A guide to delegated investment management
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What is delegated management?
Delegated investment management combines strategic advice and implementation. Typically, a mandate involves the ongoing management of most or all of the assets of a pension or endowment fund, managed to an objective and risk level set by the plan sponsor or pension committee.

Research has demonstrated a connection between investment governance and investment success. Keith Ambachtsheer suggests that the good/bad governance gap could be worth 1% to 2% of additional return each year.* (Figure 1)

So it’s logical that governance should guide the investment process. While some pension funds have adopted simple, passive equity and bond portfolios that require a lower level of specialist knowledge and time to maintain, others have attempted to build more sophisticated portfolios in pursuit of better risk-controlled returns.

Either approach may be appropriate, but to maximize the chances of success, the governance approach must match the fund strategy.

Closing the governance gap: To build or buy?
For those who want to improve the risk/return trade-off from their equity and bond portfolios, there are generally two options to enhance investment governance: build or buy. Pension funds can either build an in-house team or delegate to a specialized third party.

Building an internal team can offer attractive benefits. However, for many, it is simply not a realistic solution, as only the largest pension funds have sufficient scale to make this a genuinely viable option.

For pension funds that can’t build internally, delegated investment management can close the gap between the need for efficient investment strategies, real-time decision making and the typically constrained governance budget of a pension fund committee.

Benefits of delegated management

While it may seem that plan sponsors that opt for delegated investment management are taking a step back, this is not the case. In fact, one of the most frequently cited benefits of delegated investment management is that plan sponsors or committee members have more time to focus on key strategic issues and long-term goals for their endowment or pension plan. The plan sponsor retains accountability for the investment strategy (overall risk and return) and works with the delegated manager to determine key parameters, such as the time horizon, return and risk. The delegated manager, working with the plan sponsor, then executes the investment strategy separating the governance and execution functions.

Monitoring also becomes less of a burden on the plan sponsor as the delegated manager relationship replaces numerous relationships with investment managers and potentially other service providers.

For pension funds that can’t build internally, delegated investment management can close the gap between the need for efficient investment strategies, real-time decision making and the typically constrained governance budget of a pension fund committee.
Roles and responsibilities

Delegated investment management turns over certain functions to a third party, but it isn’t a simple outsourcing solution. Rather, it should complement the strategic responsibilities of the plan sponsor.

The model is the same as when a management team acts upon a corporate board’s strategy. Clear guidelines are needed to reflect the significant decision making delegated to the investment manager.

The plan sponsor remains in control of high-level strategy, defining the pension plan’s long-term funding objectives and determining return requirements relative to the liabilities, while the delegated investment manager implements the daily aspects of that strategy, including portfolio construction and operations.

*Figure 2* shows the range of investment decisions and activities, and which function they fall under.

**Typical delegated manager functions**

- Allocation to different asset classes, within the plan sponsor’s guidelines
- Monitoring the funding level and implementing changes based on market conditions and de-risking triggers

Delegation frees the plan sponsor to devote more time to strategy and, more important, to focus on high-quality oversight.

**Hiring and firing investment managers**

**Negotiating investment manager fees**

**Negotiating legal investment management and related agreements**

**Executing documentation**

**Managing cash flow**

**Monitoring investments at a detailed and higher level**

**Liaising with the custodian**

The appointment of a delegated investment manager can significantly increase governance effectiveness if there are up-front, clear guidelines based on the plan sponsor’s mission, objectives, and carefully defined roles and responsibilities.

**Figure 2. Governing and execution functions**

**Governing function**

- Investment strategy
- Return target
- Risk tolerance
- Strategic triggers

**Oversees**

**Execution function**

- Portfolio construction
- Asset allocation
- Risk factor exposure
- Manager selection
- Implementation
- Portfolio positions
- Cash-flow management
- Operation risk management
Required skills
Pension funds evolve over time, so it is important that a delegated investment manager has the full suite of skills and expertise to work to any set of objectives.

At the highest level, plan sponsors strive to have sufficient assets available to meet the pension promises. Exactly what this means in practice changes over time. In fact, this has changed remarkably over the last two decades as we have moved from a purely long-term approach to an increasingly mark-to-market approach driven by legislation and accounting standards.

The youthful pension plan
Although now rare, in the past pension plans were more commonly open to new entrants with participants earning additional benefit accruals with each year of employment. The time horizon created was to all intents and purposes infinite and replenished with new entrants to pay contributions, which indirectly paid pensions.

In this type of plan, a sponsor may adopt an approach akin to an endowment fund with objectives set in real terms (e.g., risk and return targets relative to inflation). A long-term investment horizon can be sought, and the plan can outperform shorter-term investors that may find they are forced sellers when short-term market shocks occur.

The midlife pension plan
Over the last few years, an increasing number of pension plans have been closed to new members — and in some cases, to new accruals for current active members. With no increase in membership and no new benefits earned, this is a fundamental change. Gradually, as the time horizon for payment of the liabilities shortens, management of this liability assumes greater importance, eventually dominating the investment strategy.

Many pension plans acknowledge this trend with well-defined journey plans (also known as glide paths) that state their long-term funding objectives expressed relative to liabilities. Pension plans will also define the time horizon over which they expect to achieve their objectives and their acceptable level of risk.

The importance of implementing this framework increases as the pension plan’s liabilities mature and there is less room to maneuver if investment performance is poor.

The mature, self-sufficient pension plan
Some pension plans are fully funded on both a going concern and solvency basis. At this stage, assets may be invested mostly in fixed-income and other low-risk assets (relative to liabilities), as it is highly probable that benefits can be provided without recourse to the sponsor.

During early self-sufficiency, cash-flow management and liquidity tend to be less of a concern than mark-to-market management, as cash flows may only be 1% to 2% of assets each year. The focus is on managing mark-to-market interest rate and inflation risks. Diverse, return-seeking assets will still have scope if they have sufficient liquidity. Indeed, liquidity management becomes increasingly important as a pension plan transitions through the self-sufficiency stage.

As benefit payments become a material draw on assets, the focus moves to cash-flow management. Bonds are held because they will generate cash flows that match the yearly predicted pension fund outflow.
**Settlement**

Ultimately, it may make sense for a pension plan to transfer all the assets and liabilities to an annuity provider and wind up the plan. This represents the end of the life of the pension plan, and the annuity provider pays the benefits.

It is important that the delegated investment manager can build a path to settlement in the portfolio management offering and has the resources to monitor the market to identify suitable opportunities.

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**Figure 3. Skills needed to manage a pension plan through time**

<table>
<thead>
<tr>
<th></th>
<th>Youthful pension fund</th>
<th>Midlife pension fund</th>
<th>Mature, self-sufficient pension fund</th>
<th>Settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Context-driven strategy</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Understand the pension plan’s liabilities and design appropriate investment strategy</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Understand the sponsor’s position in relation to the pension plan</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Understand the pension plan’s longevity risk exposure</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td><strong>Portfolio construction</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ability to research different asset classes in detail and identify attractive opportunities</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Ability to research a wide range of asset managers across different asset classes and select the best managers</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Expertise in hedging interest rate and inflation risk</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td><strong>Implementation</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ability to implement the chosen investment strategy</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Expertise in settlement transactions</td>
<td></td>
<td></td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>
A true delegated investment manager partners with a plan sponsor to fill governance gaps over the long term, transitioning through the phases of a pension plan’s evolution. Plan sponsors need to test this tenet and ensure the partnership remains effective as the plan evolves or if circumstances change. Figure 3 shows the necessary key objectives and skills at each stage.

Delegating responsibility can help a plan sponsor access relevant skills that often don’t all exist within a single entity.

Long-term partnering with a delegated manager

Clearly, a delegated manager needs to be able to construct a suitable portfolio that meets the plan sponsor’s immediate objectives. But objectives can change rapidly (e.g., the funding level materially improves, accelerating the journey plan, or new legislation expedites the transition from a midlife to a mature pension plan).

It is vital that the delegated investment manager can identify these changes and work with the plan sponsor to help redefine objectives. Similarly, the portfolio’s management should reflect evolving objectives, and the delegated manager should understand and be able to clearly explain how current portfolio construction decisions could create future constraints. For example, early in the journey plan, a private equity allocation may look attractive, but if the plan’s life cycle is suddenly accelerated, and settlement activity looks attractive, a pension plan may not be in a position to take advantage of this opportunity.

Delegating responsibility can help a plan sponsor access relevant skills that often don’t all exist within a single entity.

Potential steps to this end could include the purchase of an asset that matches a particular set of cash flows. Under this scenario, the pension plan retains ultimate responsibility for meeting its liabilities but manages them through a very secure cash-flow-matching asset.

It is essential that the delegated manager is aligned in the objective to reach settlement so opportunities aren’t missed, or worse still, the portfolio is too illiquid or costs make a transaction prohibitive.
Setting objectives
As pension plan objectives evolve over time, so should the objectives of a delegated mandate.

A delegated investment management agreement between a plan sponsor and manager should include mutually agreed upon mandate objectives and operating guidelines, and a framework for monitoring performance against the objectives. A regular review enables the mandate to evolve with the pension plan and any change in circumstances through time.

Delegated management combines advice tied to strategy (can’t be delegated) with portfolio implementation (can be delegated). Mandates are ideally structured with this in mind. As an example, the level of pension fund risk needs to reflect the plan’s objectives. The plan sponsor understands these objectives best and should retain investment strategy decisions.

The manager should have sufficient flexibility to decrease risk when appropriate, or to rebalance to a strategic benchmark when market conditions are favorable.

Risk also changes over time. Required return and the level of risk needed changes as a pension plan matures and moves along a path to fully funded status and self-sufficiency (Figure 4).

**Setting the manager’s objective**
Measuring a portfolio’s performance against a benchmark (e.g., the pension plan’s liabilities) can help with monitoring, but we don’t believe this should be the delegated manager’s objective, as the required level of outperformance changes over time.

Instead, the delegated manager can manage to a journey plan (the path that outlines how the plan sponsor intends to meet the plan’s long-term funding objective). This frees the plan sponsor to concentrate on (with advice from the delegated manager and other advisors if appropriate) setting the plan’s long-term objective, the time horizon and the initial balance between risk and return, as well as determining how the balance should change through time.

The delegated manager then implements and manages a portfolio in line with this plan. This may seem similar to mandates that are structured with a target outperformance or funding level, but there are some subtle yet important differences. Managing to the journey plan offers several advantages over other objectives we have seen.

**Managing to a journey plan**
Managing to a journey plan should be completely consistent with the plan sponsor’s ultimate objective, as it outlines how the pension plan hopes to reach its funding objective. This further aligns the interests of the manager and the plan sponsor. It allows for better investment risk management,
as risk does not need to be increased simply to adhere to a documented return target. The flexibility created allows for more efficient portfolio management, as there is no obligation to increase risk when it may not be appropriate, or rebalance to a strategic benchmark when market conditions are not favorable. For instance, assume a delegated manager had a +3% per annum return target for liabilities. If the market rewards risk taking and results substantially exceed this target, forward-looking expectations will likely be lower than anticipated in the current investment strategy (e.g., liabilities at +2.6% per annum). A contract to target liabilities at +3% will, however, force the delegated manager to continue targeting liabilities at +3% per annum, and it may add to risk at exactly the wrong time.

Rather than reacting to a change in its forward-looking return assumptions, managing to the journey plan recognizes these nuances and gives the manager flexibility to adjust the portfolio. Of course, when granting a delegated manager additional flexibility, it is important to have checks and balances in place. This is commonly achieved by using upside and downside triggers around the central journey plan. Triggers facilitate real-time decision making and implementation to allow the pension fund to take advantage of de-risking opportunities as they occur and ensure that the pension fund does not deviate too much from the journey plan.

This process represents some evolution in mandate design. Figure 5 describes common delegated mandate specifications and their implications.

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**Figure 5. Common delegated mandate specifications**

<table>
<thead>
<tr>
<th>Types of objective</th>
<th>Description</th>
<th>Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Asset allocation benchmark</strong></td>
<td>Delegated manager implements a portfolio consistent with an asset allocation set by the plan sponsor</td>
<td>Delegation largely involves manager selection and de-selection, with some active asset allocation</td>
</tr>
<tr>
<td></td>
<td>Plan sponsor specifies individual market indices against each asset category</td>
<td>Changes to asset allocation benchmark agreed by the plan sponsor</td>
</tr>
<tr>
<td></td>
<td>Some discretion to vary asset allocation; liability hedging parameters are specified</td>
<td>Process required to ensure that the asset allocation benchmark remains consistent with the plan sponsor’s objectives</td>
</tr>
<tr>
<td></td>
<td>Risk restrictions reference the extent of risk allowed relative to the benchmark and possible liabilities</td>
<td></td>
</tr>
<tr>
<td><strong>Total return mandate</strong></td>
<td>Delegated manager targets a certain return, typically in excess of liabilities</td>
<td>Greater delegation by varying asset allocation to achieve target</td>
</tr>
<tr>
<td></td>
<td>Mandates tend to specify which asset categories may be utilized, but there will not be a set allocation as above</td>
<td>Process likely to be to maintain target return, which in some cases could lead to counterintuitive rebalancing</td>
</tr>
<tr>
<td></td>
<td>Risk restrictions need to be consistent with the return target and relative to liabilities</td>
<td></td>
</tr>
<tr>
<td><strong>Journey plan mandate</strong></td>
<td>Plan sponsor sets return profile over time, possibly including funding-level triggers to change profile</td>
<td>Overall level of risk and return remain under plan sponsor control</td>
</tr>
<tr>
<td></td>
<td>Delegated manager manages to the agreed journey plan (glide path) but also takes into account actual progress versus the journey plan</td>
<td>Funding-level triggers agreed by plan sponsors allow a dynamic de-risking process consistent with the journey plan</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Delegated manager reporting on risk and return becomes key</td>
</tr>
</tbody>
</table>
Perhaps the most important aspect of structuring a delegated management agreement is setting controls around risk, and mandates should be designed with required risk constraints, such as a range around tracking error, absolute volatility or value at risk. In addition to risk controls, Figure 6 outlines some of the guidelines and controls that are frequently incorporated in delegated management agreements and some factors that a plan sponsor may wish to consider.

In summary, care should be taken when structuring a delegated management agreement, and a plan sponsor should work closely with the manager and advisors. Delegated mandates involve a significant transfer of authority, and a plan sponsor should be comfortable that the mandate’s structure allows the manager sufficient flexibility to manage the portfolio using the breadth of skills and resources at its disposal while remaining consistent with the plan sponsor’s objectives. The interests of the delegated manager and the plan sponsor should also be clearly aligned and allow for efficient portfolio management.

The delegated investment manager should be managing the portfolio with a view to an evolution in objectives and should understand and be able to explain the constraints that might be imposed in the future by portfolio construction decisions made now.

Figure 6. Sample delegated mandate guidelines

<table>
<thead>
<tr>
<th>Guideline</th>
<th>Sample specifications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Permitted asset classes and exposure limitations</td>
<td>▪ Allowed asset classes</td>
</tr>
<tr>
<td></td>
<td>▪ Minimum and maximum allocations to each permitted asset class</td>
</tr>
<tr>
<td>Diversification</td>
<td>Maximum allocations to direct investment in individual securities, investment managers or pooled funds</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Specifications may include a pre-agreed allocation to cash or time frames within which a certain proportion of the plan assets may be redeemed</td>
</tr>
<tr>
<td>Foreign currency exposure</td>
<td>▪ Limits on how much unhedged foreign currency exposure is allowed</td>
</tr>
<tr>
<td></td>
<td>▪ Instruments that are allowed for hedging currency risk</td>
</tr>
<tr>
<td>Liability hedging</td>
<td>▪ Minimum and maximum interest rate and inflation hedge ratios</td>
</tr>
<tr>
<td></td>
<td>▪ Instruments that can be used for liability hedging</td>
</tr>
<tr>
<td>Dynamic de-risking framework</td>
<td>How the manager should adjust the portfolio in the event that the plan’s funding level moves outside pre-agreed expected funding-level ranges</td>
</tr>
<tr>
<td>Permitted financial instruments</td>
<td>What financial instruments are allowed</td>
</tr>
<tr>
<td>Leverage</td>
<td>▪ Whether or not leverage is allowed</td>
</tr>
<tr>
<td></td>
<td>▪ If leverage is to be allowed, limits as to how much</td>
</tr>
<tr>
<td>Use of derivatives</td>
<td>Whether or not derivatives can be used in the portfolio and for what purposes, for example, risk management (currency hedging, liability hedging)</td>
</tr>
<tr>
<td>Pension-fund-specific restrictions</td>
<td>For example, plan sponsors that wish to restrict investment in the industry in which their sponsor operates could specify such restrictions</td>
</tr>
</tbody>
</table>
Implementation
Within a delegated mandate, a customized investment strategy is developed for each pension plan, with various implementation options available to plan sponsors.

Investment strategy can be implemented in different ways. We look at this from three perspectives:

- The choice between pooled funds and customized implementation
- Liability hedging implementation
- Accessing diversity

Historically, investments in specialist mandates, particularly in hedge funds and private markets, were satisfied by fund of funds. They provided access to diversified and specialized investments in niche asset classes for governance-constrained investors. In fact, some delegated mandates use fund of fund solutions to implement investment strategy.

Bundling investments into pooled funds
Typically, the overall investment strategy uses a number of different asset classes and/or different investment managers. A delegated manager may combine some or all of these into bundles and create pooled funds populated with the delegated manager’s highest conviction ideas.

At one extreme, all a pension fund’s invested assets could be combined into one bundle. Alternatively, a number of different bundles could be created for sub-portfolios (e.g., different asset classes). A pension fund would then hold units in these different pooled funds managed by the delegated manager.

It can be difficult for small pension funds to access a diverse range of ideas, but pooled funds can make these opportunities more accessible. A large number of pooled funds creates more asset allocation flexibility though potentially a very large number of underlying investment managers, as each fund employs several managers to ensure it is differentiated on a stand-alone basis.

Fully customized implementation
Alternatively, fully customized implementation enables the delegated manager to reach separate asset manager agreements on the client’s behalf and to tailor the eventual portfolio to the plan’s particular needs (Figure 7).

Figure 7. Access to customized investment solutions

<table>
<thead>
<tr>
<th>Level of custom arrangements possible</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pooled funds containing wide range of assets</td>
</tr>
<tr>
<td>The pension fund invests in a number of pooled funds managed by the delegated manager</td>
</tr>
<tr>
<td>Some assets may be allocated directly to underlying manager funds</td>
</tr>
<tr>
<td>Pooled funds for specific opportunities</td>
</tr>
<tr>
<td>Segregated implementation</td>
</tr>
<tr>
<td>All assets allocated to underlying manager mandates or funds</td>
</tr>
</tbody>
</table>
When deciding whether to select a pooled fund or a customized portfolio, plan sponsors should be mindful of:

1. **Investment beliefs and restrictions**
   Investors should first consider their mission and investment beliefs, and the extent of risk specific to them. At the onset of a delegated mandate, the plan sponsor should consider any beliefs that need to be reflected in its investment arrangements (e.g., if the plan sponsor does not believe in active management in a particular asset class).

2. **Access to opportunities**
   Either a pooled or a segregated approach should offer the same access to opportunities; however, plan sponsors should be aware of the range of different funds that are available.

   Some delegated managers already operate funds that cover the major asset classes, but a delegated mandate should make new opportunities accessible. The plan sponsor should understand the flexibility that each of the funds has in investing in new opportunities.

   As an example, following the credit crisis, there were a number of opportunities to lend to distressed companies. If several of the pooled funds in the pension fund’s portfolio had the discretion to allocate to sub-investment-grade credit and chose to do so, a higher-than-intended exposure to riskier credit for the pension fund could have resulted.

3. **Portfolio construction and management**
   A delegated manager needs to ensure a portfolio is sufficiently transparent so a plan sponsor can confirm that assets reflect overall investment objectives. This is accomplished by providing clear data and an understanding of risk and return, the managers’ style, concentration of positions, liquidity and leverage – both at an individual manager and the portfolio composite levels. The impact of any portfolio changes can then be assessed not only against risk and return objectives, but also against other risks and implementation issues (such as liquidity), and the plan’s investment beliefs and/or restrictions.

4. **Costs**
   Fees and costs can materially influence a pension plan’s outcome. The level of fees will vary depending on implementation. A pooled fund may have both administration costs and underlying manager fees; however, the large size of a pooled fund may allow a delegated manager to negotiate more favorable investor fees, bringing costs down. Transparency of fees and costs to the plan sponsor is also important, particularly investment and delegated manager fees and expenses embedded in any pooled funds.

5. **Liquidity**
   Liquidity describes the cost and ease of selling an asset. While the liquidity of underlying fund managers is largely dependent on the asset managers, a delegated offering’s structure can also impact liquidity.

When a fund of funds is used, additional liquidity considerations surface that are dependent on the delegated manager’s terms or the funds used. Where a pension fund already has some assets that it does not want to sell, moving to a delegated mandate using a fund of funds could force a sale if these assets cannot be transferred to the pooled fund. Similarly, if the plan sponsor was to change the delegated manager in the future, then a new delegated manager is unlikely to hold investments in a competitor’s fund. The entire portfolio might have to be disinvested and commensurate costs incurred.
Implementing liability hedging solutions

Liability hedging solutions have largely the same implementation considerations as for return-seeking assets, but plan sponsors also need to consider:

- The level of and ability to control leverage – a custom arrangement makes it easier to control
- Whether active management should be included within the liability hedging portfolio or not

Ultimately, the plan sponsor needs to be comfortable with the delegated manager’s approach to liability hedging and the various controls it applies when considering implementation. This should be established at the outset of a delegated mandate.

The approach to diversity

Diversity is not a new concept for pension plans. While seemingly simple, the definition of diversity is multi-layered. Most simply, it is investment in different asset classes. Since assets are not perfectly correlated, if one asset class experiences poor returns, then a pension fund with diverse holdings may suffer a smaller loss.

Genuine diversity?

Constructing a portfolio that includes uncorrelated strategies that deliver their returns from similar drivers may not provide the required diversification during times of stress. Instead of relying on modeled risk, which is based on assumptions for risk, return and correlations, asset owners should recognize uncertainty and understand the fundamental drivers of return and what risks they are being rewarded for taking. Figure 8 shows the key drivers of return. Many asset classes access more than one of these key drivers.

A number of pension plans have invested in a range of different funds, which have helped to reduce modeled risk. Even so, many continue to rely heavily on equity risk premium. Delegated management should allow pension funds to diversify in a way that goes beyond investing in a number of different funds or providing an alternative means of investing in mainstream asset classes. An example of a seemingly diverse portfolio is shown in Figures 9 and 10. Figure 9 suggests a portfolio spread across a range of assets.

Delegated management should allow pension funds to really diversify in a way that goes beyond investing in a number of different funds or providing an alternative means of investing in mainstream asset classes.

![Figure 8. Sources of investment returns](image)

<table>
<thead>
<tr>
<th>Risk premium</th>
<th>Investors are rewarded for bearing the risk of:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>Being lower down the capital structure in the event of corporate default</td>
</tr>
<tr>
<td>Credit</td>
<td>Debt issuers defaulting on their bond obligations</td>
</tr>
<tr>
<td>Illiquidity</td>
<td>Holding an asset that cannot be quickly or cheaply sold</td>
</tr>
<tr>
<td>Insurance</td>
<td>Providing protection against extreme losses</td>
</tr>
<tr>
<td>Term</td>
<td>The uncertain return and mark-to-market volatility of taking duration risk</td>
</tr>
<tr>
<td>Currency</td>
<td>The risk that the purchasing power of the currency falls due to a currency crisis</td>
</tr>
<tr>
<td>Skill</td>
<td>A manager, previously considered skillful, underperforming its benchmark</td>
</tr>
</tbody>
</table>

On closer inspection, the majority of risk arises from the allocation to equities. The 50% allocation to different types of equities contributes to over 80% of the risk.

Instead of relying on asset classifications, a diversified portfolio that balances exposure to different risks has a better chance of reducing risk.

A large number of delegated management options are available to plan sponsors. Both the benefits of a customized option and the simplicity of a fund approach should be explored. Of course, with some delegated managers, it may also be possible to benefit from both by combining fund investments with a custom mandate.
Figure 9. A seemingly diverse portfolio

- U.K. equities: 15%
- U.S. equities: 3%
- Europe equities: 12%
- Japan equities: 7%
- Asia Pacific (excluding Japan) equities: 3%
- Emerging market equities: 17%
- Government bonds: 2%
- Corporate bonds: 1%
- Cash: 25%
- Other: 0%

Figure 10. A different perspective on diversity

Bar chart showing different perspectives on diversity.
Conflicts of interest
The widely acknowledged principal-agent problem highlights how an agent’s self-motivation is often at the principal’s expense. Potential conflicts can arise between investors and their chosen investment managers.

The potential problem arises because the agent has superior information that makes it difficult for the principal to monitor the agent’s actions and assess its motivations. The problem may be exacerbated if the interests of the principal and agent differ. For example, the principal, a pension fund, is investing to meet its long-term liabilities, while the agent, an investment manager, is remunerated based on short-term performance.

Pension plans operate in an environment that has multiple layers of principal-agent problems. Plan beneficiaries entrust the stewardship of their pensions to the plan sponsor, which delegates investment, safekeeping and other activities to various service providers, from plan administrators, custodians and investment consultants, to investment managers.

Conflicts of interest can exist among any of the links in the chain outlined in Figure 11. While these issues are not new to the pension industry, increasing investment complexity and fallout from the global financial crisis have focused more attention on managing conflicts and improving the alignment between investors and their delegated agents.

Potential conflicts
Among the numerous asset management activities that create potential conflicts are situations where a manager or consultant:

- Could make a gain or avoid a loss to the firm at a client’s expense
- Has an interest in the outcome of a decision or service that is not the same as the client’s
- Has an incentive to favor one client over another
- Has an incentive to favor a service provider that is not the best solution for the client
- Purchases research and trade execution services for clients, and allocates costs among clients
- Is offered gifts or entertainment that may compromise objectivity

We expect asset managers to have clear policies outlining how they manage conflicts of interest, so the same should be expected of delegated managers. Potential conflicts exist in both traditional advisory roles and delegated relationships as well as between the two, as providers that offer both services may be able to increase their fees by advising plan sponsors to switch to a delegated model.
Utilizing internal funds

- How does a provider ensure that internal funds are the most appropriate products to use in an overall structure?
- This varies depending on whether the underlying funds are responsible for stock selection or are a fund of fund solution of external managers. However, ensuring fee structures do not result in any double layering of fees is vital as a minimum.

Communication of changes in views on investment managers and/or products

- How does a provider ensure that all its clients have access to changes in its view at the same time to ensure one group of clients is not favored over another?
- One solution would be to notify all clients (fiduciary and advisory) receiving advice in the relevant asset class or strategy type at the same time so that they have equal opportunity to react to the changes.

Allocations to capacity constrained funds/strategies

- How does a provider ensure that any capacity-constrained investment ideas are available and fairly allocated across its client base?
- One solution would be for allocations to be managed in a systematic manner so that all clients that are employing a provider in the asset class or strategy concerned receive fair and equitable treatment.

The role of fees in managing conflicts

Fees have received a lot of attention. Delegated management is often offered as a bundled service, so it is important to understand the level of complexity in the underlying investment strategy and the range of activities that the service covers. The complete transparency of all costs incurred in managing the portfolio under a delegated arrangement is vital as is a comparison on a like-for-like basis across providers. It is very difficult to monitor and compare underlying transaction costs consistently, but a delegated manager can control the following:

- Delegated manager’s base and performance fees
- Fee for any additional advice provided by the delegated manager
- Base and performance fees for the underlying investment managers
- When used, the fund of fund provider’s fees and underlying manager fees
- Embedded expenses
- Custody and administration charges
- Performance monitoring
- Fees for other services, such as legal advice
Delegated managers are typically paid a fixed fee or a fee related to the portfolio’s size rather than project or time-cost fees typically charged in an investment advisory arrangement. It is important to understand not only why different fee structures make sense for different service providers but also the incentives that different fee structures create.

- All-inclusive or bundled fee structures, where the pension fund pays the delegated manager a fee that covers all underlying costs, are easy to understand. Full transparency, however, may be difficult, and it may create an incentive to invest in low-cost (and potentially suboptimal) underlying mandates if the delegated manager’s remuneration is based just on the difference between fees charged and fees paid. And when delegated managers use their scale to negotiate fee reductions with the underlying managers, these may not be passed on to the pension fund.

- Asset-based fees can create the incentive for asset gathering, which may have a negative impact if the manager doesn’t have the resources and investment opportunities to manage a larger asset base. When a consultant is appointed to advise on some asset classes and act as a delegated manager on others, there is the potential for the delegated manager to structure its advice in a way that favors the delegated asset classes, as these attract a higher fee for the manager.

- Performance fees can encourage unnecessary risk taking, as the delegated manager is rewarded on the upside but does not suffer proportionately on the downside. In addition, delegated managers may be paid a performance fee based on short-term performance, and incentivized to add short-term value rather than to take longer-term positions in line with the plan sponsor’s objectives. Performance fees may also make managers less incentivized to advise on de-risking opportunities that improve funding levels and reduce portfolio risks, and consequently managers’ fees.

Most important, any advice or service should be based entirely on the plan’s specific investment needs, and fees for different service offerings should be easily comparable.

It is important to understand not only why different fee structures make sense for different service providers but also the incentives that different fee structures create.

Conflict-mitigation principles

Delegated investment managers should be engaged as long-term partners; a relationship of mutual trust is beneficial. The following principles can help mitigate conflicts when appointing a delegated manager:

- Agree to full transparency at the outset.
- Define clear roles and responsibilities for all parties at the outset.
- Include the responsibilities of the delegated manager, the plan sponsor and any third parties.
- Measure the manager against defined, appropriate goals and targets, and a suitable time frame for performance assessment.
- Define the evaluation metrics that will be used and the frequency of assessments.
- Structure the delegated manager’s compensation to align the interests of the manager and plan sponsor.
- Ensure the manager has an appropriate policy for managing conflicts and treating all clients fairly.
- Appreciate that managing conflicts is not a one-time process — the procedure to identify, manage and monitor conflicts needs to evolve over time as circumstances change.
Monitoring
In an advisory model, the plan sponsor typically monitors each of the underlying investment managers in the pension fund’s portfolio against an appropriate benchmark. How do plan sponsors create a framework to assess a delegated manager?

A delegated model assigns hiring and firing of underlying asset managers and the monitoring of mandates to the delegated manager. The plan sponsor oversees the delegated manager.

Measures of success
A thorough assessment of a delegated manager is both qualitative and quantitative, and can be achieved by using a balanced scorecard of hard and soft measures of success. A plan’s funding level progression, typically a key plan sponsor focus, is a potential hard monitoring metric, as is progression against the journey plan.

Figure 13 provides some metrics for a balanced scorecard. These metrics create a framework for plan sponsors to assess their own decisions and those made by their delegated managers. How measures are used in an assessment, however, should be customized to the individual client’s needs.

Benchmarks for quantitative monitoring
In the delegated management industry, we typically see two types of performance benchmarks: performance relative to liabilities or a comparator portfolio (typically a low-governance equity bond portfolio or a diversified composite based on market indexes). The key benefits and drawbacks of each type of benchmark are shown in Figure 14.

Performance relative to liabilities is the better measure of success, as it is consistent with the plan sponsor’s objective; however, there is merit in simultaneously using other measures, as they can provide meaningful information that performance relative to liabilities does not easily show.

When comparator portfolios are used for monitoring, they need to be updated as the pension fund’s circumstances and risk profile change through time.

Performance attribution
While performance measurement allows the plan sponsor to understand whether the investment objectives are being met and if the underlying managers are achieving their targets, the plan sponsor also needs to understand how a delegated manager’s skill in various areas has contributed to the overall performance.

Performance attribution analysis helps the plan sponsor to better understand why a pension fund’s return is different from the fund’s benchmark, whether relative performance reflected a delegated manager’s skill and which decisions added value. Figure 15 shows how comparing total pension fund performance against a number of comparators can disaggregate this performance figure and identify performance drivers.
### Figure 13. Sample balanced scorecard

<table>
<thead>
<tr>
<th>Risk</th>
<th>Metrics</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Business</strong></td>
<td>▪ Stability of the delegated manager’s business</td>
</tr>
<tr>
<td></td>
<td>▪ Staff turnover</td>
</tr>
<tr>
<td></td>
<td>▪ Staff training, professional qualifications and experience</td>
</tr>
<tr>
<td><strong>Return</strong></td>
<td>▪ Performance against objectives and suitable benchmarks</td>
</tr>
<tr>
<td></td>
<td>▪ Performance of managers within the portfolio</td>
</tr>
<tr>
<td></td>
<td>▪ Forward-looking measures of return</td>
</tr>
<tr>
<td><strong>Investment process</strong></td>
<td>▪ Clarity of investment process</td>
</tr>
<tr>
<td></td>
<td>▪ Research resource and track record in innovation and thought leadership</td>
</tr>
<tr>
<td></td>
<td>▪ Cost awareness and control</td>
</tr>
<tr>
<td><strong>Risk management</strong></td>
<td>▪ Is the level of risk taken within the mandate guidelines?</td>
</tr>
<tr>
<td></td>
<td>▪ Is the level of return appropriate for the level of risk taken?</td>
</tr>
<tr>
<td></td>
<td>▪ Is there an appropriate risk-monitoring framework in place?</td>
</tr>
<tr>
<td></td>
<td>▪ Forward-looking risk analysis</td>
</tr>
<tr>
<td><strong>Implementation efficiency</strong></td>
<td>▪ Speed of implementation</td>
</tr>
<tr>
<td></td>
<td>▪ Errors made and appropriateness of process for dealing with errors</td>
</tr>
<tr>
<td></td>
<td>▪ Appropriate internal controls</td>
</tr>
<tr>
<td><strong>Service delivery</strong></td>
<td>▪ Quality of strategic advice</td>
</tr>
<tr>
<td></td>
<td>▪ Plan sponsor training/education</td>
</tr>
<tr>
<td></td>
<td>▪ Communication</td>
</tr>
<tr>
<td></td>
<td>▪ Responsiveness</td>
</tr>
<tr>
<td><strong>Conflicts of interest</strong></td>
<td>▪ Appropriate process for identifying and managing potential conflicts of interest</td>
</tr>
<tr>
<td><strong>Transparency</strong></td>
<td>Does the manager provide enough information to allow the plan sponsor to understand what changes have been made, the rationale for these changes and what value has been added?</td>
</tr>
<tr>
<td><strong>Proactivity and innovation</strong></td>
<td>▪ Best-in-class manager selection</td>
</tr>
<tr>
<td></td>
<td>▪ Dynamism and flexibility</td>
</tr>
<tr>
<td></td>
<td>▪ High-quality investment ideas</td>
</tr>
</tbody>
</table>

### Figure 14. Comparing benchmarks

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Diversified composite</th>
<th>Equity/Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Benefit</strong></td>
<td>Consistent with the plan sponsor’s overarching objective</td>
<td>Shows if the manager has added value through relative asset class views and manager selection</td>
</tr>
<tr>
<td><strong>Drawback</strong></td>
<td>Market returns likely to dominate attribution</td>
<td>Not necessarily consistent with the plan sponsor’s objectives/ pension fund’s journey plan</td>
</tr>
</tbody>
</table>
Imagine a pension plan with a delegated mandate objective of liabilities +3% per annum. Assume the following returns were achieved:

<table>
<thead>
<tr>
<th>Actual portfolio return (% per annum)</th>
<th>Liability benchmark return (% per annum)</th>
<th>Equity/Bond portfolio at same risk (% per annum)</th>
<th>Diversified comparator</th>
</tr>
</thead>
<tbody>
<tr>
<td>Absolute return</td>
<td>5.5%</td>
<td>3.0%</td>
<td>2.5%</td>
</tr>
</tbody>
</table>

**Did the delegated manager meets its objective?**

The pension plan has probably fallen behind its journey plan by achieving liabilities of +2.5% over the last year against a target of liabilities +3% per annum. The funding level would have improved by slightly less than is required to meet the pension plan’s long-term goals.

If we then look at where value was delivered, Figure 16 shows what we could see from this form of attribution.

In this example, taking investment risk was not particularly well rewarded. The equity/bond portfolio delivered a lower return than liabilities; however, a diversified portfolio was beneficial, delivering 1% of additional return over and above the equity/bond portfolio. Then there was a further 2% of added value from the delegated manager’s active asset allocation and investment manager selection decisions.

In a challenging market, these results are considered very productive, despite funding progress slightly trailing longer-term expectations.

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**Figure 16. Example: Added value**

<table>
<thead>
<tr>
<th>Actual portfolio return (% per annum)</th>
<th>Liability benchmark return (% per annum)</th>
<th>Equity/Bond portfolio at same risk (% per annum)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relative return</td>
<td>-0.5%</td>
<td>+1.0%</td>
</tr>
</tbody>
</table>

Did taking risk add value?  

Did diversity add value?  

Did asset allocation/manager selection add value?  

✓

✓ ✓
Performance comparisons and reporting variations

Comparing the performance of different delegated managers is very difficult, as the type and level of reporting provided varies considerably. This reflects different provider approaches to the portfolio management and the unique nature of each delegated mandate.

For example, consider the following: In a given year, pension plan A achieves a return of liabilities +2%, and pension plan B achieves a return of liabilities +3%. Surely pension plan B achieved a better result.

But what if we now told you:

- Pension plan B hasn't achieved its return target of liabilities +3.5%, and is behind its journey plan.
- Pension plan A has outperformed its return target of liabilities +1.2%, and consequently, its funding level increased, and it reduced risk and its reliance on the sponsor company.

Which achieved a better result?

We would also question the merits of comparing performance across providers. It is possible to compare the performance of multiple investment managers against a market index, but delegated management is more nuanced, as the best objective is plan specific and can vary considerably (e.g., performance relative to the plan’s journey plan, liabilities and an equal risk comparator portfolio). This can also incentivize delegated managers to attempt to outperform each other rather than focus on the individual plan’s objectives.

While a useful comparison of pension fund performance across delegated providers is difficult, if not impossible, to achieve, on a like-for-like basis, we think it best to compare managers across a range of metrics that should drive success relative to a client’s specific objectives; the range of criteria in Figure 14 is a good starting point.

In conclusion, plan sponsors need to establish a framework for monitoring their delegated manager that is consistent with the objectives of the manager and plan sponsor. Delegated managers should provide the plan sponsor with adequate information and training, so there is understanding of what drives the manager’s performance. The plan sponsor should also be aware that comparisons across delegated managers are difficult and interpreting comparisons require care.
Fees

Delegated investment management fee structures vary considerably. These differences make comparison between providers and their service offerings difficult. Different types of fee structures may be justified, however, and can improve alignment with the plan sponsor.

A wide and varied range of activities are included in delegated management, and a broad skill set required, all of which warrants a higher fee than seen in an advisory relationship. However, considering the pension fund’s total costs, there is potential for lower overall fees, as delegated managers can often negotiate larger fee reductions with underlying investment managers.

Delegated management fee structures can include base (ad valorem) fees, performance fees or a combination of the two. Mandate specifics and plan sponsor preferences typically dictate the structure selected.

Base fees (ad valorem)

Base fees are charged either as a fixed nominal amount or, more commonly, as a percentage of the assets managed (ad valorem). Delegated managers typically adopt one of two base fee structures:

- A bundled structure that aggregates all of the costs associated with a delegated manager’s activities into one fee, which includes any fees paid to the underlying asset managers
- An unbundled structure that splits out the fees for the delegated manager’s services and the fees for any underlying service providers (the delegated manager will typically be responsible for paying the underlying manager fees from the pension plan’s assets, so full transparency of what each fee relates to is necessary)

A plan sponsor can more fairly assess the value of different delegated investment managers when the fee structures are transparent and activities are identified. This is particularly true when the plan sponsor is potentially transitioning to a different governance approach, such as moving from a traditional advisory model to a delegated solution. An all-inclusive bundled fee structure is simple to understand and provides more certainty of the pension fund’s costs, but it makes it difficult to assign a cost or value to underlying activities and could potentially create an incentive to appoint lower-cost managers.

In contrast, an unbundled fee structure that separates out the fee paid to the delegated manager and the underlying asset managers allows a plan sponsor to see what is charged for each service. In addition, in unbundled fee structures, any fee savings from reduced fees that the delegated manager negotiates will be passed directly onto the pension fund.

Whichever model is adopted, a plan sponsor needs to understand the benefits and drawbacks of each structure to make an informed decision that creates comfort that the value added from appointing a delegated manager justifies its fee.

Whichever model is adopted, a plan sponsor needs to understand the benefits and drawbacks of each structure to make an informed decision that creates comfort that the value added from appointing a delegated manager justifies its fee.
Performance fees

Performance fees are commonly charged as a set percentage of the return over a certain performance hurdle. Advocates of performance fees argue that they provide managers with an incentive to perform. However, this can also mean that alignment of interests is more difficult to secure.

Many investors, particularly pension funds, focus on long-term, risk-controlled returns, whereas managers are assessed and remunerated based on shorter-term performance. A performance fee model for a delegated manager needs to be carefully constructed to align interests and provide a long-term focus. In general, we expect pension funds to reduce risk over time as their funding positions improve and as they get closer to their long-term objectives.

Plan sponsors should recognize the following performance fee features:

- Performance fees exhibit inherent asymmetry: When performance is good, the manager receives a performance fee, but when performance is poor, the manager does not participate fully in the downside. This can encourage managers to take more risk if performance is poor.
- Short-term performance can be highly volatile, so fee structures should reduce this volatility.

- Performance fees should be paid, where possible, for value added, based on the return generated relative to a predetermined benchmark, and in excess of the base fee and expenses. Unfortunately, however, this is not a perfect measure of value added, and plan sponsors will need to accept that they will be paying for some market returns (beta) inherent in the chosen investment strategy.
- Balance is key in combined performance and base fee structures: In our view, around a third of a manager's total fee should depend on performance. In most cases, the manager's participation rate should not be too large. Performance fees of 15% to 20% that are frequently seen in hedge funds and private market funds are probably inappropriate.

In summary, there are various ways to structure a delegated management fee, some of which are more transparent than others. The plan sponsor needs to understand what activities (and underlying fees, where applicable) are included in the delegated manager's fee. Only then will the plan sponsor be in a position to judge whether this fee represents good value.

Afterword

Delegated investment management could materially benefit pension plans looking to add to their investment decision-making capabilities.

The industry has developed considerably over recent years, presenting pension plans with a variety of credible propositions from competing providers. As with many other professional service selections, details are important, and there are no real short cuts. Please feel free to contact us at investment@willistowerswatson.com to discuss any of the concepts in this guide in greater detail.
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