How to Keep Trustees' Eyes on the Long Term Ball:[19]

- Develop and use benchmarks that are specific to the fund's long term objectives. Use this to assess whether the aggregate value of all manager performances in the fund are still on track.
  Note: if you are not on track, perhaps it is the blend of managers that is the problem and not the individual managers themselves.

- Develop and use benchmarks that are specific to each manager's declared style. This should provide the sole basis for determining whether the manager is fulfilling his job or not.

- Use performance attribution analysis on the total fund (this can be supplied by a good consultant) to evaluate the contributions of different levels of decision-making to investment performance.
  Note: Too often trustees fire the wrong person. They believe the manager achieved the underperformance when often it is the person "blending" the underlying managers that is responsible.

- Use performance attribution analysis on each individual to assess whether their performance was a function of their deliberate strategies or just plain good luck. This is the only way to really assess whether a manager is following their mandate and adding real value. (This can be provided by a good consultant or the manager themselves).
- *Note: If trustees cannot differentiate between performance returns that were a function of the market going up or down and returns that were a function of manager skill they will fire (or hire) managers for the wrong reasons.*

A paradox is haunting asset management.

The paradox is that funds with very long-term purposes are being managed to meet short-term objectives that may neither be feasible nor important. And they are *not* being managed to achieve long-term objectives that are both feasible and worthwhile[20].

2.6 Setting the benchmarks[21]

The key point here is that most funds probably should have more than one benchmark.

- The **primary** benchmark captures the long term funding requirements or performance expectations for the fund. It should reflect that long term optimal blend of investable assets (permitted by the fund's investment policy) that best addresses those funding requirements over a specified timeframe.

  – Typically this blend will be some proportional exposure to equities, bonds, cash, foreign assets, property etc.

  – Trustees can then assess the aggregate performance of the fund's underlying managers against this passive measure.

  – This is the benchmark trustees need to pay most attention to as it provides the best measure of the on-going health of the fund.

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  - While this particular benchmark is typically long term in nature, if the fund's member composition or performance objectives change, or if there are dramatic changes in market conditions, the trustees may need to reconsider and redefine this optimal blend.

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- **Secondary benchmarks** are the benchmarks that should be used to assess your manager's performance and skill. At best, these benchmarks should be a passive reflection of the manager's particular investment style or process. It should cover the universe of shares that are a reflection of the manager's mandate or of their particular investment style.

  Example (1): A manager with a general balanced mandate would require a benchmark which is that blend of the JSE All-Share Index, JSE All-Bond Index, Malan Money Market Index which best reflects the neutral asset mix over time (or that asset mix that the manager would typically hold if he had no view on the market's movements.)

  Example (2): A manager with a specialist mandate such as small cap shares, requires an equity benchmark that captures the small cap segment of the market.

If the benchmark is not a true reflection of the manager's typical investment style, then it will be impossible to assess whether outperformance or underperformance was a function of skill or lack there-of.[22]

Performance Benchmarks to assess manager skill **must** have the following characteristics.[23]

- Unambiguous – the names and weightings of all securities represented in the benchmark are clearly specified
- Investable – if the manager wants to take a neutral view, he should be able to invest in all of the benchmark's underlying securities.
- Measurable – the benchmark's return can be calculated with reasonable frequency
- Appropriate – the benchmark is consistent with the manager's investment style
- Reflective of current investment opinions – the manager is able to get information on the underlying securities.
- Specified in advance – the benchmark is constructed and weightings of its constituents known at the start of an evaluation period.

Question

Given the criteria given here for viable manager benchmarks, which of the following performance criteria would ***fail*** to qualify as valid benchmarks of manager skill.

- Out performance of other managers in the performance surveys
- Out performance of inflation
- Top quartile performance of the fund when measured in the Consulting Actuaries Survey
- None of the above
- *All of the above*

Answer to question on the previous page: All of the above

Note:

1. Using other managers as the performance benchmark violates every requirement of a valid benchmark accept one. To begin with, it is impossible to specify the manager universe benchmark in advance, one doesn't know until after the fact who the median manager is. How can you beat another fund manager if you don't know what they are holding in advance. Only chance places one manager ahead of another in this framework – not skill.

   Manager benchmarks are also uninvestable, ambiguous, and the portfolios the other managers held are unavailable for inspection both before and usually after the evaluation period.

   Finally, a benchmark comprised of other manager performances is unlikely to be appropriate or consistent with your specific manager's style.

2. Inflation as a benchmark would fail most specifically on the grounds that it is an uninvestable benchmark. There are, as yet no index-linked investment vehicles in South Africa.

3. The funds covered in the Consulting Actuaries Survey reflect a multitude of different funding requirements. Some are defined benefit funds, some are defined contribution funds, some have a very mature or shrinking member populations. As such, the investment strategies behind each fund differ widely. Performance comparisons would basically be meaningless because we would be comparing apples and oranges.