



Investing Pension Funds as if the Long Term Really Did Matter

Ideas from the Universities Superannuation Scheme and
Hewitt Bacon & Woodrow Competition

January 2004

Foreword



When Hewitt Bacon & Woodrow and the Universities Superannuation Scheme launched the competition in March 2003, we had little idea what response it would get.

This report—which brings together the best ideas from all 88 entries—is clear proof that all the effort has been more than worthwhile.

It is also the case—and this is another reason why this report is so useful—that this is work in progress.

Some of the ideas contained within this report can be tested on a modest scale. Some ideas can usefully be elaborated. And there are some issues that demand deeper creativity and more concentrated professional attention—how ‘genuinely responsible’ can best be defined and implemented is the obvious example.

But what I find most interesting from this range of ideas—some practical and some about investment principles and approach—is that there is probably at least one thing that can be done which won’t harm, and could improve, our long-term financial performance and/or our impact as corporate citizens.

We can then share the lessons we have learnt from these experiences, which is one reason why we welcome a new website, which the UK Social Investment Forum (www.uksif.org) will be launching next month to help take forward discussions related to the competition.

One final comment: The entrants have all agreed to the sharing of their thoughts and trust that commercial organisations will treat them fairly. If readers of this report are interested in particular ideas, I would urge you to use the website to find the relevant entrant(s). The chances are that this will be to your benefit, as this report contains only a summary and the entrants may be willing to share more of their thinking. It could thus deliver a positive and beneficial outcome for all parties. I firmly believe these new partnerships are essential if we are to respond effectively to the complex challenges of managing pension funds as if ‘the long term really did matter’.

A handwritten signature in black ink that reads "Graeme Davies". The signature is written in a cursive, flowing style.

Sir Graeme Davies

Chairman

USS Ltd



Contents

Introduction	1
Investing for the Long Term	2
Integration With Liabilities	6
Organisational Structure and Incentives	8
Measuring Success	11
Rewarding Corporate Responsible Behaviour	13
Responsible Asset Allocation	15
Influence	16
Impact	18
Appendix—Competition Score Sheet	20

Introduction

The competition and judging process

In March 2003, the Universities Superannuation Scheme (USS) and Hewitt Bacon & Woodrow (Hewitt) sponsored a global competition for managing pension fund assets 'As if the Long Term Really Did Matter'. The competition was based on a hypothetical mandate for a global consortium of pension funds.

Hewitt scored the 88 entries using 10 criteria agreed with the judges and linked to the dual objectives of the competition:

- Genuinely long term.
- Genuinely responsible.

The score sheet is in the Appendix to this report.

Using these scores as a starting point, the competition judges selected eight entries. These shortlisted entrants were given some feedback on the strengths and weaknesses of their original proposals and invited to resubmit a more comprehensive solution. The full panel of judges interviewed the entrants over the telephone, and agreed the winners and commendations. Only then were the identities of the entrants revealed to the judges and to Hewitt.

The full text of the eight shortlisted entries, along with more details about the original competition, can be found on the **Competition** page of the USS website, under **Special Interest Groups** on: www.usshq.co.uk

Purpose of this report

In amongst the 4,000 words that comprised each of the 88 original entries, there were some germs of ideas that we did not want to lose. This report summarises the essence of these ideas.

Our hope is that those wishing to contribute to the ongoing debate can build on these ideas, using them as starting points and inspiration to complement and complete their own solutions.

A small number of the original entrants decided to withdraw their entries from this process when they failed to reach the shortlist. In line with their wishes, their ideas have been excluded from this report.

Our commentary

In each section of this report, we highlight the particular weaknesses of the current system which the judges were keen to overcome. We have also added some comments on the themes underlying the ideas. We hope these will help broaden the debate beyond the specific ideas, ideally to develop a real mandate for a real consortium of pension funds.



Investing for the Long Term

We were looking for a believable and clear definition of a long-term (10- to 20-year) mandate.

Most current mandates are subject to rolling three-year performance objectives and quarterly performance reviews. These measures and this process give the impression that the mandates are continually under review and the managers vulnerable to replacement. This leads to short-term behaviour to control risks. The judges were keen to see an alternative way of defining the investment approach behind the mandate, which deliberately requires or encourages a long-term appointment.

Long-term frameworks

One entry uses a structure for covering a 20-year horizon with objectives for the parts of the mandate that were closely related to members' concerns. Rather than traditional benchmarks and performance objectives, the set of simple principles and guidelines for the management of the fund included:

- Preserving the members' contributions; and
- Increasing the members' returns over the long term.

These two objectives were then followed through and directly linked to allocations to suitable types of asset—e.g. high quality bonds and secure growth stocks, respectively. The stock selection in the equity component was also designed to pass a number of investment tests related to the particular objectives.

Linking asset classes to their role

A similar idea on articulating longer-term objectives was to split the asset allocation into a 'protective asset class' and an 'active asset class'. The protection asset class comprised low-risk fixed income investments with a time horizon for the income chosen to match the pension fund's liabilities.

This entry also suggested a dynamic asset allocation rule for moving between these asset types, moving out of the active assets when values fall. This was designed to meet a constraint based on protecting the assets.

Benchmarks

A number of different long-term benchmarks were put forward in the entries, with absolute return and inflation-linked approaches proving popular. Typically these would aim for price inflation (RPI in the UK) plus 4%, to give a good mix between absolute and real returns.

Unconstrained approaches

Some ideas covered alternative ways of capturing added value (alpha) from higher-risk equity mandates which would be better suited to a longer-term perspective. Risk controls would be relaxed to allow the manager to take more stock selection risk. Some entries advocated giving the manager the flexibility to take short positions in stocks that they felt likely to decline over the longer term.

Dynamic manager of managers

Other entries attempted to eliminate all risks other than those from stock selection. One entry suggested a dynamic approach to the manager structure, appointing managers and multi-managers using a mechanistic approach and quantitative risk management tools.

Quant overlay

Another entry suggested neutralising market risks through an overlay mandate, implemented using financial instruments such as derivatives and exchange traded funds (ETFs). Again, this was driven by the desire to use this structure to eliminate all of the risks other than those from stock picking, aiming for positive absolute returns with the minimal amount of market risk.

Cash benchmarks

Cash benchmarks featured in another structure which invested equal weights in a variety of approaches. Each part of the mandate had a particular longer-term objective, but the overriding concern for the total portfolio was to preserve scheme members' capital.

These individual parts included:

- Absolute return vehicles with products designed to generate real returns after inflation.
- Long-term-only investments to offer the prospect of capital gains primarily, although not exclusively, through global equity investments.

A concentrated core

A further variation on a traditional structure included a core portfolio which tracked a global equity portfolio based on a limited number of stocks.

Reducing the number of stocks, while increasing the risk, created a more manageable portfolio for undertaking active corporate governance and engagement with companies.

Dynamic asset allocation

Other entrants also reacted against what they saw as recent irrational market bubbles by using quantitative disciplines.

One dynamic asset allocation process encouraged the purchase of risky assets in rising markets and sales in falling markets. The stated intention was to capture trend movements while removing the majority of the emotion from the investment process.

Disciplined rebalancing

Another of the more quantitative ideas required portfolio managers following the mandate to adopt a ruthless approach to rebalancing the portfolio, with adjustments to pre-agreed asset and manager allocation strictly carried out on an annual basis.

This process was designed to reduce the dependency on 'star' managers chasing short-term outperformance.





Restrictions on short-term behaviour

An alternative way to modify behaviour is to penalise undesirable short-term activities.

A turnover limit was suggested to restrict sales and purchases in the portfolio to a value of no greater than 100% of the portfolio over a rolling three-year period. This was designed to discourage short-term focus and excessive trading.

This limit would be implemented by offsetting any trading costs involved in sales and purchases in excess of this limit against the manager's fees. The manager would not be stopped from making the trade if a particularly good opportunity arose.

Manager monitoring

Another idea was to counter short-termism by monitoring the holding period of investments and questioning the fund manager if any were held for less than five years.

This entry suggested that because of transaction costs, short-term investment bubbles, and the slow investment process necessary to gain market exposure for large funds, it was right that they should only invest in holdings they planned to keep for the long term.

Value philosophy

The demand for a long-term approach prompted several entrants to rethink the desired style for pension fund portfolios.

Some favoured a return to a 'value' style, attracted by the higher dividend income obtained from these investments. One described an equity portfolio constructed with a bias to low volatility stocks that were not particularly sensitive to the market (low beta). Instead, the emphasis in selecting companies for investment was on sustainable dividend income and defensible competitive advantage.

Consumption-weighted approach

Another fundamental proposal put forward the idea of constructing portfolios of investment in line with the 'factors of production' relevant to the retirement needs of members. The portfolio would be biased towards companies linked to pensioners' consumption patterns, linking the investments and economic impact more strongly to the beneficiaries' interests.

Adapting tactics from other disciplines

Another entry proposed adapting military tactics for fund managers to use in the way they analyse companies and continue with ongoing engagement. The proposal suggested three stages to a typical process: a 'Capability Audit' stage; a comprehensive strategic 'Planning' stage; and finally, the art of 'Campaigning'.

Responsible property

Several entries took the view that less liquid asset classes (such as direct property) had a place in a long-term fund. This would allow the fund to take advantage of any illiquidity premium in the market prices. The inflation-linked nature of rents and mortgages are also attractive in meeting liability cashflows.

While these are not new arguments, responsible investing in property could include action to enhance the environmental qualities and community use of the property owned to improve its value.

Geared property fund

Other mandates were designed to make traditional asset classes more accessible or relevant to pension funds.

One idea was an income fund invested in a very diverse portfolio of properties. The consortium's investments in the property fund could be either in the form of bonds or limited partnership interests.

The aim of this structure would be to offer better diversification than traditional property portfolios and an alternative source of inflation-linked or fixed income investments for meeting liabilities.

AAA rated bank

Other entries considered more radical structural and organisational moves.

One put forward the idea of creating a bank as an investment for the consortium. The intention would be to accept deposits at a cheaper rate than any other bank, by creating it in a way to give a high-credit (AAA) rating. This organisation would also be able to offer bank loans as an investment for the consortium.

Macroeconomic revolution

One idea claimed not only to have the potential of doubling per capita income every five years but also to eliminate internal conflicts and repair the environment.

The suggestion was to use long-term savings to purchase land and resources through which, the entry claimed, pensioners would have the opportunity to re-write the rules of capitalism. The concept requires governments to stop taxing production and consumption, with the outcome of such a radical change allowing individuals to share and participate directly in the global market place.

Comment

It's clear that extending the time frame enables:

- Investment in less liquid or marketable assets.
- More integrated multi-asset approaches.
- Higher levels of stock-specific risk.

Other suggestions directly tackled some of the perceived ills of a short-term speculative approach, such as:

- Excessive trading.
- Higher volatility of asset classes, sectors and stocks driven by momentum or other factors with little link to fundamentals.
- Approaches that depart from the basic characteristics of investments, such as cash flows.

These themes, and the more radical ideas listed above, are worth developing. Are there weapons that pension funds, consultants and fund managers could borrow from other disciplines in the battle against short termism?





Integration With Liabilities

We were looking for asset allocation and stock selection approaches to be clearly and coherently integrated with risk management against the consortium's liabilities.

The current approach to institutional investment management is characterised by a structure of mandates for asset classes, each linked to index or peer group benchmarks. A significant part of the risk relative to the fund's liabilities is not managed through the mandates themselves. The judges were looking for approaches that explicitly recognise the reasons why the monies are being invested.

Cash flow focus

Several entries developed ideas founded on generating continued cash flow to meet the consortium's liabilities. For example, equity investments biased towards high dividends, rather than one-off payments as company share buy back schemes; and property with upward rent reviews.

Vintage year funds

Some entries developed particular schemes for linking the liability cash flows to the asset allocation.

One example was to structure the mandate around the cash inflow in any year. Each 'vintage year' was defined as a year's contributions and would give rise to many years of liability outflows in the future. The mandates for the different vintage years could be allocated to different managers so that they could focus on the particular duration characteristics.

Dynamic benchmarks

A similar structure was based on different asset allocations for different years of cash outflow, with lower risk being taken for those closer to being paid out. This led to an overall benchmark which was dynamic and directly linked to the maturing liabilities to better manage sponsor risk.

The liabilities and benchmark reviews were carried out annually or more frequently to reflect market movements, changes in the promised benefits and the sponsor's risk and return requirements.

Duration matching

Several proposals also recognised the importance of choosing assets where the time horizon for the income and other payments match the duration of the pension fund's liabilities. The assets used to build a duration-matched asset class included more traditional institutional investments like bonds and other long-duration opportunities like tropical hardwood.

Surplus management

Other entries hinged the objectives and benchmarks around the overall financial health of the pension arrangements, using the relationship between the assets and liabilities rather than the liabilities in isolation.

One proposal suggested that the objective of the mandate should be linked to managing the surplus of the fund (the excess of assets over liabilities). The aim would be to maximise the level of benefits that can be provided for a given level of contribution, subject to whatever constraints the sponsor feels necessary on the volatility of the surplus. Consistent benchmarks and success metrics would be based on the growth in the surplus over longer time periods and the volatility of the change in surplus over shorter timescales.

Something for the members

Another radical entry suggested developing a range of lifestyle solutions for members on retirement, such as accommodation. The consortium could invest in residential property to meet these unconventional benefit options.

Comment

It is clear that making a closer link to liabilities helps pension funds control the true risks of their investment strategy—risks that have an impact on the overall finances and viability of the pension fund. The particular specification of the consortium's mandate was for 5% of several well-funded schemes, each with positive cash flow, so liability considerations were not paramount. However, liability assessment and asset management techniques already permit more sophisticated approaches than are generally being used in pension fund mandates.

The key themes underlying a more accurate reflection of liability characteristics in the asset allocation and stock selection are:

- Estimates of liability cash flows and duration.
- More frequent and dynamic assessment of the value of liabilities, pension contributions and surplus, and adjustments to the corresponding asset allocation.
- Articulating and adopting different approaches for different parts of the assets and/or liabilities.



Organisational Structure and Incentives

We were looking for implementation through organisational structure and incentives clearly aligned with the long-term interests of the consortium.

Traditional ‘ad valorem’ and performance-related fees based on out-performance of conventional index benchmarks, paid annually, provide little incentive for long-term performance. Remuneration structures within fund management houses tend to reinforce short-term results. Arms-length relationships between clients and fund managers based on legal mandates and frequent, formal meetings focus primarily on detailed performance and portfolio measures are not aligned with the long-term nature of the hypothetical mandate in the competition.

The judges were keen to see new thinking to challenge the status quo of relationships and remuneration.

Organisational structure

Some entries proposed establishing alternative corporate structures to better serve the consortium, for example:

- Long-term capital partnership—creating new asset holding partnerships which would acquire and develop capital to meet the requirements for the consortium’s long-term needs.
- AAA rated bank as an investment for the consortium—responsible for providing interests on deposits and managing a portfolio of loans and bonds. It would have lending, treasury, corporate finance, insurance, and other relevant bank departments.

Split fees calculation

One proposal suggested a more ethically defensible reward system to align the interests of the fund manager and the consortium by using a split fee structure. This would have a fixed management fee and a performance fee.

In order to move the focus onto a longer-term performance horizon, the performance fee would be based on a rolling five-year performance, adjusted by the level of volatility achieved over the fee period. This would help deter the manager from adopting the most aggressive asset allocation strategy available to them in the hope of maximising overall returns, without considering the risk of the positions undertaken.

Segregated fee account mechanism

Another idea also covered splitting manager fees into two parts:

- The first part would pay the basic running costs of the manager on a quarterly basis.
- The second performance-related part would be based on long-term outperformance criteria, with payments being made on an interim basis locked away in a segregated fee account. This would be visible but not available to the manager until the longer time period had been reached for distributions from the performance pot.

Salaries plus performance-related pay

One proposal put forward remunerating fund managers based on fixed salaries set at levels equivalent to other corporate managers. Through achieving good returns, the managers would receive incentives but would earn penalties for poor returns. This particular entry suggested rewards for absolute returns above 10% and penalties for returns below 5%.

Shares in the fund

Another suggestion was to reward fund managers with shares in the fund they were managing. These shares would be locked up for a period of time so that the remuneration is directly aligned to the performance of the fund.

Deferred bonuses

Other entries also focused on the timing rather than the amount of the performance-related fees to managers.

One suggested delaying bonuses to encourage a long-term perspective on transactions. Fund managers would still be remunerated in line with market rates, but their bonuses would be paid three years later, when the medium-term impact of their investment decisions would be clearer.

The bonus in one year could also be based on the particular investment decisions made three years ago—or any other specified period, or combinations of previous periods.

Contractual relationships

Another entry suggested that relationships between the consortium and individual fund managers should be closer than the current arms-length situation. This relationship might be similar to those currently used by larger funds for their in-house investment staff.

The proposal was to use contracts between parties and individuals that are based on contracts of employment. These contracts would run with a presumption of continuity, rather than a limited fixed term, but would include provisions for notice and termination by either party. This would give the individual fund managers better security of tenure than is currently the case.

Decision-making process

A few entries tried to include decision-making prowess as a trigger for extra rewards. In general, this requires more clarity and responsibility for decisions than in the traditional process.

One entry attempted to redesign the process to address what it saw as the limitations of compartmentalisation within the existing structure. It aimed to break down some of the boundaries in the investment process of a fund, using specific incentives to achieve particular results. For example, it suggested creating different groups to own different decisions, including more diverse representation from sponsors, consultants and managers in each group. One of these groups would be an investment council which would oversee the whole process.





Comment

Change in this area is likely to meet with considerable resistance as the current structure sees fund managers well rewarded, regardless of whether they succeed or fail. However, it is clear that an ad valorem fee structure is not aligned with this type of mandate.

The key issues to tackle are:

- The appropriate roles and relationships—these should drive consistent contracts, organisational structures and rewards.
- The calculation of basic fees—based on costs or a retainer to promote provision of client service rather than selling products and reporting on performance.
- The type of additional performance that is rewarded—in particular the balance between quantitative elements (e.g. outperformance, risk reduction) and qualitative elements (e.g. quality of decisions, service levels).
- The timing and form of the payments.

It is likely that all of these issues will need tailoring to suit the definition and objectives of any particular mandate to reflect both the client's requirements and the manager's skills and capabilities.

Implementing more radical organisational structures and outsourcing for a global consortium of pension funds is likely to require more regulatory flexibility than currently exists at a global level.

Measuring Success

We were looking for a clear and coherent process for ongoing monitoring and measuring success, which is aligned with the longer-term interests of the consortium.

The judges recognised that the current emphasis on quantitative monitoring, measurement and benchmarking encourages short-term behaviour. They were looking for practical alternatives, with concrete success measures more directly aligned to the long-term mandate.

Multiple objectives

One proposal suggested an approach based on a scorecard of several objectives and corresponding success measures. The three objectives outlined in the entry were to manage risk relative to liabilities; deliver positive real returns and avoid material losses; and deliver performance above peer medians.

While this approach can lead to conflicts, it may better respond to changing priorities and circumstances at the sponsoring employer or in the economic environment. Dividing the mandate into parts with different objectives may help make the balance between the objectives more explicit.

Performance measures

Absolute or inflation-linked returns were popular, although not all of these showed a long-term philosophy. To reduce focus on year or quarter ends, one proposal suggested measures based on preserving the real or absolute value of the scheme's assets over any rolling 12-month period.

Internal rate of return

Some ideas followed through their investment philosophy to the proposed success measure.

For example, in the proposal where the portfolio construction was biased according to the consumption patterns of pensioners, the benchmark was based on a measure of this consumption-weighted inflation plus 5%.

The investments in this portfolio were also chosen consistently by calculating the longer-term internal rates of return corresponding to the investment cash flows. Only those with returns expected to exceed the inflation plus 5% hurdle rate would be selected. This also allows a consistent approach to be used for quoted and unquoted investments.

Active risk budgeting

Other proposals suggested ways of changing the focus from improving returns to managing risk.

One suggested a risk target of losing 10% of the fund in no more than one in 20 years. This translates to a Value at Risk (VaR) budget of 10% over one year with a 95% confidence level. The VaR target can be translated into performance, information ratio and volatility targets if necessary to better suit managers' systems.





Comment

The lack of new or radical ideas on the measurement of success indicates the difficulty of breaking away from current practices. It is also clear that, although a long-term approach is desirable, neither parties will want to wait 10 or 20 years before success is assessed and rewards paid or remedial action taken.

Current measurement processes have become firmly embedded in fund managers' systems, reporting and compliance processes. These all have relatively high set-up costs and are barriers to entry for smaller organisations, which may offer more innovative or appropriate solutions.

There may also be a reluctance to suggest a new approach which, like those we have tried before, will come with its own unintended consequences. To evolve practices in this area all parties need to consider the following questions:

- Do the success measures reflect the mandate, the fees and the incentives?
- Should different timescales be used for different measures or different parts of a mandate to reflect its role in the overall strategy and structure?
- For those parts of the mandate subject to long-term performance measures, how do fiduciaries meet their duties to monitor and measure success in the meantime?

It is unlikely that one success measure fits all clients and managers. Even for quantitative measures, setting the balance between measures for extra returns and those for reduced risk will be at least as important as defining the detailed calculations for the particular measures. Complementary qualitative measures are also likely to have a growing role to play in a scorecard approach which balances different measures for different time periods.

Rewarding Corporate Responsible Behaviour

We were looking for a clear professional understanding and definition of how investment activity can reward responsible corporate behaviour and reduce irresponsible behaviour.

The judges recognised that most current investment practice does not encourage fund managers to play an active role in influencing the actions of the companies in which they invest. Even managers who offer corporate governance or 'SRI' products and services rarely offer a systematic or portfolio-wide service. The judges were keen to find approaches in which companies are encouraged to act in ways that improve, or at least do not reduce, the quality of life for the consortium's pension fund members. They wanted to see an explanation of what the fund managers would be looking for in companies, so that the fund manager would be well placed to leverage ownership rights for the long-term benefit of the pension fund members.

Responsible frameworks

There were a number of ideas for frameworks to help structure the identification of suitable investment opportunities. An example is the triple pillar approach—Economic, Environmental and Social. The proposal suggested scoring each of these criteria to help build a responsible set of investments.

Another example was to use analysis on management motivation as part of in-depth research into companies. This would be used alongside the more traditional market analysis and company analysis to identify the scope for influencing company management.

Bespoke indices

One proposal suggested a screening process to create a bespoke index as a universe of companies from which the portfolio would be created. The index would not be weighted by the traditional market capitalisation. Instead, it would give the largest weights to those companies with superior corporate governance and responsibility and smaller weights to those with lower levels of governance and responsibility. The fund would exclude companies classed as inadequate.

New committee for stock selection criteria

Other proposals focused on the process of defining what would constitute a responsible investment.

One suggestion was to create a new global committee to assign simple corporate responsibility ratings. The committee would include representatives from sponsoring organisations, academics and some specialised analysts. Input would also be sought from journalists who investigate and expose irresponsible corporate activity.





Views from groups of members

Another approach sought to include the views of members. Rather than asking for input individually, this entry proposed segmenting the membership into different groups or clusters. They suggested analysing the different preferences or interpretations of factors such as ‘quality of life’ and ‘responsible globalisation’ for each group.

The liabilities for each cluster would be calculated and the investment policy for the corresponding pool of assets managed in line with each group’s characteristics and investment preferences.

Committee of reference

Another idea was to establish a committee to identify the issues of concern for most scheme members. A web site would be used to gain feedback and also to report back on successful examples of engagement. Feedback could be sought from members at least every three years.

Comment

The ideas covered in this section focus on:

- The definition of ‘responsible’.
- The process of defining ‘responsible’.

In most of the entries to the competition, the ‘responsible’ element clearly played second fiddle to the ‘long-term’ part. Adding this as an afterthought reflects the current niche status of most SRI activity. However, it also misses the opportunity presented by the long-term nature of this mandate to operate over a timescale where the return and risk benefits of responsible, influential investing have the potential to outweigh the costs.

Many of the entries also assumed that a greater role would be played by other parties—experts, scheme members or specialist research providers. Fewer entries suggested that the fund managers should adapt their core investment decision-making process. Again, this may be an opportunity missed.

Making sure that the definition of ‘responsible’ and the priority areas for action evolve over time is key in combining ‘responsible’ with genuinely ‘long term’.

Responsible Asset Allocation

We were looking for well-defined criteria for genuinely responsible investment to be reflected and integrated in asset allocation and stock selection.

The judges felt that most current mandates neglect asset allocation as a primary consideration when designing a truly responsible approach.

Infrastructure

Many proposals adopted multi-asset approaches, which drew more on the less traditional asset classes. For example, by splitting a private equity investment into 50% traditional private equity and 50% infrastructure, one proposal suggested that the fund would better meet its dual requirements to provide returns and social benefit to the members.

Local regeneration

Another entry focused on investing in partnership with local authorities to achieve regeneration in the difficult mixed use neighbourhoods around town and city centres. Again, this would be expected to benefit scheme members.

Emerging opportunities

Other investments on the fringes of the current opportunity set were suggested as better suited to responsible investment. Here there may be more of an opportunity to make a difference.

Comment

It is not part of traditional fund management practice to actively consider asset allocation to improve the quality of life in retirement for current pension fund members. To meet trustee and fiduciary duties, the benefits to the members may need to be considered in terms that are broader than the narrow context of the returns on the pension fund assets. As well as making investments that benefit members directly, other asset allocation decisions may improve the overall diversification or risk profile of the fund.

Suggestions made by entrants ranged from:

- Improving services locally or nationally; to
- Stimulating the global economy to provide a better environment for successful globalisation.





Influence

We were looking for a relationship with investee companies designed to influence responsible corporate behaviour but implemented with an understanding of appropriate costs and benefits.

The judges recognised the current challenges of active engagement and wanted to see that entrants appreciated the full implications of developing influential relationships with companies. This included consideration of the ‘free rider’ issues when another investor gains, but does not bear any cost, when a fund manager takes action to influence a company in which they both invest.

Focused investment

One proposal suggested that the fund should focus its investment on specific types of venture or research capital within established companies.

The aim would be to support growth and research projects which have a long-term nature and which would otherwise be difficult to finance. This approach was designed to give the investor a more influential position in research developments.

Support for directors

Another idea was for the consortium to support a non-profit and self-funding institution to train and support high-quality independent board candidates.

This institution would then invest in companies appointing these directors, confident of an aligned philosophy and the establishment and maintenance of appropriate governance standards. As these directors are not introduced by incumbent management and are not financially dependent on board compensation, they would avoid financial and social pressures.

Steering committee

One proposal suggested using a steering committee to implement a responsible approach to both fixed income and equity strategies. The steering committee would have no role apart from maintaining relationships with investee companies, and taking control of all responsible investment issues.

This committee would involve a cross-section of representatives from the consortium and managers. While monitoring the companies, it would specifically look for genuine intent from the investee companies to adopt responsible policies. This narrow focus and broad range of perspectives adds a different dimension to the traditional approaches to responsible investment.

Influencing the way corporates issue capital

At a more fundamental level, one entry suggested that the change of philosophy to focus on cash flows may help bypass the market valuation of those cash flows. It suggested that this frees the manager to buy cash flows according to the value the scheme puts on them.

This demand for cash flows should encourage companies and the business community to provide these cash flow characteristics when issuing capital. Furthermore, if certainty of dividends is given greater weight than uncertain growth from retained earnings, companies may seriously consider whether withholding earnings for re-investment is the most value effective way of raising capital.

Comment

The main theme of the ideas is to develop processes that link corporate activity more closely to the investors' requirements and/or the fund managers' investment selection criteria. This helps to contain costs by incurring them only to obtain the benefits that are expected to be captured in the investment process and/or will be valued by the client.





Impact

We were looking for evidence that the fund managers would consider and actively monitor the overall positive impact on the social or economic environment.

Many pension funds are ‘universal investors’, investing in a broad portfolio of assets which will benefit from the general economic health of the economy and improvements in overall markets, not just individual companies.

Benefits to the economy could be measured directly, for example, by gauging the ease with which small companies gain access to capital. Benefits to society (and less directly to the economy) could also be considered, for example, by assessing improvements in human capital.

The judges were keen that the longer-term benefits both to the economy and to pension fund members would be assessed as part of implementing the mandate.

Non-financial risk assessment

One approach suggested using the non-financial analysis of companies as an input when identifying longer-term financial and regulatory risks to a company or industry. These risks would be recorded and action taken to influence the companies and broader environment to reduce the risks. For each risk, the impact of the actions would be monitored and used to measure success.

Costs included at stock selection

Another idea suggested carrying out investment tests on stocks before they are bought for the fund. These include investigating the adverse environmental or social impacts of the company’s activity and estimating their impact based on the expected value of future real costs. This would be included in the analysis of each stock and would be used in stock valuation, selection and ongoing monitoring.

Positive on society

One proposal suggested that the consortium should take direct action to help build society’s intellectual capital, with the expectation that this would benefit the economy and scheme members.

An example was to offer students a loan service. The overall objective would be to increase the number of students able to go to university, while boosting the demand for services in academia. Other activities would be targeted at educational activities designed to promote lower crime rates, a higher skilled workforce or higher overall health levels.

Comment

This was the area of responsible activity that was least well-addressed by the entrants to the competition. To a degree this is understandable, given the current use of index and peer group benchmarks to measure relative success.

Integrating and measuring the impact of a responsible investment strategy as part of the investment process is clearly challenging. However, a longer timescale means that making a significant impact becomes a more realistic prospect. There is also scope for different investors to focus on different areas for economic improvement to maximise the total influence of institutional investment: diversity is likely to improve the marginal benefits of the action taken.

It is unlikely to be cost-effective for any one fund manager to provide bespoke products for many different clients which span many areas of economic improvement. However, there is scope for fund managers to choose areas where they feel most able to add value, and where there is sufficient client demand. As in any other part of the investment process, this will help them to differentiate their services and products.



Appendix—Competition Score Sheet

Score

Genuinely Long Term	Score +1, 0, -1	Score +1, 0, -1	Genuinely Responsible
Investing for the Long Term Believable and clear definition of long term (10- to 20-year) mandate			Rewarding Corporate Responsible Behaviour Clear professional understanding and definition of how investment activity can reward responsible and reduce irresponsible corporate behaviour
Integration with Liabilities Asset allocation and stock selection is clearly and coherently integrated with risk management against liabilities			Responsible Asset Allocation Well-defined criteria for genuinely responsible investment reflected and integrated in asset allocation and stock selection
Organisational Structure and Incentives Implementation through organisational structure and incentives clearly aligned with the long term interests of the consortium			Influence Relationship with investee companies designed to influence responsible corporate behaviour and implemented with an understanding of appropriate costs and benefits (e.g. free rider issues)
Measuring Success Clear and coherent process for ongoing monitoring and measuring success in a way which is aligned with the longer term interests of the consortium			Impact Overall positive impact on social/economic environment considered and actively monitored
Scaleable approach to long-term investment—extending to a larger part of the mandate would improve impact			Scaleable approach to responsible investment—could be extended to a larger part of the mandate to give greater impact
TOTAL			
GRAND TOTAL			

Filter

The entry should be excluded from the shortlist because it fails against one or more of the following:

Not Appropriate	Not Innovative	Incomprehensible	Not Ready Technically	No Substance	Not Practical/ Prudent
Missed the point of the mandate/ not answering the question	Not new thinking for the pension fund market	Jargon-ridden, complex and difficult even for an investment expert to understand	Barriers to getting it off the ground unlikely to be overcome within five years	Marketing puff which mainly repeats back the mandate	Not a credible solution for a pension fund investment e.g. not prudent investment