

Performance Benchmarks for Institutional Investors: Measuring, Monitoring and Modifying Investment Behaviour

Performance benchmarks in the UK have been around since the early 1970s. They are an essential part of the investment strategy of any institutional investor and help both to define client/trustee expectations and to set targets for the fund manager. Benchmarks can be set in relation to liabilities and can therefore change if the liabilities change, say, as a result of increasing maturity. Benchmarks might also be influenced by regulations (e.g., a minimum funding requirement), accounting standards (e.g., Financial Reporting Standard 17 which for the first time in the UK puts pension scheme assets and liabilities directly onto the sponsoring company's balance sheet), or client/trustee preferences (e.g., trustees might prefer to minimise the volatility of employer contributions into a pension plan than minimise the average level of employer contributions, given that, in final salary plans, the pension is funded on a balance of cost basis).

The benchmark, appropriately set, has important implications for how the actions of the fund manager are monitored and interpreted. An appropriate benchmark recognises formally that the strategic asset allocation or SAA (i.e., the *long-run* division of the portfolio between the major categories of investment assets, such as equities, bonds and property) is a risk decision relative to the liabilities, rather than an expected return decision. In other words, the SAA, properly interpreted, is not an investment decision at all: instead it is determined largely by reference to the maturity structure of the anticipated liability cash flows. In contrast, the stock selection and market timing (i.e., tactical asset allocation) decisions are investment decisions and it is the fund manager's performance in these two categories that should be judged against the benchmark provided by the SAA.

The two main types of benchmarks used in the UK are external asset-class benchmarks and peer-group benchmarks. These benchmarks are used by both 'gross funds' (i.e., those, such as mutual funds, without explicit liabilities) and 'net funds' (i.e., those, such as pension funds, with explicit liabilities). When external performance measurement first began, most pension funds selected customised benchmarks (which involved tailoring the weights of the external benchmarks to the specific requirements of the fund). Shortly after, curiosity about how other funds were performing led to the introduction of peer-group benchmarks. More recently, following the recognition that the objectives of different pension funds differ widely, there has been a return to customised benchmarks.

A long-standing problem in the UK has been inadequate investment in venture capital companies. This is partly due to their exclusion from standard benchmarks, but also because of the unwillingness of institutional investors to move away from their preferred position of portfolio investment in favour of direct investment. US institutional investors have ten times the investment in venture capital of their UK counterparts. It is possible that establishing a suitable venture capital benchmark might help to promote pension fund investment in new start-ups. It certainly appears to be the case that behaviour follows measurement when a performance benchmark is established: the benchmark changes from being a tool of measurement to a driver of behaviour.

But benchmarks are not the only factor of importance: fee structures also have a major impact. The fund manager's fee typically depends solely on the value of assets under management, not on the value added by the fund manager and there is typically no reward for outperforming either the external or peer-group benchmark and no penalty for underperforming them. However, the *long-term* success of any fund management house depends on its relative performance against its peer-group. The large fund management houses in the UK have recently lost business not because of poor *absolute* performance, but because of poor *relative* performance.

It is possible to combine an unsuitable benchmark with an unsuitable fee structure. Peer-group benchmarks provide a strong incentive not to underperform the median fund manager, while fee structures based on the value of assets under management do not provide a particularly strong incentive to engage seriously in active fund management. We should not be surprised to find that the outcome of this fee-benchmark combination is herding around the median fund manager who, in turn, is doing little more than match the underlying benchmark index. In other words, this benchmark and fee structure have the effect of modifying the behaviour of the fund manager from that which was agreed with the client/trustee. This is rational behaviour by the fund manager given that his long-term survival in the industry depends on his relative performance against other fund managers. But it is certainly not what the client/trustee intended. Similarly,

a fee structure that awarded outperformance of a benchmark without penalising underperformance would lead to the fund manager taking risks with the client/trustee's assets in a way that the client/trustee did not intend.

By contrast, a good benchmark combined with a suitable fee structure would enable an above-average fund manager to deliver, on a systematic basis, superior investment performance without taking on excessive risks. The fact that the evidence indicates that fund managers cannot systematically deliver superior investment performance over extended periods is more an indication of the efficiency of financial markets than of the ineffectiveness of either the benchmark or the particular fee structure.

A good benchmark would be one that did not have built-in biases either in favour of or against particular asset classes. In particular, a dynamic financial system demands that there is no bias against start-up capital, and so a good benchmark would contain the appropriate market weighting in venture capital securities. A good benchmark might therefore be based on a multiple of indices that cover all the key asset categories. In turn, a good fee structure has an appropriate performance-related element.

Performance benchmarks are important for three key reasons: they help to measure the investment performance of institutional fund managers, they provide clients/trustees with a reference point for monitoring that performance, and they can also have the effect of modifying the behaviour of fund managers. Benchmarks are important, but so are fee structures. Together, they can either provide the right incentives for fund managers or they can seriously distort their investment behaviour.

David Blake