Marathon Club

Investing for the long term

Long-Term, Long-Only Investing

A Consultation Paper



The Marathon Club

The Marathon Club is a direct follow-up project to the competition run by USS Ltd and Hewitt (with support from FTfm) entitled 'Managing pension funds as if the long-term really did matter'. The Club is comprised of approximately 18 members ranging from institutional fund trustees, senior executives or senior specialists who have a proven track-record in playing a relevant leadership role in public and private institutional funds and endowments.

The overall goal of the Club is to stimulate pension funds, endowments and other institutional investors ("Institutional Funds") and their agents to be more long- term in their thinking and actions, and place more emphasis on being responsible and active owners with a view to increasing knowledge about how their investment strategy and process can improve the long term financial and qualitative buying power of fund beneficiaries.

The Club has four core objectives:

- 1. Publish and disseminate a series of practical "how to" (and "why to") briefings which explain how trustees and consultants can foster a more long term and responsible approach.
- 2. Develop and promote templates or blueprints for mandates that encourage long-term, responsible and active investment approaches.
- 3. Encourage Institutional Funds to award new mandates or adapt existing mandates and reporting processes accordingly.
- 4. Supplement other approaches to continuous professional development of trustees, investment consultants and critical other players so they are better able to contribute to the goal.

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Introductory note from Sir Graeme Davies

"Compared with their predecessors, modern investors concentrate too much on annual, quarterly, or even monthly valuation of what they hold, and on capital appreciation and depreciation generally; and too little either on immediate yield or on future prospects and intrinsic worth."

As many of you will know, these are not my words, but rather those of J.M. Keynes in 1938. What he would make of churn rates of over 100% in equity portfolios today, I can only guess. But this report, and the Marathon Club itself, does not seek to replicate the discussions going on in academia and think-tanks about market short-termism¹. Rather, we are a group of practitioners – senior executives and trustees, who have the fiduciary duty that goes with being an asset owner – who want to do something constructive and practical about the short-termism we see in the market today by going back to the fundamentals of investment.

Amongst corporates, for example, the performance of companies, and thus their underlying listed securities, is significantly influenced by the actions and statements of directors, who are ever mindful of a need to satisfy the earnings expectations of watching analysts. Indeed their own remuneration is often closely tied to these numbers. On the investment side, active fund managers, when selecting potential investments for their portfolios, are also keenly aware that their clients – not least the pension funds of the companies that are being so evaluated in this short-term manner – are assessing their performance on a quarterly basis. This obsession with short-term performance measurement is, therefore, deep rooted in the investment system and is reflected in a fixation with a narrow set of earnings-based performance statistics.

It is the strongly held belief of the Marathon Club that this short-term focus by all parties leads to investment choices being made which fail to maximise the longer-term financial performance of client portfolios, investee companies and the wider economy. Investors are forming their decisions on outcomes that cannot be reliably forecast. Managers are allocating capital to value-destroying projects which, nevertheless, deliver on short-term targets such as analysts' earnings per share estimates. Businesses are being valued on the basis of accounting metrics that do not capture the effect of extra-financial factors on long-term operating performance. In receipt of the wrong signals from investors, investment managers are in danger of inefficiently allocating capital.

Many institutional investors are, by our very nature, long-term investors. So we cannot escape asking ourselves if the present focus on quarterly performance, and the behaviours this promotes, is in line with the best interests of our customers and end beneficiaries. Of course, there is the financial bottom line to consider but, as the Marathon Club recognised when we started, in addition to being more long term in our thinking and actions, we need to place more emphasis on being responsible and active owners. Improving the long-term financial and qualitative buying power of fund beneficiaries should be our primary goal. It is not enough to secure an individual's pension and then fail to consider our collective impact on the factors affecting the quality of that pensioner's retirement.

This paper seeks to meet a widely expressed need for greater clarity about what distinguishes long-term investing and, in particular, what a 'good' long-term, long-only mandate would look like. It poses several questions, a summary of which can be found in Appendix 1, on which it would be very helpful to get your responses. The Club exists to facilitate greater collaboration amongst funds for the sake of the end beneficiaries and we hope you will help us in this goal.

Graeme Davis Chairman Marathon Club

¹ See, for example, Matteo Tonello, *Revisiting Stock Market Short-Termism*, The Conference Board Research Report R-1388-05-RR, 2006.

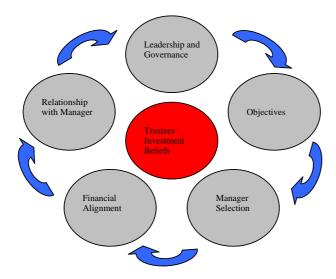
Executive summary

Long-term, long-only (LTLO) investment is a fundamental, research-oriented investment approach that incorporates the variables that explain business success and has a focused discipline of optimising positive absolute returns over the long-term business cycle.

Introduction

Our core belief is that active long-term investing is beneficial to achieving added value to the investment decision-making process, and that guidance on the main options of LTLO will help develop this approach. We have produced this guide to LTLO investment mandates in response to a need within parts of the investment industry for clarification of what constitutes an LTLO approach and what, in turn, the components of an LTLO mandate might include. Its aims are twofold:

- in Section 1 we seek to raise awareness of the wider industry issues and thinking behind the adoption of LTLO investment approaches. In particular, we have sought to define what is meant by LTLO and to identify the critical factors that those with investment responsibilities, i.e. pension fund trustees and other fiduciaries with similar responsibilities for trusts and foundations, should consider if they are to develop and implement a long-term mandate. We also raise a number of issues where we believe further debate on, and evolution of, the ideas may be required; and
- Section 2 contains guidance on what the components of an LTLO mandate might include. Investment beliefs are central to an LTLO mandate, and trustees should not underestimate the importance of articulating them. This is shown in the diagram below:



An industry-wide distillation of ideas

In preparing this document we carried out an initial consultation exercise, during which we drew upon the wide-ranging experience and know-how of leaders in the investment industry, including investment managers, investment consultants, pension managers and academics. Further research evidence was provided by two surveys that we commissioned – one amongst trustees of pension funds and the other amongst fund managers.

The ideas and methodologies put forward in this report are, therefore, the distillation of the first phase of this consultation and reflect the current thoughts and experiences of a distinguished group of industry experts. But, LTLO investment is in its infancy in the UK and this report marks the start of a second phase of consultation.

Readers please note: the collective term 'trustees' is used throughout this report to refer to all fiduciaries with investment responsibilities, be they for pension funds, trusts or foundations. An LTLO investment approach is just as applicable for a charitable trust or other foundation, as it is for a pension fund.

Consulting further with industry

Throughout the report, you will find questions posed on the ideas we put forward, to which we urge you to respond.

Our aim with this further consultation exercise is to take the debate to every part of the investment industry – namely to trustees, pensions managers, investment advisers, investment managers and securities analysts. Based on the responses we receive we will endeavour to refine and develop the guidance provided here so that, as far as possible, it reflects the collective views of thought-leaders throughout the industry and can serve as an effective blueprint for the wider development and implementation of LTLO mandates. Based on this consultation, a Guide to LTLO Investment Mandates will be issued in September 2006.

It is our hope that the Guide will encourage Trustees to seek to invest with a long-term approach and facilitate the development of LTLO mandates by advisers and investment managers.

At each stage, as we mentioned, we raise questions for you to consider. Your input is important to us and we thank you in advance for your feedback by Friday 2nd June, 2006. Those providing feedback will receive a compilation of all un-attributed feedback. See Appendix 1 on page 26 for details on where to send your comments

Section 1 LTLO – the broader perspective

Background

Paul Myners, when initiating his review of institutional investment in the UK in May 2000, posed the following question, both for himself and for others intending to respond to his consultation:

"We have a large pool of long-term capital, but do we invest it with a sufficiently long-term view?"

Myners said:

"The use of relative return objectives over short time periods as the major component of decision-making about manager appointments is detrimental to the long-term health of pension funds ...

Nevertheless, there are three clear facts:

- a large number of fund managers believe that their pension fund clients are very concerned by short-term performance;
- a number of pension funds and their advisers insist that they are not; and
- pension funds will inevitably look at quarterly performance figures."

Although Myners' comments were targeted at pension fund trustees and their managers and advisers, the issues he raises are just as applicable to other fiduciaries of charitable and other foundations.

Why does long termism matter?

Myners and Keynes, and several others in the years in-between, have warned of the dangers of stock market short-termism. This is not surprising. Certain features of the market, such as the need for the efficient allocation of capital, are timeless. As noted by the Conference Board Research Report, allocative efficiency is critical to the medium to longer term health of the economy:

"Where accompanied by a set of rules that assures equal treatment to all market participants, steady and sustainable growth becomes the key to prosperity for a society. Market short-termism, on the contrary, undermines confidence in the soundness of the underlying economy, favours opacity on strategic goals, and encourages opportunistic behaviours by a few to the detriment of the many".

Whilst asset owners may not be able, or may not even consider it appropriate, to disregard short-horizon investment strategies completely, there is growing consensus that it is in the interests of the beneficial owners of the assets that greater emphasis be placed on long-term investment strategies than has recently been the case.

This is partly because of the significant falls that occurred in global equity markets between 2000 and 2003. Since then, many funds and their advisers have turned away from their previous reliance on simply trying to match, or outperform, the total returns on market indices over rolling short-term periods of no more than three years. Such misplaced reliance serves only to incentivise investment managers to concentrate on asset index relative returns, rather than positive, absolute returns or, better still, targeted returns relative to liability costs, or the costs of other planned obligations and expenditure. A critical factor here is that the precursor to equity markets' poor performance between 2000 and 2003 was the widespread misallocation of capital during the prior bull market. This misallocation is closely related to mandates which focused on asset index relative returns.

How should we define LTLO investing?

The Marathon Club has produced this consultation to LTLO Investing in response to a need within parts of the investment industry for clarification of what constitutes an LTLO approach and what, in turn, the components of an LTLO mandate might include.

Benjamin Graham's legacy includes the following definition:

"An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."

In contrasting 'investment' from 'speculation', Benjamin Graham echoed J.M.Keynes (who preferred to use the term 'enterprise' rather than 'investment') when saying:

"I appropriate the term 'speculation' for the activity of forecasting the psychology of the market, and the term 'enterprise' for the activity of forecasting the prospective yield of assets over their whole life."

The controversial pensions accounting standard, FRS 17, also reminds us that the expected rate of return on assets is:

"the average rate of return, including both income and changes in fair value, but net of scheme expenses, expected over the remaining life of the related obligation on the actual assets held by the scheme."

This accounting definition clearly reminds trustees to focus on the fact that funds to pay pensions are ultimately generated by a combination of income received and realised fair values.

These definition strands go beyond simply viewing LTLO as a form of absolute return investing because, in order to meet Graham's test of an adequate return, the targeted returns have also to match or outperform liabilities or other costs, over the remaining life of the funds.

LTLO – The Marathon Club's definition

Our first phase of consultation sought elaboration on the themes outlined above so that we could come to a more precise definition of LTLO investing. The definition that the Marathon Club has arrived at is:

Long-term, long-only (LTLO) investment is a fundamental, research-oriented investment approach that incorporates the variables that explain business success and that has a focused discipline of optimising positive absolute returns over the long-term business cycle.

In the remainder of Section 1, we set out:

- the key features of an LTLO mandate, and
- some of the pitfalls associated with LTLO mandates.

Key features of an LTLO mandate

The following sets out some of the key features which the Marathon Club's background research indicated are typically associated with an LTLO mandate. More detailed explanation in support is provided in Section 2.

Aims

These may include:

- achieving positive absolute returns over the long-term, the length of time to be defined in terms of business and market cycles, or in relation to the duration of liabilities;
- a strong capital preservation bias;
- optimising returns, including income. The focus here is an equal emphasis on returns and strong risk management;
- minimising transaction costs and deferring the realisation of capital gains until competing investment opportunities are identified;
- designing specific performance targets aligned to the fund's overall objectives, rather than using external benchmarks based on market indices;
- manager remuneration based on alignment of financial interests; and
- engagement that enhances the allocation of capital.

Investment strategies

Investment strategies may be designed around:

- a bottom-up research approach that emphasises the fundamentals of a business (for example, the quality of management or credit; the strength of the business or covenant and its valuation attractiveness) and fully incorporates extra-financial factors which can influence corporate performance in a material way²;
- pursuit of a rigorous 'buy discipline' for acquiring assets at market prices significantly below the investment manager's assessment of their economic value;
- pursuit of a strict 'sell discipline' when assets no longer meet the investment manager's valuation or other appropriate criteria;
- concentrated portfolios which differ radically from the index and sector weightings of the broader markets;
- low portfolio turnover (10-30% per year, rather than 50-200% which typifies more conventional managers);
- internal targets of Retail Price Index (RPI)/Consumer Price Index (CPI) plus 5% or more per year;
- promoting long-term ownership to encourage effective engagement with, and dialogue between, investment managers and the senior management of businesses invested in to encourage the development of shared long-term strategies and more efficient use of capital invested within the businesses; and
- investing money as appropriate opportunities arise, rather than vesting immediately into an existing portfolio on terms which may not represent attractive valuations.

² Extra-financial factors are those fundamentals that have the potential to impact companies' financial performance or reputation in a material way and which are not generally captured in investment decisions. These factors tend to be of a medium- to long-term nature, the timing of their impact is often difficult to predict, and they are frequently difficult to quantify, at least at the start of efforts to do so. For further details see: *Enhanced Analytics for Enhanced Performance: The Business Case for Extra-Financial Factors in Investing*, Universities Superannuation Scheme (March 2006).

Characteristics of the investment manager

Characteristics of the type of investment manager who may be suited to implement an LTLO mandate might include:

- a strong commitment to continuous improvements in research processes and investment models;
- the people managing the process must have the intellectual courage and conviction to think differently from the market when it pays to do so;
- a requirement for managers to control capacity and to close to new entrants when such a closure benefits existing investors;
- clear rules to discourage potential clients who believe in market timing and speculation, for example by imposing early redemption penalties;
- a lengthy track record that stretches back over several business and market cycles, which shows how their approach works in a number of different cyclical periods;
- a business with long term stability. This may come from its ownership by the current generation of managers, or at least by their having a very significant minority holding; and
- as sharp a focus on process as on outcomes, with a clear idea of what good portfolio management looks like, irrespective of interim performance.

Share your views:

- 1. What is your view on our summary definition? What changes, if any, would you suggest?
- 2. What are your views on our list of aims, investment strategies and characteristics? What additions or deletions, if any, would you suggest?
- 3. Institutional Investors have been referred to as 'Universal Owners'. The concept is that because of their size they own a slice of the entire economy and thus have a vested interest in factors which affect its long-term growth and society as a whole. Do you believe that the concept of universal ownership is relevant to LTLO?

LTLO mandates – what are the pitfalls?

For over two decades the traditional basis of investing has been through index-relative mandates, either passive or active. LTLO will seem a radical step for many, given such length of experience in doing things differently. Consultants and trustees are inherently prudent, cautious and many seem reluctant to change. There is a lack of awareness of LTLO, and a lack of understanding of the implications of changing a manager that has underperformed. Even though LTLO appears to be a better fit with liabilities, because of its long-term nature and focus on absolute return, the adoption of LTLO mandates has been slow.

Trustees and investment managers may suffer the same fixation: too much attention to short-term financial performance and not enough to process, particularly the incorporation of forward-looking and extra-financial factors. The industry is also challenged to differentiate one rigorous and disciplined process from another. Trustees who want to award LTLO mandates need to equip themselves and their agents with the skills that will enable them to determine whether investment managers are systematically integrating data into their decisions when they are being made as opposed to after the event.

Criticism has been directed at LTLO as follows:

- Market efficiency: The underlying premise of LTLO equity investing is that long-term pricing inefficiencies exist in equity markets which can be exploited by skilled managers who are not benchmark driven. There is the possibility of two, quite distinct, aspects to this. Fundamental inefficiency may exist because extra-financial factors are missed out in many decisions. Informational efficiency results in the market being difficult to beat.
 - Proponents of efficient markets will challenge this premise and cite the considerable evidence that the vast majority of active managers do not outperform market indices over longer-term time periods. This argument suggests a poor understanding of the investment approach of many of the skilled managers. These managers are internally benchmark driven in the sense that they seek to protect capital, while at the same time trying to outperform alternative investments available to their clients in cash or government securities.
- Concentrated portfolios: There is a tendency among LTLO managers to operate with highly concentrated portfolios that limit risk diversification.
 - While it is true that some LTLO portfolios may be more concentrated, passive diversification that mimics and index also dilutes the potential to add value.
- **Limited capacity:** There are a limited number of experienced managers available, especially outside the US, with some closed to new investment already, whilst others close for business for lengthy periods.
- **High fees:** Compared to index-relative passive and active mandates, fees for LTLO mandates tend to be high. However, trustees should look at manager returns net of fees.
- **Restriction on selling short:** The restriction to long-only investment prevents skilled money managers from exploiting opportunities to profit from the over-valuation of securities. Being able to sell short could also lower portfolio volatility.

LTLO managers may argue that investing with more concentrated portfolios of well-researched securities tends to result in lower volatility than from index-relative portfolios, and in lower portfolio turnover than from long and short portfolios. The Marathon Club notes that not all skilled long-only equity managers are comfortable with short selling as risk in shorting is greater.

Share your views:

- 4. What are your views on our analysis of the reasons why some trustees have not used LTLO to date?
- 5. Have we identified the relevant pitfalls of LTLO investing? What other pitfalls can you suggest?

Section 2 A guide to the key components of an LTLO mandate

Investing LTLO - an overview

One of the key performance risk issues for funds, as any trustee would agree, is that sub-optimal investment managers and mandates may be selected or retained.

However, an investment mandate is only a part of an overall investment strategy. An investment strategy should address both short-term and long-term requirements.

By short-term we mean periods of between three months (the typical frequency for monitoring fund investments) and three years (the typical frequency for performing full actuarial valuations of pension scheme liabilities or the typical length of rolling business plans). By long-term, which is the subject of this report, we mean for periods of longer than three years, typically between five and ten years, or the length of the business and market cycles.

In setting a long-term strategy, trustees will need to consider the following:

Funding strategy

Establishing and updating their fund's funding strategy to identify the estimated cash flows and, thus, the investment returns required to pay obligations as they fall due. Asset/liability modeling is amongst the tools available to inform trustees at this stage.

For pension fund trustees there is a new statutory funding framework to consider. In brief, this requires trustees to prepare and maintain a statement of funding principles, setting out their policy for meeting the statutory funding objective. Where the statutory funding framework is not met, trustees are required to put in place a recovery plan, which has been agreed with the sponsoring employer. More details on this are provided in Appendix 2.

• Investment return objectives

There are typically one or two main investment return objectives to be determined.

The primary return objective is the overall return which the fund is trying to earn on its total assets, taking risk into account. This objective should be directly related to the underlying liabilities or expenditure commitments. The return objective for pension funds, for example, should be one defined relative to the liabilities, such as 'to outperform the liabilities by 2% per annum'.

The secondary return objectives are asset class specific. These will consider the level of return required by an investor for investing in particular asset classes (sometimes referred to as 'the cost of capital' or 'opportunity cost'). In this instance, the greatest challenge arises in defining an appropriate benchmark that can be aligned with the achievement of the primary objective. Extra-financial factors should also be incorporated into the process, where appropriate.

Asset allocation

Trustees will need to consider the broad asset classes that can deliver returns to match or outperform target assumptions, but also with appropriate diversification.

• Portfolio structure

It will be important to consider how the asset classes might be grouped and the type of mandates that are required. David Swensen, CIO of Yale University, sums up the importance of portfolio structure as follows:

"The degree of risk assumed in pursuit of investment returns constitutes the core issue in investment management. ... The fundamental objective of portfolio management lies in faithful implementation of long-term policy targets. If trustees allow actual portfolio holdings to differ materially from asset class targets, the resulting portfolio fails to reflect risk and return preferences expressed through the asset allocation process."

Other important structural factors to consider are manager style diversification, including passive and active management approaches.

Benchmarks

The setting of benchmarks for the portfolio holdings is an integral part of the process, but it is at this point that multiple benchmarks might be introduced to reflect particular risk requirements and diversification.

Mandates

Mandates are the final outcome of this review process.

• LTLO as part of the investment strategy

When considering LTLO investment as part of this review process, trustees should again follow a step-by-step approach:

- decide whether or not they believe a proportion of the fund's assets should be allocated to LTLO, or indeed whether LTLO could be a whole fund approach;
- examine and assess carefully the advantages and disadvantages of LTLO in the light of the funding needs and present circumstances of the fund;
- evaluate the potential benefits, after all costs, of an investment in LTLO;
- decide what proportion of the fund's assets is to be invested in LTLO;
- ensure that any LTLO mandates are appropriate, given the fund's liability profile and after considering carefully the degree of risk the fund can afford to take;
- ensure diversity of the LTLO mandates;
- appoint suitable investment managers with experience and a proven track record in LTLO investing; and
- consider fiduciary responsibility with respect to extra-financial factors.

Summary

LTLO should be considered as part of any strategic review of investment and funding principles. However, whether or not this happens in practice will hinge on how strongly trustees believe in the relative merits of LTLO versus existing investment mandates.

Share your views

6. Does this overview provide a comprehensive description of the strategic review process? Is the inclusion of LTLO in the process adequately described?

The key components

The research findings of our phase 1 consultation exercise have enabled us to provide guidance on each of the key components involved in determining an LTLO strategy, as follows:

- determine investment beliefs;
- objectives for LTLO mandates;
- manager selection;
- alignment of financial interests;
- monitoring and relationship management; and
- leadership, governance and the role of internal executives and consultants.

We consider each of the above in turn.

Share your views

7. Are there any key components we have missed?

Determine investment beliefs

The formulation and articulation of beliefs is a fundamental building block in the formulation of a coherent investment policy. Putting these beliefs in writing should establish a reference point and guidance to withstand the uncertainties and challenges to confidence created by market movements. A focus by trustees on determining core issues and beliefs can be critical to establishing or reaffirming their overall approach to investment, ahead of strategic asset allocation, selection of individual managers, mandate structure, with or without LTLO, and monitoring and maintaining good relationships with managers.

There are a number of core issues which trustees should consider when formulating their investment beliefs:

Core issues

- sources of investment return;
- importance of liquidity;
- attitudes towards investment management;
- monitoring managers and alignment of financial interests;
- · reputational and social issues; and
- future economic performance.

A detailed checklist of questions to help trustees define their beliefs in relation to these core issues is given below:

Sources of investment return

Do trustees believe that:

- The main source of return is participation in economic growth?
- It is possible to derive additional return from skill in forecasting and trading versus other market participants?
- Fundamental, research-oriented buy-and-hold investing is superior to other styles over the longer-term?
- Return is derived as compensation for market volatility?
- Equities outperform bonds over the long-term such that trustees should buy and hold them?
- Markets are inefficient? If so, to what extent? Are some markets more efficient than others?
- Superior returns come from managers using superior judgement and research to value investments?
- Changes in quarterly earnings per share are a proxy for changes in shareholder value?
- Engagement has an impact on investment returns?
- Extra-financial factors are important in corporate and stock market performance?

Importance of Liquidity

To what extent can trustees afford illiquidity in their portfolio?

Do trustees need to invest in assets that have a market price readily available?

Do trustees believe that:

- Liquidity is nothing to do with real risk, and this is especially so for pension funds who have little need of it in the short and medium-term?
- There is a high price to be paid by investors for liquidity?
- There are greater opportunities in illiquid investments?
- Volatility and risk of illiquidity are huge sources of return?

Attitudes towards investment management

Do trustees believe it is possible:

- For a manager to add value ('alpha')?
- For any manager to persistently outperform over time?
- That they or their advisers can identify managers who can persistently demonstrate added value in advance?
- For any manager to add value through timely selection of asset classes ("asset allocation")?

Monitoring managers and alignment of financial interests

Do trustees need to monitor short-term performance for quarterly decision-making?

Do trustees believe:

• The use of rolling returns over a three or five-year period gives a false sense of steady growth?

- Investment returns come in waves rather than a straight line?
- A return pattern made up of small, steady returns with a small prospect of large loss is preferable to a return pattern made up of small losses with a small prospect of a large payoff?
- Market prices always reflect fair values?
- Manager performance should be judged solely, or largely, on basis of enhancement of market value of assets?
- They should use multiple indicators to judge investment manager performance? Which indicators do trustees want to use?
- Managers need to be incentivised with performance fees?
- Part of compensation should be deferred?

Which factors should lead trustees to end a contract with a manager? How much of the trustees' decision should be based on performance measures.

Reputational and social issues

Are there any extra-financial issues that trustees think can have a material impact on long-term value which the market is not pricing accurately and which may therefore be of particular significance to long-term investors, in financial and/or reputational terms?

Do trustees believe that investment managers should be sending signals to management to better enhance the allocation of capital and to promote stronger understanding of the role extra-financial factors play in shareholder wealth creation or destruction?

Future economic performance

What views do trustees hold of investment opportunities and the long-term returns of different asset classes?

Which markets or industries represent attractive investment opportunities or risks over the investment horizon?

Share your views

- 8. Do you agree there is a value in articulating collective trustee beliefs as a backdrop to the investment approach?
- 9. Can you suggest any improvements to the checklist of questions on investment beliefs?

Objectives for LTLO mandates

Warren Buffett said:

"The first rule of investment is don't lose money, the second rule is don't forget the first rule, and those are all the rules there are."

Objectives for an investment mandate help to give direction to the manager on what the trustees wish to achieve, and serve as a tool for measuring progress. Trustees have been disillusioned by managers advising them that they had met their objectives by exceeding the return on an index benchmark, whereas capital was lost as the markets fell. The Marathon Club believes that trustees need to re-examine the objectives set for their managers to prevent this. They need to pay attention to what they are asking the manager to do, and over what time period they expect to achieve the results.

The Marathon Club believes that the efficient allocation and preservation of capital should be central objectives of an LTLO mandate. It is not enough simply to preserve capital; it should also maintain its purchasing power over the long term. Once these primary objectives have been set, the capital must then seek appropriate compensation for investing in that particular asset class, as opposed to other investments. It is the term of the trustees' requirement to pay their obligations that will dictate the time period over which the return objectives need to be met. Any interim period is really only relevant for measurement of progress or performance.

Thus, trustees must consider how the following five elements will be addressed when structuring LTLO mandates and setting the objectives:

- efficient allocation and preservation of capital;
- maintenance of purchasing power;
- additional return to compensate for assuming higher risk;
- the frequency with which they will monitor progress towards their objectives; and
- what the other success factors will be, besides portfolio performance.

Possible objectives for LTLO mandates

Following the considerations above, the Marathon Club believes that LTLO mandates should seek absolute return objectives such as:

- to deliver an absolute return of RPI/CPI plus X percent over a business cycle (or a minimum period of five years);
- to deliver an annual return of gilts plus X percent over a business cycle (or a minimum period of five years); or
- to deliver an absolute return of X percent over a business cycle (or a minimum period of five years).

Whilst the above may be the most appropriate objectives for trustees, there remains the issue that some relationship to a market index may still be required for the measurement of performance and compensation. Furthermore, not many managers at this time may offer products with absolute return targets. For this purpose, the Marathon Club suggests that trustees translate the absolute return objectives to a target above the market index that is nearly equivalent. Over time, as LTLO mandates become more prevalent, the Marathon Club hopes that managers will shift to being compensated against the absolute return objectives.

Timeframe

The Marathon Club is somewhat sceptical that simply lengthening the timeframe of the contract will necessarily overcome short-termism. Managers are encouraged to be short-term orientated if the trustees monitor managers frequently, such as every quarter, and the emphasis is on short-term performance measures. The Marathon Club suggests that trustees lean more towards longer intervals, such as an annual basis, for a comprehensive manager review. Most importantly, the Marathon Club advises trustees to focus on indicators which demonstrate that the manager's process is being adhered to. The focus must be on long-term performance, irrespective of the frequency of the meetings.

Share your views

- 10. Do you agree with the five elements for setting LTLO investment return objectives?
- 11. Do you agree that increasing the term of the investment mandate will, by itself, do little to overcome short termism?
- 12. Are there other ways you can suggest to set investment objectives to promote long-term investment?
- 13. How can the paradox of reconciling an absolute return objective with performance relative to a market index (for fee calculation purposes) be addressed?

Manager selection

Introduction

The most important decision trustees need to make with regard to an LTLO mandate is to select the right manager. Choosing the right partner is critical to the success of a long-term relationship. Those with experience of advising on, or investing with, LTLO mandates stress that trustees need to devote significant time and resources to both the manager selection and the monitoring processes.

As we mentioned in Section 1, LTLO managers have not been brought to the attention of trustees so either this has to change, which it may do slowly, or trustees need to be more proactive and seek LTLO managers out. By the same token, some of the potential LTLO managers do not deliberately seek pensions business, so trustees and their advisers need to initiate their interest. As more trustees seek LTLO mandates, the choice of good managers offering them should expand but, for this to happen, trustees and consultants need to educate themselves on the expanded definition of LTLO.

Pre-tender

The Marathon Club believes that under conventional mandates, the managers and trustees often do not spend enough time together prior to appointment. The 'beauty parade' format has, in many cases, been too short and superficial, and trustees only really get to know managers, if at all, much later. A much higher mutual understanding of the beliefs of each party must be reached at the very outset to see if there is a fit.

The Marathon Club recommends that before embarking on a tender process, trustees and advisers start by inviting one or more leading LTLO managers to make a presentation to the fiduciary board or its investment sub-committee. Such a briefing, without commitments on either side, may go a long way to explaining to trustees whether such fundamental investment is for them or not. If there is sufficient agreement on the investment philosophy demonstrated in such a briefing, the trustees and advisers can then move on to the stage of seeking tenders.

Drawing up a shortlist

Once a target list of providers has been identified, trustees should endeavour through research to develop a clear understanding of each manager's:

- organisation and ownership structure, goals, financial position and management; and
- business model, clients and long-term targets and, most importantly, the investment philosophy and process.

The research process should identify the source of returns and question whether these are sustainable. Each manager should have a clear process for adding value. The managers should also be able to demonstrate that they can deliver, and that there is an alignment of beliefs and behaviours consistent with the trustees' beliefs.

While smaller funds are unlikely to have the advice or other skills necessary to contemplate the introduction of LTLO mandates, those few that do may be happy to select one to three managers from a relatively short list of those available (i.e. not closed to new investment).

What information should be provided in the tender?

Some of the characteristics of LTLO managers which should be highlighted in a tendering process include the following:

- in some, but not necessarily all cases, a lengthy track record stretching back over several business and market cycles;
- long-term stability of the investment management business. This may come from its ownership by the current generation of managers, or at least by their having a very significant minority holding;
- manager remuneration based on alignment of financial interests, e.g. co-investment in the same strategy or fund;

- investment processes with a focus on capital maintenance and a distinctive investment philosophy, typically based on fundamentals, for researching investment opportunities;
- evidence of being able to hold a contrary view to the market;
- concentrated portfolios which differ radically from the index and sector weightings of the broader markets;
- low portfolio turnover (10-30% per annum, rather than 50-200% seen among conventional managers);
- internal absolute return targets. NB: trustees need to ask themselves and their advisers whether LTLO managers who are prepared to accept targets such as RPI plus 5% per annum or more, or whose internal benchmark is cash plus or gilts plus, are adequate in relation to their investment policy;
- investing money only as opportunities arise, rather than vesting immediately into an existing portfolio (sometimes on a commitment/drawdown basis like private equity, or being prepared to hold cash or bonds until sufficient real asset opportunities present themselves); and
- managers who control fund capacity and close funds to new inflows whenever necessary.

Trustees should still ensure that LTLO managers they select in the UK are FSA registered. If investing with overseas managers, where regulation may be more relaxed, trustees should ensure the managers are registered with the US Securities and Exchange Commission (SEC) or regulator of an equivalent standard.

Duration of contract

It is important that the trustees and the manager should take time to agree at the outset what events would be used to review the contract. This is likely to include concerns about key people, ownership or process changes, regardless of what the results are. In other words, if the initial conditions that were considered essential for entering into a long-term relationship change, then the continuity of the contract is reviewed. This could even include turnover in the trustee or foundation board leading to a change of beliefs. Documenting the reasons, expectations and monitoring processes will serve to remind both parties of the objectives.

Although the duration of the contract is not necessarily synonymous with long-term investment, the Marathon Club recognises that there may be extended periods of poor performance and, therefore, trustees will need to consider this as they approach long-term mandates.

J.M. Keynes said:

"An investor is aiming, or should be aiming primarily at long period results, and should be solely judged by these. The fact of holding shares which have fallen in a general decline of the market proves nothing and should not be a subject of reproach. It should certainly not be an argument for unloading when the market is least able to support such action".

As a minimum, trustees should accept that they may only obtain an objective appraisal of performance if they consider a full business cycle as the term of the appointment. Within this timescale trustees should consider which signals could be used for the early identification of potential problems.

Share your views

- 14. Do you agree that the manager selection process will need to change significantly? What do you think is the biggest obstacle scarcity of appropriate investment managers, competence of investment advisers, willingness of trustees to adequately resource the search for appropriate investment managers or something else?
- 15. Should manager appointments specify a minimum time period? If so, how long should that be?
- 16. How should trustees react to periods of under-performance?

Alignment of financial interests

It is essential that financial interests be aligned as closely as possible, so that trustees' and managers' expectations will be met over the duration of the contract.

Performance fees and co-investment

The private equity and hedge fund markets already use this form of compensation. Investment managers demonstrate real conviction in their investment approach when they invest substantial personal assets along with their investors and moreover, when they link their compensation to their performance.

On the benefits of co-investment, the following excerpt from the third quarter 2005 newsletter of Eagle Capital Management, Inc. is illustrative:

"In ancient Rome, when a bridge was completed, the architects and engineers who had initially designed it stood beneath the structure as the first carriages drove over. If the design was faulty, the bridge would collapse and they would be crushed. THAT is an incentive that aligns behaviour with client interest".

From the perspective of clients, performance-related fees can have the following merits:

- they align the manager's compensation with the client's performance; if the manager does not outperform then the performance-related fee will be less than an ad valorem fee;
- performance fees may also be helpful as they may allow a manager to close to new business;
- they may also be beneficial for governance reasons, in that clients only pay a higher fee when performance is good;
- investors may feel that managers who are willing to accept a performance-related fee are signalling confidence in their ability to add value; and
- flexibility fees can be tailored to suit a client's risk appetite.

Performance related fees can have the following drawbacks:

- they are less predictable than ad valorem fee structures; and
- the fee payable is higher if managers do perform well. Investors who are confident in a manager's ability to outperform might prefer an ad valorem fee or fixed fee, which could prove cheaper over time.

In any arrangement higher fees should be justified in the long-term by improved returns. A fee should be structured so that the performance element can be related to the returns in the same, or adjacent, reporting period.

Some managers may prefer a mix of both performance-related and ad valorem fees. Mixing fee structures can provide an element of risk reduction for both clients and managers. For example, a manager who has some performance-related fees may see some diversification to revenues during down markets, assuming relative performance is good.

Other issues to consider when setting performance fees:

- What should the level of the base fee be set at? Should it relate to the market level for fees for passive management? Should it vary for different types of mandates, e.g. UK equity, global equity, small cap equity, large cap equity, emerging markets equity, UK fixed income, global fixed income, etc.?
- What are the various hurdle rates? Is the hurdle rate an index benchmark, an index benchmark plus a margin, inflation or a positive absolute return? How does the hurdle rate selected impact the performance fee?
- How should trustees and managers agree a suitable time period for measurement of the performance fee? Is there an annual performance fee to be paid from the start of the mandate, i.e. based on length of time with the manager,

or should it be based on a calendar year? Should the performance fee be set for out-performance over rolling periods?

- How should trustees use claw-back and reset provisions to cover past losses before managers are paid?
- Should a portion of the performance fee be deferred? If so, for how long?
- Should fund managers be rewarded for adhering to the process that trustees want them to adhere to? Thus, if trustees have specified required behaviours, should trustees pay for this regardless of performance, especially in the short-term?

A sliding scale redemption charge agreed between managers and trustees

Redemption fees should progressively reduce over the term of the mandate and may be fully withdrawn after some specified period. The aim of this structure is to discourage short-term behaviour by trustees for reasons solely to do with short-term performance. Exclusions to this fee should include trigger events for review of the mandate which are non-performance related.

Share your views

17. What are your views on our proposals in respect of performance fees, co-investment and redemption charges?

18. Do you consider that performance fees do not affect manager performance in the long run and are not, therefore, cost effective? If so, why?

Monitoring and relationship management

Before deciding on the content of the more formal manager review process, trustees should ask themselves what they are trying to achieve through the monitoring process.

The monitoring process should be designed to achieve a successful working relationship over the long term. Its objective should be to determine whether the philosophy and processes, which were agreed when the mandate was awarded, are being followed by the manager. The periodic review is an opportunity for trustees to test the portfolio and review whether the infrastructure behind the process remains stable.

The focus of the periodic review meetings must not be superficial presentations by managers and limited questioning by trustees. Instead, each meeting should involve adequate consideration of the manager's adherence to his/her process and the performance of the assets within the portfolio. The focus must not be on price-based, short-term performance measures. Such measures are inappropriate to assist decision-making over whether to retain or change managers under an LTLO approach. However, it is inevitable that total fund performance reports, including LTLO alongside other mandates, will continue to be compiled quarterly and benchmarked against market returns and/or peer groups. In many cases, LTLO managers will be able to provide the comparative portfolio-specific information, as will custodians and other performance measurers.

Timing of review meetings

Trustees or their agents may, particularly in the early stages of the mandate, want to see the managers more frequently. The regular pattern of meetings is best determined only when a good dialogue and understanding of the investment strategy and approach has built up between the trustees and the manager.

Contents of a review meeting

The Marathon Club recommends that a review meeting covers the following:

- review changes to organisation ownership, particularly continuing co-investment, team structure and general management, client acquisitions and losses, key staff, compensation, investment process and systems. Trustees should encourage the manager's evolution, i.e. subtle shifts to keep pace with evolving markets. Reactive changes to an investment process following a period of underperformance would be grounds for concern;
- review specific cases of engagement with investee companies;
- review adherence to required behaviours; and
- review portfolio performance. There are a number of performance metrics, as listed in Appendix 3, which can be used to monitor the performance of a long-term mandate. These metrics avoid the need for arbitrary short-term comparisons to indices and place more emphasis on taking account of the way in which the manager is managing the money. NB: in general terms we warn of 'analysis paralysis' setting in if too many benchmarks and risk controls are applied to LTLO mandates by trustees, or by internal executives or advisors acting on their behalf.

For quarterly monitoring purposes, and also as general preparation for less frequent review meetings, trustees may wish to develop some form of 'scorecard' to give a snapshot of the characteristics of the portfolio holdings and realised performance.

LTLO performance monitoring – issues to consider

Trustees will generally need to be more tolerant of LTLO managers who may encounter occasional bumps in the road (experiencing periodic performance decrements in anticipation of a major pay off) and, at the same time, be more sceptical of managers who outperform quarter-in quarter-out for a time.

The chances of large incremental returns should diminish following a series of positive results and it is believed there is a statistical association between persistent positive increments and eventual 'blow-ups'.

Trustees should also differentiate between manager inputs and outputs in manager reviews. Outputs are the result of past inputs. For example, a manager may have had excellent performance in 2005, but this would be attributable to actions taken in earlier years. The LTLO monitoring process should focus more on inputs.

What should trustees be looking at?

Trustees should judge the manager by his/her actions and, not by what they say, i.e. the focus should be how closely the behaviours match with those that are required and have been promised. Monitoring the majority of long-term mandates will require greater consideration of individual securities in the portfolio to ensure that the manager is sticking to his/her process. For concentrated portfolios it may be feasible to consider all the securities at each meeting. But for portfolios with a larger number of securities, attention may focus instead on the top and bottom ten performers and on the overall, combined effects.

In considering the sales and purchases and the reasons for them, this follows on from the understanding of manager buy and sell disciplines learned during the pre-appointment research/due diligence stages. Subsequent trading (or a lack of it) can be used to see whether or not the expected process is being maintained. A manager who claims, for example, to buy '50 pence-pounds' should in almost all cases be selling them when they have moved towards a pound of intrinsic or fair value, not holding unrealised gains. A manager who, on the other hand, still holds said stocks at a 20% unrealised loss needs to explain why the idea is worth holding on to, and not just dropped and replaced with better prospects.

Share your views

19. Do you agree with our proposals for manager review meetings? If not, what would you do differently?

Governance, leadership and the role of internal executives and advisors

Given that trustees' actions will vary from fund to fund, depending upon the total resources allowed for trustee governance, there is no clear definition of roles and/or trustees' relationships with their internal executives and advisors. The National Association of Pension Funds has explored this area in more detail in its March 2005 publication, and we would refer readers to this source for additional information.

In general terms, the following should be considered in the context of LTLO:

- where trustees' available time and collective expertise is limited, it is essential to determine what matters should be delegated to in-house resources, if any, and what to external service providers;
- whatever the present resources and budget are, trustees will have to assess whether they have the ability, the time and, importantly, the desire to spend the additional up-front time required for researching LTLO investment opportunities, and then how to meet the less frequent, but more time-intensive monitoring requirements;
- similar sorts of considerations may apply to internal executives. If they have tended to overlook (or be unaware of) LTLO opportunities in the past, it may be difficult for them to change and adapt to new forms of mandate and investment monitoring. However, it may be difficult to justify additional resources, particularly as the LTLO manager's own fees will tend to be higher than previous conventional mandates;
- investment advisors have also typically overlooked LTLO in the past, so they too may have a learning curve to overcome. However, a far more pressing professional issue may be in relation to capacity constraints among preferred LTLO managers, which may find the advisors having to ration their clients across available capacity;
- through education and facilitation, advisors and investment managers can assist trustees with the process of articulation of investment beliefs and the development of a statement of investment policy; and
- advisers require an expanded skill set in order to appraise LTLO managers, particularly if the definition of LTLO is expanded to incorporate a proper treatment of extra-financial factors and engagement.

Share your views

20. Do you agree that many trustees should delegate more of their governance role to internal executives and/or advisors? In particular, having set the objectives and determined the risk budget, should trustees leave mandate design, manager structure, selection and monitoring to delegates?

21. In what ways, if any, would in-house managers or wholly owned subsidiaries be better placed to manage LTLO mandates?

Appendix 1 – Summary of consultation questions posed

Each of the consultation questions raised in this document is listed below, together with details of where to send your thoughts. Please feel free to elaborate on any of the ideas raised, or to suggest ideas you believe need further exploration. We would appreciate receiving comments back by 2 June 2006.

- 1. What is your view on our summary definition? What changes, if any, would you suggest?
- 2. What are your views on our list of aims, investment strategies and characteristics? What additions or deletions, if any, would you suggest?
- 3. Institutional Investors have been referred to as 'Universal Owners'. The concept is that because of their size they own a slice of the entire economy and thus have a vested interest in factors which affect its long-term growth and society as a whole. Do you believe that the concept of universal ownership is relevant to LTLO?
- 4. What are your views on our analysis of the reasons why some trustees have not used LTLO to date?
- 5. Have we identified the relevant pitfalls of LTLO investing? What other pitfalls can you suggest?
- 6. Does this overview provide a comprehensive description of the strategic review process? Is the inclusion of LTLO in the process adequately described?
- 7. Are there any key components we have missed?
- 8. Do you agree there is a value in articulating collective trustee beliefs as a backdrop to the investment approach?
- 9. Can you suggest any improvements to the checklist of questions on investment beliefs?
- 10. Do you agree with the five elements for setting LTLO investment return objectives?
- 11. Do you agree that increasing the term of the investment mandate will, by itself, do little to overcome short termism?
- 12. Are there other ways you can suggest to set investment objectives to promote long-term investment?
- 13. How can the paradox of reconciling an absolute return objective with performance relative to a market index (for fee calculation purposes) be addressed?
- 14. Do you agree that the manager selection process will need to change significantly? What do you think is the biggest obstacle scarcity of appropriate investment managers, competence of investment advisers, willingness of trustees to adequately resource the search for appropriate investment managers or something else?
- 15. Should manager appointments specify a minimum time period? If so, how long should that be?
- 16. How should trustees react to periods of under-performance?
- 17. What are your views on our proposals in respect of performance fees, co-investment and redemption charges?
- 18. Do you consider that performance fees do not affect manager performance in the long run and are not, therefore, cost effective? If so, why?
- 19. Do you agree with our proposals for manager review meetings? If not, what would you do differently?
- 20. Do you agree that many trustees should delegate more of their governance role to internal executives and/or advisors? In particular, having set the objectives and determined the risk budget, should trustees leave mandate design, manager structure, selection and monitoring to delegates?
- 21. In what ways, if any, would in-house managers or wholly owned subsidiaries be better placed to manage LTLO mandates?

Contact details

Please send your comments by Friday 2 June 2006 to:

Yusuf Samad (yusuf.samad@hewitt.com) or Giustino Palazzetti (giustino.palazzetti@hewitt.com)

The Marathon Club

6 More London Place, London SE1 2DA

Tel. 020 7939 4363

A summary of the responses to this consultation document will be published on the Marathon Club website at: www.marathonclub.co.uk

A pdf version of this paper is available on the Marathon Club website.

We thank you in advance for your responses.

Appendix 2 – The legal framework and trustees' responsibilities

When considering any investment of scheme assets, trustees must be aware of some important provisions of UK pensions law.

Note: Although local authorities operate under a different regulatory regime, the principles explained here are similar in their application to those applying to local authorities.

The Pensions Act 1995

The Pensions Act 1995 required trustees who make investment decisions or, where they have delegated that responsibility, their fund manager(s) to consider:

- the need to have a spread of investments; and
- the suitability of investments.

The Pensions Act 2004

The above requirements changed from 30 December 2005 to satisfy European law, although the underlying principles remain the same. The effect of the Pensions Act 2004 is that trustees or fund managers have to exercise their investment powers prudently. This includes exercising those powers:

- with a view to securing the security, quality and liquidity of the investment fund;
- where relevant, with a view to giving effect to the requirements of the statutory funding framework;
- having regard to the need for a spread of investments for the scheme; and
- making sure that the scheme assets are invested mainly in regulated markets.

When choosing investments, trustees or the fund manager(s) acting on their behalf must exercise their investment powers in line with the scheme's Statement of Investment Principles (SIP) and must first obtain and consider proper advice before taking decisions. Trustees must then determine when they should review an investment and, when they do so, again obtain and consider proper advice about it.

UK pensions law thus allows trustees to delegate day-to-day investment decisions and, as a general rule, trustees will not be held personally responsible for any mistake the fund manager makes, as long as trustees have made sure that they:

- have the appropriate knowledge and experience for managing their scheme's investments; and
- carry out their work competently and in line with trustees' policy for choosing investments, as set out in the SIP.

The trustees of most UK schemes must draw up a written SIP. The SIP is an important document which sets out the principles governing how decisions about investments must be made.

Statement of Investment Principles (SIP)

The SIP must include trustees' policy on:

- the kinds of investments to be held, and the balance between different kinds of investment;
- risk (under the Pensions Act 2004 this refers to risk management processes and how risk is measured) and the expected return on investments;
- realising investments;
- making sure they meet the requirements for choosing investments;

- the extent, if at all, they take account of social, environmental or ethical considerations when taking investment decisions:
- using rights (including voting rights) attached to investments if they have them; and
- making sure, where relevant, that the scheme meets the Minimum Funding Requirement (MFR). NB: this only applies until the MFR is replaced by the Statutory Funding Framework (SFF), of which more below.

Before the SIP is drawn up, trustees must:

- obtain and consider the written advice of a person who they reasonably believe to have the appropriate knowledge and experience of financial matters and investment management; and
- consult with the employer. In this case, 'consultation' means considering the employer's views carefully. It does not mean that trustees have to agree with the employer, or carry out their wishes. In fact the law makes the point that trustees do not need the employer's agreement.

Trustees will need to review the SIP regularly and revise it from time to time. As of 30 December 2005, trustees have to review their SIP at least every three years and whenever there has been a significant change in investment policy. When trustees revise the SIP, they will need to take advice and consult with the employer in the same way as when the SIP was initially drawn up.

Statutory Funding Framework (SFF)

The SFF, which is replacing the MFR, is being phased in from September 2005. Its aim is to make sure that a scheme's assets cover its technical provisions (the actuarial value of its accrued liabilities calculated in a particular way).

Employers will no longer have to fund their scheme to a uniform level. Instead, trustees will be able to take account of the circumstances of their own scheme when deciding a strategy for funding the scheme's liabilities and correcting any deficits

Under the SFF, trustees will have to do the following:

- prepare and maintain a statement of funding principles setting out their policy for meeting the statutory funding objective. Normally trustees must agree the statement with the sponsoring employer;
- obtain an actuarial valuation report at least once every three years;
- if trustees get an actuarial valuation at least once every three years then they should also get an actuarial report for the intervening years;
- draw up a schedule of contributions showing the rate of contributions to be paid by the employer and (if they pay contributions) the members in order to meet or continue to meet the statutory funding framework, and the dates by which payments are to be made. The schedule must be certified by the scheme actuary, who must be satisfied that it is consistent with the SIP. Normally trustees must agree the schedule with the sponsoring employer; and
- where the statutory funding framework is not met, put in place a recovery plan which trustees have agreed with the employer. The recovery plan must set out the steps to be taken to meet the statutory funding framework and the timeframe for doing so. Usually trustees will have to send a copy of the recovery plan to the Pensions Regulator.

If trustees cannot get the employer's agreement when the law requires them to, they must report this to the Pensions Regulator within a reasonable time.

Appendix 3 – Performance metrics for LTLO

The principles governing performance measurement

The return to any portfolio can be thought of as being comprised of a broad market or asset class exposure termed beta, and an alpha component, which is the value added by the manager through skill. This is true regardless of investment strategy. Therefore, the appropriate starting point for performance measurement is a 'strategic' benchmark that captures the beta exposure of an investment strategy. LTLO managers should not be rewarded much for strategic beta, as this is a commodity and available to institutional investors at minimal cost through passive management. They should be rewarded for positive contributions through market or asset allocation and for the value added through skill in each asset class.

Non-benchmark measures of performance (e.g. trading decisions or changes to fundamental portfolio characteristics) are helpful in understanding qualitatively if a manager is continuing to pursue a particular investment strategy by identifying deviations from that strategy, and by assessing if relative performance is a function of skill or luck.

Unfortunately, it takes many years to distinguish skill from luck.

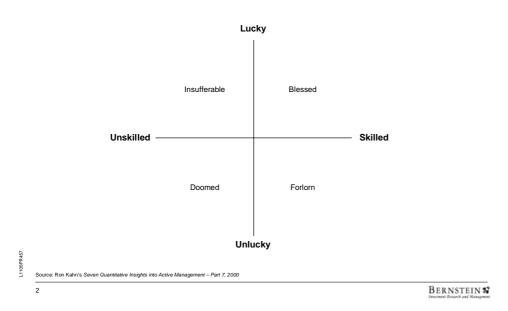
Distinguishing skill from luck is not easy. The information ratio, defined as the alpha per unit of deviation from the benchmark, is a tool for assessing the skill of an active manager. For an active manager with an information ratio of 0.5, it takes 11 years to have statistical confidence that the outperformance is a result of skill, not luck. For lower information ratios it takes even longer. Clearly, this is a problem, not least because trustees and investment-manager processes are rarely unchanged over 11-year, or longer, periods.

95% Confidence of a Positive Premium 1.0 0.5 0.1 11 31 Years Source: AllianceBernstein

Even skilful managers underperform.

Managers with positive information ratios will underperform benchmarks from time to time. Therefore, terminating an underperforming manager risks replacing a skilful manager, who has been unlucky, with an unskilled, but lucky one. Successful managers need both skill and luck.

Distinguishing Skill From Luck: Good and Bad News



Purely quantitative measures of performance can provide signals that prompt a manager review, but judgment is necessary to decide if a manager is unskilled or unlucky. Qualitative factors are essential in making this judgment.

Performance metrics available

There is a range of performance metrics that could be considered. Some of these are more traditional benchmark related measures whilst others are non-benchmark-related and more commonly found in areas such as private equity management.

Initial indicators

These include:

- trends in the information ratio;
- risk measures such as value at risk (VAR), price to value ratio, or volatility of absolute returns; and
- turnover (x% of purchases and sales over the year).

Measures away from benchmark

When periodic monitoring is undertaken, greater attention should be given to establishing whether the portfolio represents the outcome of the investment process, as initially described by the manager. Trustees should consider reviewing that the individual characteristics of the portfolio at any monitoring date are consistent with the overall investment process, e.g. in terms of number of holdings, concentration, type of holdings, valuation characteristics price-to-earnings, yield, price to sales, estimated intrinsic value etc.) or fundamental characteristics (return on equity, operating margins, sales growth rates, leverage, etc.). Trustees should ask managers to provide this information, even though some of the measures, such as intrinsic value, are likely to be subjective estimates.

The portfolio analysis tools, as described below, should help to identify whether the process has delivered returns as expected and whether it still has the potential to do so.

• internal rate of return (IRR) on realised investments. An IRR metric based on investments realised would provide a true picture of average performance for investments that had reached their full potential. This measure looks at the difference between the price paid for an asset, the price it was sold for and calculates the return over the holding

period. This is a particularly meaningful measure for long-term mandates since it uses the entry and exit prices, as selected by the manager, and hence avoids performance measurement based on volatile short-term market pricing, which can suffer from noise; and

• the remaining unsold holdings within the portfolio could be considered as 'work in progress' investments, which still need time to mature. It would be possible to calculate an unrealised IRR for the unsold holdings based on quarter-end or year-end market prices, although such metrics should not receive the same level of significance as the realised IRR metric based on actual sale prices achieved. Trustees may find it more helpful to develop with managers a comparison of price to estimated fair value approach when reviewing the ongoing portfolio. This should naturally lead to a discussion on buy, hold and sell disciplines, actual purchases and sales, and analysis of investments out of favour with the markets.

Which risk measures are appropriate for LTLO mandates?

Short-term risk measures, such as tracking error and VAR, may still be useful for identifying what questions to ask, e.g. why are managers not taking enough risk?

Some managers tend to look at absolute volatility of the portfolio return and compare it to the volatility of the relevant market as a whole to assess potential risk of loss of capital and evaluate compensation for risk. Trustees could set an objective to maintain absolute volatility of portfolio return less than a pre-agreed level. Volatility relative to longer-dated gilts, which often serve as a proxy for liabilities, is another potentially useful measure.

Some trustees may wish to have indicators that show rewarded and unrewarded risk. Others may wish to use downside tracking errors of, say, x% per year cumulatively for the first three years, reducing to x% cumulatively thereafter as the mandate approached seven years or more since inception. This narrowing with time is an idea that may be relevant as trustees expect the LTLO managers to outperform over time, and the early tolerance in terms of tracking error is based on early divergence of the LTLO portfolios from index weightings.

However, with capital preservation in mind, a stated objective of losing no more than x% of the portfolio in any given year (a VAR type measure) may be appropriate.

The price to estimated value has a strong support amongst proponents of long-term mandates. This measure gives an indication of the extent to which the portfolio is at a discount to the estimated value. It represents the potential gain in the portfolio if market consensus were to converge to the manager's expectations about individual holdings. From a risk perspective, this can be useful in giving an indication of the level of protection in the portfolio. This measure is clearly dependent on the subjective estimates of value provided by the investment manager.

There are other types of risk control which could be applied at the portfolio level and which should be in place, regardless of the benchmark chosen, to define the risk objective. These include controls such as minimum (and possibly maximum) number of securities, maximum size of any single position, no gearing permitted, and turnover limits.

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