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RIMCA Whitepaper



How To Evaluate an Investment Policy Statement – A Pension Fund Stakeholder's Guide!

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We have received an overwhelming level of engagement on our April Issue where we focused on the importance of the Investment Policy Statement (IPS). Subsequently, we have been requested to unpack our process on evaluating IPSs.

Important to start by emphasizing, once again, that the real value of an IPS is in its implementation. It is a living document that funds should have an ongoing intimate relationship with for guidance.

Any investment strategy review should start with the evaluation of the current IPS. No review is worth it if it is not anchored on an honest evaluation of the current IPS. In the evaluation process, the focus should be on identifying any gaps in the existing IPS as well as highlighting any provisions of the IPS that require revising. Another key objective is to assess the extent to which the IPS has been effectively implemented. Furthermore, and importantly, the review process should evaluate whether the investment strategy, as captured in the IPS, has been successful in achieving the fund's laid-out objectives.

We follow a clear 10-point process that is designed to unpack and evaluate the IPS in line with the critical purpose for which it is designed to serve.

Our 10-point process evaluates the IPS across these key dimensions:

- Comprehensiveness of Policy Scope,
- Soundness of Risk and Investment Management Philosophy,
- Clarity of Investment Objectives and Constraints,
- Precision of Investment Strategy and Parameters,
- Robustness of Governance and Accountability Standards,
- Depth of Regulatory Compliance Provisions,
- Effectiveness of Risk Management Framework,
- Efficacy of Manager Selection Programme,
- Implementation Efficiency, and
- Strategy Performance and Evaluation.

Comprehensiveness of Policy Scope

Whether it is for a Defined Benefit (DB) or Defined Contribution (DC) fund, an IPS should be comprehensive enough to cover all the nuances of investing for the benefit of members. Its clauses should be such that members' interests are at the centre and front of its provisions. Subsequent to that, interests of the rest of the stakeholders also need be adequately covered too.

In this thought piece, we share insights as they pertain to evaluating a DC fund IPS. That of a DB fund has its own unique features that require a different but comparable approach. Needless to say, a deep understanding of a fund's liabilities and financial obligations are key to evaluating an IPS. In our experience, a liability-driven mindset is critical for the effective evaluation of any IPS.

For a DC fund, issues like the pension level the fund is aiming to achieve for its members is very critical. Accordingly, it is imperative that clarity on this be considerably given in the IPS. While most funds would want to aim for very high net replacement ratios, this is just not realistic in some instances when one looks at the contribution rate. Such a high net replacement ratio target with a low contribution level means the fund is setting itself on a high risk-taking course – which of course could easily be considered as negligent.

Admittedly, and rather speedily, the world is fast converging to a point that the era of looking at investment through a two-dimensional space are now over. Other than returns and risk, there is now a third dimension that also needs to be clearly provided for in the IPS – the fund's relationship and treatment of the environment. This does not in any way seek to replace the primary goal of pension fund investing of growing members' retirement savings. It simply expands it, nudging pension funds to invest for purpose – paying particular attention to Environmental, Social and Governance (ESG) issues.

Soundness of Risk and Investment Management Philosophy

While the risk and return metrics are almost always captured in every IPS, it is

the risk and investment philosophy we find absent in most IPSs – with the absence of the former being a lot more prevalent than that of the latter.

Failure to articulate and capture the fund's investment philosophy has the unintended effect of leaving the fund to be influenced by the views of different service providers and advisers at different points in time. It also takes away the beacon and point of reference to which everyone should anchor back to for guidance and direction. Without a clearly stated investment philosophy of its own, the fund is vulnerable to a lot of outside influence – which many a times is not consistent and likely not to be aligned with the fund's own long-term interests and goals. A well-crafted IPS guards the fund against this possibility.

The type, quality, and quantum of risk exposure a fund takes ultimately determines the quality and quantum of returns it achieves. Risk is not a fate, but a choice – the choice a fund takes that ultimately determines the returns it achieves. There is a general tone of referring to risk as something that is to be avoided at all times and is only taken grudgingly. On the contrary, an IPS needs to have a tone that acknowledges what investment risk truly is – a source of risk premiums.

Clarity of Investment Objectives and Constraints

A fund's goals and aspirations receive more clarity when they are converted into investment objectives within the context of its circumstances and externally/self-imposed constraints. We take particular note of the way the returns are defined in the IPS. The returns that really matter to a fund are the net of fees returns. These are the returns that convert a member's contributions into a growing “pot” of fund credits. Any reference to returns should then be clear that it is with respect to net of fees investment returns.

While nominal positive returns power fund credits growth, they are not sufficient on their own. The real growth that members are interested in is the growth in their fund credits over and above any inflationary influences. In quoting the fund's investment objectives, the IPS needs to capture the real return aspirations quoted as inflation plus x% returns per annum.

Where a fund has a number of different categories of membership, there has to be clarity that the IPS has been crafted taking into account their individual interests and risk-return preferences. In a DC fund, different membership groups could include, contributing members vs non-contributing/paid-up members, or young vs old members, or for each member, the differences in preferences of treatment between normal contributions vs additional voluntary contributions.

It is not unusual for a fund to impose its own constraints and limits. This might include investments that are totally prohibited altogether by the fund. This could include prohibiting the fund from gaining exposure to sin industries (for example, alcohol and cigarettes producers). The IPS needs to specifically mention what the fund's self-imposed constraints and limits are.

Precision of Investment Strategy and Parameters

Most IPSs occasionally make reference to different membership categories of the fund based on age and years to retirement. However, it is rarely clear from the investment strategy alone what allocations of the assets are assigned to the different membership cohorts. A more effective policy would be to have a clear and distinct strategy for each of the membership cohorts. This could be in the form of a risk-profiled range of portfolios from aggressive, to moderate, to conservative portfolios.

Another common shortcoming is that IPSs, while they may quote the expected long term real returns of each of the main asset classes to be invested in, they fail to link that to the attainment of its targeted pension level for an average member. The result is normally that the fund has assets that achieve what they are expected to achieve while members still fail to achieve their retirement goals. The reason – the expected returns had not been made to speak to the retirement goals. An intentional attempt to assess the adequacy of the returns (defined in relation to inflation) would provide confirmation on whether they are the right assets with which to achieve the targeted pension level.

Another important aspect is a fund's rebalancing philosophy. There are two schools of thought on portfolio rebalancing. The one says, "rebalancing, not only does it bring back a portfolio to its long-term strategic asset allocation, it is also consistent with the basic investment principle of selling high and buying low". The second one, a bit contradictory to the first says; "rebalancing entails abandoning some of a portfolio's winners to support its losers". Certainly, the two views are at odds and the IPS needs to provide more detail on how the fund views the act of portfolio rebalancing and when rebalancing is to be performed.

Robustness of Governance and Accountability Standards

A robust governance and accountability framework requires that each and every key role player's responsibilities are clearly defined with no overlaps between different players. The framework needs to also ensure that there are no gaps within the structure that leave some key functions with no authority delegated to them.

While the IPS adequately provides for the Board to delegate some investment management responsibilities, it should be clear from the wording that none of those fiduciary responsibilities have been abdicated to the appointed specialists.

Another key general shortcoming is that, in assessing a fund's investment governance framework, one normally observes the absence of a mechanism to monitor the monitors – the appointed investment consultants. The investment consulting appointment provides a very critical service to a fund. By its very nature, it is a trust-based relationship. This though opens the fund up to the risk that, at times, while the Board is receiving a lot of important advice from their investment consultant it may become blind to the need of instituting a performance measurement framework for the investment consultant.

Secondly, another key role player in the investment management realm is the investment committee – and one should always be in place by the way. Not

many funds though are aligned to this practice and regulatory requirement. With that clarified, it is imperative that some from amongst the investment committee members are well informed about investment management issues to be able to provide the required guidance to the Board. The effectiveness of the investment committee has a very strong bearing on whether ultimately members are able to earn meaningful returns on their retirement savings.

Trustee training on investment related matters is a required, must-have, provision of an IPS. Trustees are called upon to make decisions on very important investment matters. The assumption that Trustees are conversant with such highly complex subject matters can certainly not be correct. While the intention is not to turn them into investment professionals, there should be a mechanism of keeping them abreast of trends and developments in the investment world. The IPS needs to provide for a clear programme of regular Trustee training on investment related matters.

We normally find that the roles of the Board are generally clearly well captured in the IPS. Where things normally differ though is on the depth and breadth of the outlined Trustees' roles. We also find that the responsibilities of the rest of the role players are covered to different depths of magnitude across different funds. The good practice is though to adequately provide clarity on the roles and responsibilities of each of the role players including the PO, the fund Actuary, investment managers, custodians, and administrators, both investment and member records administrators.

Depth of Regulatory Compliance Provisions

While the global standard practice is for every fund to have a well-detailed IPS, the Insurance and Pensions Commission (IPEC) has made it a regulatory requirement for each fund to prepare and submit its own IPS for IPEC's consideration. It is then required it be demonstratable that the IPS has been crafted in the spirit of the aspirations of the regulatory provisions.

While every fund is unique, with its own special circumstances, we occasionally

come across IPSs that have not been crafted to the letter and spirit of the directives of the regulator.

Effectiveness of Risk Management Framework

An effective risk management programme starts with capturing the amount of risk the Board is prepared to take on behalf of members. That demonstrates how risk tolerant or risk averse the Board is, further allowing it to formally quantify the level of risk the Trustees are willing to take to achieve the set fund goals and investment objectives.

Evaluation of the risk management framework encompasses an assessment of how the fund's risk budgeting is informed by its risk philosophy. It is a measure of the extent the Board is prepared to go in pursuit of exploiting rewarded risks – that is, risks including, but not limited to, strategic risk, benchmark risk, manager risk, absolute/volatility risk, tracking error/relative risk, and active-share risk that the fund is prepared to take. Policy risk though remains the one fundamental risk that can neither be measured nor determined ex-ante – requiring that it be evaluated differently.

Efficacy of Manager Selection Programme

How a fund selects and blends its investment managers influences the likelihood of achieving its investment objectives. Managers need to be blended in a well thought-out and structured process. While the idea is to diversify away manager risk, it should not be done to a point where the assets are so fragmented across managers with the risk of performance cancelling each other across different managers. For each fund, there is an ideal number of asset managers to invest in per asset class. There has to be a clear policy on the manager selection criteria. The IPS needs to set out the criteria for manager selection beyond just satisfying the legal requirements of how it researches, identifies, selects, and appoints investment managers.

Implementation Efficiency

Any policy is only as good as the extent to which it is implementable and the

degree to which it is actually implemented. To assess this, one has to consider deliberations and outcomes of investment committee meetings. These work as a reflection of the level of commitment of the fund towards implementing its IPS. Investment committees need to be meeting regularly – ideally, once every quarter. The committee should include members of the Board that are at least generally conversant with investment management matters.

Monitoring any breaches to regulatory limits and self-imposed constraints are part of checking the full adoption and application of the provisions of an IPS.

While contributions occasionally ultimately find their way to their rightful portfolios, it is normally the case that they overstay in cash and cash-equivalent portfolios for reasons with little to do with the fund's liquidity requirements. This is usually an area that needs a proper monitoring mechanism to ensure that incoming contributions are invested timeously.

Strategy Performance and Evaluation

Monitoring investment performance can be a very involving and time-consuming commitment. The standard is for the investment committee to delegate this to an investment consultant while it retains accountability for reporting purposes to the Board. Where no investment consultant is appointed, the fund should be able to demonstrate that it has the resources and tools to be able to do this in-house. We find very few funds with this in-house capability and yet they are yet to seek the services of a retainer investment consultant.

It is critical that the fund has a well laid out investment performance mechanism that is implemented consistently. Systematically monitoring rolling multi-year performance on a regular basis ensures that the fund keeps a tab on how well its investments are doing. It also ensures that the Board is constantly aware of the continued sufficiency of the investments' performance to meet the fund's objectives.

Policy Review

Investment strategy formulation is not a once-off event, it is a process with incremental fine-tuning iterations. The IPS should provide for how frequently it will be reviewed. The global standard practice is to clearly provide that the IPS will be reviewed annually, and on an ad-hoc basis when circumstances do warrant it.

While there is no single comprehensive list of circumstances that would be considered exhaustive for triggering an immediate review of the IPS, it is standard good practice to highlight some notable examples as points of reference. This, not only does it bring convergence in the minds of the current Board, but it will also help future Board members with a mental framework of the type of issues that would invoke an immediate review of the policy statement.

Conclusion

Arguably the second most important governance document after a fund's own rules, Trustees need to regularly evaluate their IPSs to ensure that they remain relevant and fit for purpose. In a DC fund, it is the IPS that does most of the heavy lifting towards taking members to a comfortable life in retirement. It is that important and ought to be treated with that level of importance.

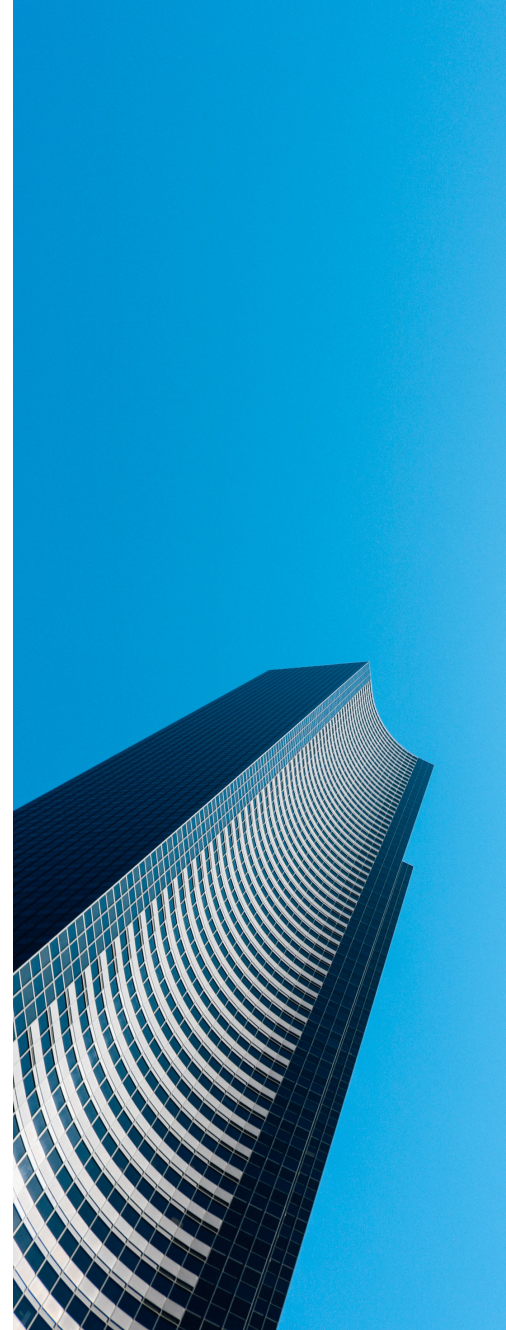
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