2 MEASURING AND MONITORING INVESTMENT STRATEGY

Measuring fund managers' performance against their mandated benchmarks tells us something about how that service provider performed. This is an essential step. But it tells us nothing about whether we got value for money given the costs of that solution (or those underlying fund managers). We also don't know if we were adequately rewarded for the magnitude of risks assumed by those underlying managers. Measuring our aggregate manager performance against a strategic asset allocation tells us something about whether the solution was well designed to beat that specific benchmark. But it tells us nothing about whether members can retire with an adequate income replacement.

In effect, it's time we rethink exactly what we are measuring in our investment strategies and why.

Regulation 28 is quite explicit in what is required of us as fiduciaries. Members' liabilities are central to the design and monitoring of a retirement fund's investment strategy:

"This duty supports the adoption of a responsible investment approach… that will earn adequate risk-adjusted returns suitable for the fund's specific member profile, liquidity needs and liabilities."

This then suggests that, of all the things we measure about our investment strategies, the most important one is knowing whether they are meeting our members' liabilities.

What this then implies is that trustees need to be able to demonstrate that:
■ The fund's investment strategy is appropriately designed to address member profiles and retirement income requirements.
■ This strategy remains appropriate over time.

Combine these two insights with conventional investment performance monitoring, and finally trustees will have a proper framework for assessing whether any components of their investment strategy have become suboptimal.

Liabilities, like assets, change all the time. As markets move, liabilities move. This means we need to give fiduciaries and key decision makers a tool that can assess these changes and their implications. Think of this as a live liability monitoring tool.

Simply put, the tool provides regularly updated projections of returns and evaluates whether the existing strategy is still expected to meet a fund's liability target. The tool's purpose is to act as an early warning system for identifying inadequate expected returns, which may trigger a full ALM. What a full ALM can then add to the mix is whether the composition of the membership has changed in any way and if so, how this too can have an impact on whether the fund strategy is still appropriate.

TACKLING THE PROBLEM HEAD-ON

Below we use the example of a typical member invested in a life stage investment range, targeting a replacement ratio of 75%.

What makes this graph different from performance graphs that are generally presented to most investment committees, is the orange and grey stack bar. Taken together, this orange and grey stack represents the rate of return that is required to obtain an expected replacement ratio equal to the target. For example, here members need a return of 11.1% per year (0.6% plus 10.5%) from the high-growth portfolio in their strategy to reach a targeted replacement ratio of 75%. The tool deconstructs this into the expected return based on the asset allocation of the portfolio (10.5% per year shown in grey in our example) and the current shortfall (0.6%

per year in our example). This 0.6% per year is effectively the alpha that would be required beyond that projected asset class returns if the solution is going to meet the member liabilities.

Trustees should monitor this shortfall to ensure that the objectives in the fund and the strategies to reach these are reasonable. A large shortfall of projected return against required return may indicate a fund needs a change of asset allocation strategy. But there is only so much that an asset allocation strategy can be realistically tweaked without introducing unacceptable risks. Really large shortfalls may require trustees to consider alternative inputs into the projected outcomes, such as a change in contribution rates and retirement ages.

In the example used, new members could expect a replacement ratio of 66% (which assumes the pensionable salary is 100%). Here the tool calculates how much more members would need to contribute to achieve an expected replacement ratio equal to the target set. In our case study here, members would need to contribute an extra 2.6% of their salary to get an expected replacement ratio of 75%. Contributing 2.6% more would have the same impact as earning 0.6% per year alpha.

But really large shortfalls may also require a revisit to a detailed ALM exercise. At that point, our process starts again.
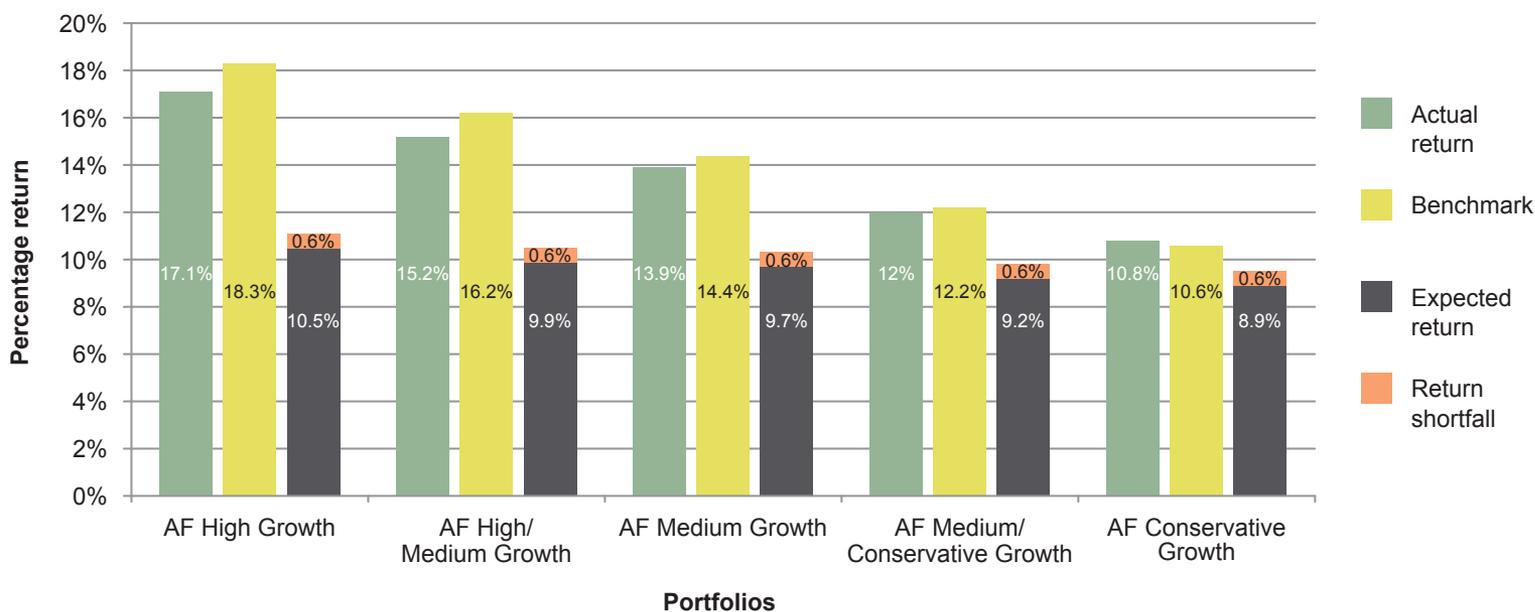
New fund members can expect to retire on 66% of their salary, on average. If members contribute a further 2.6%, they can expect to retire with 75% of their salaries, on average. The proportion of salary a member receives may differ significantly from these projections.

Source: Alexander Forbes Research and Product Development (2014)