

10.

**Financial
Management of
the Pension**

10.1-1 Investment Performance

Investment Performance is the return on an investment portfolio.

The investment portfolio can contain a single asset or multiple assets. The investment performance is measured over a specific period of time and in a specific currency. Investors often distinguish different types of return. One is the distinction between the total return and the price return, where the former takes into account income (interest and dividends), whereas the latter only takes into account capital appreciation.

Investment Performance

Another distinction is between net and gross return. The 'pure' net return to the investor is the return net of all fees, expenses, and taxes, whereas the 'pure' gross return is the return before all fees, expenses, and taxes. Various variations between these two extremes exist. Which return one looks at depends on what one is trying to measure. For example, if one wishes to measure the ability of an investment manager to add value, then the return net of transaction expenses, but gross of all other fees, expenses, and taxes is an appropriate measure to look at since fees, expenses, and taxes other than transaction expenses are often outside the control of the investment manager.

Another important distinction is between the money (dollar)-weighted return and the time-weighted return. The former is appropriate if the manager determines the timing of inflows in or outflows from the portfolio. The latter is appropriate when the manager is not responsible for the timing of cash inflows into and cash outflows from the portfolio.

10.2-1 Monitoring Performance

"In addition to any liability which he may have under any other provision of this part, a fiduciary with respect to a plan shall be liable for a breach of fiduciary responsibility of another fiduciary with respect to the same plan"

(ERISA Sec 405(a))

A fiduciary's duties do not end with the development of an investment policy statement and the selection of appropriate money managers to implement the policy. The fiduciary must ensure that those persons charged with investment responsibility comply with the provisions of the plan's investment policy statement.

Conducting an Analysis – 1 of 3

Most court cases arising out of the failure of the fiduciary to supervise properly clearly indicate that it is not sufficient for a fiduciary to merely review an investment report from the money manager.

The analysis must go deeper. The fiduciary should determine:

1. Whether the plan achieved its expected return and investment objectives. This is the most critical question the fiduciary must answer. For if the plan has not reached its objectives, the plan sponsor may be faced with making additional unplanned contributions to cover shortfalls. Or, the fiduciary may be faced with unhappy participants who question the fiduciary's prudent handling of their retirement assets. In either case, the fiduciary should determine whether the shortfall was a result of underexposure of asset classes offering greater returns, market upheaval, manager performance, high administrative and/or investment expenses, or a combination of factors.

Conducting an Analysis – 2 of 3

2. Whether the manager is still abiding by the plan's investment policy statement. Specifically, whether restrictions or constraints for different asset classes are being followed and whether asset allocation restrictions are being adhered to. This is one point in the supervisory process where the fiduciary should review whether the portfolio should be rebalanced (e.g. sell equities to increase fixed income exposure) to remain aligned with the allocation agreed upon in the investment policy statement.

Conducting an Analysis – 3 of 3

3. What contributed to the total return of the portfolio? A number of components make up total return. Each should be isolated to determine its impact. These components are:

a) Performance that can be attributed to the money manager's decisions. In other words, what premium above the S&P 500 did the equity manager earn? Empirical studies have shown that a majority of managers do not add a premium and actually subtract from the performance that could have been achieved by, passive management (e.g., buying an index).

b) Performance that can be attributed to the fiduciary's selection of money managers. How does the managers' performance compare with managers of like style or strategy, and also with managers of the same asset class.

Terminating a Manager

In monitoring and supervising the manager, the question will arise: "Under what circumstances should a manager be replaced?"

It may be easier to answer the question by stating when it may not be appropriate. Poor short-term (two - years or less) performance should not be justification in and of itself. Most consultants agree that a manager should be given at least two years to allow for the manager's performance abilities to be recognized. In addition, the fiduciary should not expect even a "star" money manager to hit a home run every year.

Terminating a Manager

There are times however when a prudent fiduciary should consider firing a money manager. One reason would be a change in the manager's investment strategy or style. No fiduciary should entrust assets to an untested strategy.

Also, the fiduciary should be alert for the manager suffering from performance anemia and who may initiate changes to increase returns by investing in the latest Wall Street fad. This adds undue risk to a portfolio.

An inexperienced manager suffering from poor performance may try to redeem his or her record by taking inordinate risks that often compound investment errors and further degrade performance.

Conclusion

Monitoring money manager performance goes beyond a simple review of manager-provided figures. Changes in a manager's style, Staff, and/or changes in plan objectives may necessitate the replacement of a manager.

The investment policy Statement should not be viewed as a static document - circumstances may change requiring a change in asset mixes and/or managers.