

Fiduciary Management: The next generation

The recent crisis once again highlighted the vulnerability of funded pension systems to adverse financial market developments and showed that Trustees need to be flexible to cope with such shocks. The financial crisis is acting as a catalyst with Trustees posing fundamental questions regarding the effectiveness and professionalism of their organizations, investment beliefs and risk cultures.

The outsourcing and in-sourcing of risk management and investment services through some form of fiduciary management, implemented consulting, solvency and overlay management is being considered by many pension funds.

There is a risk that most organizational restructurings with external parties will fail to yield the desired results. However, the most common obstacles in building fiduciary alliances can be avoided.

This article shares a few important lessons learnt from schemes changing their investment and risk management organisations and fiduciary outsourcing.

Old generation fiduciary management is not the holy grail

A few months after the start of the financial crisis, in February 2009, Avida international issued a survey amongst leaders in the pension industry in the Netherlands, with participants from large funds such as the public servants, the health sector and metal workers as well as smaller industry wide and corporate plans. About 440 out of 590 pension funds in the Netherlands are facing problems, under the new regulatory framework. This applies to pension funds with different scales, organisations, knowledge levels, investment strategies, beliefs and so on.

Fluctuations in asset values and discount rates have an increasing impact on balance sheets. Professional risk management with modern instruments, transparency and flexibility are vital elements in running a pension fund. Governance structures and organisations should be designed in such a way that these aspects are facilitated.

In the first wave of fiduciary management the emphasis was put the on portfolio construction, manager selection and risk monitoring on an asset only and operational level. Management information systems were backward looking. Risk monitoring was more important than risk management. Incentive schemes for fiduciary managers did not always result in good alignment and mandates were relatively static. Finally transparency proved to be an issue on some cases.

The recent crisis made it clear that this the first generation of fiduciary management is not the holy grail.

In the search for the optimal organisation, with the appropriate balance between internal resources complemented with well designed external partnerships, we invite Pension Trustees and Directors to take into account a few lessons which can be learnt from managers and Directors who have faced similar challenges.

A few years ago Ambachtsheer already recalled, “the vast majority of pension funds have not consciously set out to build a high-performance culture”. This was illustrated by a survey which was held by ICPM in respectively 1997 and 2005.

Pension Fund Governance (ICPM Survey)

Table 3: Pension Fund Governance and Management: Specific Challenges

1. Agency / context issues
a. Balancing stakeholder interests
b. Understanding the legal / regulatory environment
2. Oversight effectiveness issues
a. Appropriate skill / knowledge set for the Board
b. Clear delegation to management
3. Investment beliefs / risk management issues
a. Understanding context-based risk and its management
b. Informed investment beliefs and their relevance
c. Shift to risk budget-based investment process
4. Strategic planning / management effectiveness issues
a. Resource planning, organization design, and compensation
b. Clear delegation from the Board
c. Effective information-technology (IT) systems

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Having a sound organisational strategy translates itself into superior performances and an enhanced risk profile for the pension funds and its participants.

Lessons learnt: towards the next generation of fiduciary management

With respect to the coordination of investment and risk management processes, the survey of Avida international showed a general consensus on the following issues:

- The board of trustees must always stay in control; when things get serious (low solvency ratio's, large disruptions in the market), the board must be able to follow its own course and cannot solely depend on one or two advisors or external managers;
- The best performing pension funds have clearly defined risk at the solvency level and have designed their internal and external organisations in such a way that the focus is at the solvency level;
- External parties such as a fiduciary managers, delegated chief investment officers or implemented consultants do not take responsibility in these times of crisis, but rather act as advisers;
- The external providers must adapt to the fund's desires and culture, and not vice versa;
- Different outsourcing and in-sourcing models are possible. Careful consideration should be given to the countervailing balance in the organisation and the way the mandate for the external provider is structured.
- Achieving a clear alignment of interest is vital, particularly if an important part of the investment strategy and risk management is outsourced. A delegated chief investment officer, fiduciary manager or implemented consultant needs to work in the interest of the participants of the pension fund, with no conflicts of interest or different agendas.

Building effective alliances and fiduciary outsourcing is an art in itself

Decision-making processes in building strategic alliances with fiduciary managers tend to have a momentum of their own. Growing participant commitment, euphoria and overconfidence of decision-makers often lead to incomplete analyses of potential candidates or overestimation of the potential benefits.

Some pensions funds start various forms of external partnering, without overseeing all consequences. Most participants have a professional background in the industry, such as portfolio managers, investment consultants, and actuaries, but don't have the experience to manage a strategic organisational change process, such as fiduciary outsourcing.

A few years ago a McKinsey study showed that 67% of alliances in normal businesses have serious problems in first two years, due to cultural conflicts: changes in the environment; bad organisational and cultural fit between partners; bad strategic fit; lack of trust; lack of alignment and bad management of interfaces; lack of stakeholder support; and lack of consistency with the 'larger whole'. This is particularly relevant in case of fiduciary alliances with foreign players and alliances between small pension funds and big conglomerates. Smaller funds risk losing control over their own destiny if they don't keep a critical nucleus of internal local competencies.

Research shows that decision makers and their consultants tend to give disproportionate attention to 'hard' measurable issues like strategic and financial data. In the pension arena still, traditional ways for selecting external managers are applied to designed strategic partnerships. Organisational and cultural issues tend to be postponed until the implementation phase in the belief that these can be solved after the contractual phase.

Pennsylvania's Wharton University's research on effectiveness of alliances shows that success can be explained by 'Relational capital' in mutual respect, trust and knowledge of each other's businesses.

To summarise, three elements are key to any successful deal making and outsourcing process: the strategic fit, the organizational fit and cultural fit.

Role of independent specialist adviser

More and more external parties are offering a wide range of investment and risk management solutions. The Pension Trustees have to find their way in this labyrinth and decide on the most appropriate organisation design and possible alliances with external parties given their specific preferences and points of departure.

This requires the assistance of an external adviser who is completely independent.

Advisers should offer a well-balanced structured approach which pays equal attention to professional investment and risk management related aspects on the one hand and human and relational aspects on the other hand. An integrated approach is needed, covering all relevant processes from the strategic level to the work floor. One cannot change one aspect of an organisation without overseeing the entire chain and understanding the consequences for other areas in the organisation.

A MIT Sloan survey has shown that the success rate of an alliance with an external party increases after two years from 40% to 75% if a specialist role is used of an independent specialist who brings actual experience in similar situations.

Fiduciary management can be a very good alternative if we take the lessons from the recent crisis on board and open the door for the next generation.