewitt Fiduciary Management Survey 2014
Summary

There have been calls in the industry for fiduciary performance league tables however league tables are only suitable for products, where the participants have similar investment objectives and are compared against similar benchmarks. Fiduciary management is a bespoke solution, not a product and therefore a league table would be inappropriate and misleading.

Each scheme has unique liabilities and investment objectives and as such unique operational parameters. The solution put in place will be tailored to their needs and thus the expected returns would also be unique. Therefore the best way to measure performance is versus their unique investment objective.

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About Delegated Consulting Services

Aon Hewitt’s fiduciary offering (Delegated Consulting Services) is focused on helping trustees and sponsors achieve better security for their scheme members. We do this through helping you meet your unique long term objectives and, importantly, through improving your scheme’s funding level. What makes us different? Only we ask the best questions and then really listen to exactly what our clients tell us. By working in partnership in this way we can then create a truly bespoke solution that is designed to meet your unique requirements. We don’t just say bespoke, we live by it.

Aon Hewitt currently holds fiduciary manager of the year awards from three of the industry’s leading publications; Professional Pensions (2015), Pensions Age (2015) and the FT (2014). Our ability to create truly bespoke solutions has been cited as part of these award wins and is one of the reasons why our clients vary significantly in size and how we work with them. Examples of some of the solutions we can offer clients include full fiduciary with bespoke growth and liability matching portfolios and daily monitoring of triggers. We also offer single solutions (partial fiduciary mandates) such as hedge funds, alternatives mandates and flight planning with dynamic de-risking programme.

About Aon Hewitt

Aon Hewitt empowers organisations and individuals to secure a better future through innovative talent, retirement and health solutions. We advise, design and execute a wide range of solutions that enable clients to cultivate talent to drive organisational and personal performance and growth, navigate risk while providing new levels of financial security, and redefine health solutions for greater choice, affordability and wellness. Aon Hewitt is a global leader in human resource solutions, with over 30,000 professionals in 90 countries serving more than 20,000 clients worldwide. For more information on Aon Hewitt, please visit: aonhewitt.com

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