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No IT? No Comment

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The financial crisis and its concomitant regulatory reaction have dramatically increased the pressure on pension fund trustees. The challenge is having to balance the need to boost investment returns by including new complex asset classes, with greater responsibility to monitor and understand the resultant aggregate risk of the investment portfolio. Neil Puri, Chief Executive of SRL Global explains the problem and the answer which, to translate Audi's famous slogan, is: ***Progress through Technology***.

It's tough being a trustee of a pension fund these days. Not that the job was ever easy, but the recent financial crisis and high profile bailouts, both corporate and sovereign, have thrown up all sorts of new demands and flagged risks that, hitherto, had rarely been recognised and, even more rarely, considered.

> *"the promises and panaceas that gleam like false teeth."*

For example, until recently, a DB pension scheme trustee's attention was largely focused on scheme liabilities. Dramatic changes to life expectancy and annuity rate often meant that the pensions promise given to scheme members was becoming harder and harder to keep, bringing to mind Lord Rothschild's description of political party manifestos: "the promises and panaceas that gleam like false teeth."

Close Encounters

But, as all pensionistas now know, liabilities are only one side of the story. The financial crisis of 2008/09 brought the issues of investment returns and, moreover, the management of scheme assets straight onto the middle of the screen.

> *Assets, with a capital 'A', are what will ultimately deliver the pensions promise*

Trustees were faced by an Armageddon scenario. Few were really prepared for what took the pensions world by overwhelming surprise as scheme liabilities were increasing at the same time that asset values were plummeting. There was suddenly a new awareness that Assets, with a capital 'A', are what will ultimately deliver the pensions promise and that both liabilities and assets needed urgent attention and were of equal, critical significance to trustees.

What the financial crisis really highlighted was just how much the asset management industry had evolved over the last twenty years. Investment was no longer just in the blue chip equities of companies we all knew. Cash was held with Icelandic banks and somehow UK building societies and banks were brought down by exposure to sub-prime mortgage debt on the other side of the globe. Investment had increased in geographic distance and opacity.

No Outsourcing of Responsibility

Here is a list of some of the multiple considerations charged to trustees when deciding upon, or indeed modifying, a pension scheme's investment strategy:

- Any limitations on investments contained in the trust deed and rules
- Legal or regulatory requirements, in particular ERI in the case of a sponsored scheme
- Fiduciary duty to choose investments that are in the best financial interests of the scheme members - for example, a trustee must not allow personal or political convictions to get in the way of achieving the best returns for the scheme
- Suitability of different asset classes to meet the needs of the scheme and future liabilities
- The risks involved in different types of investment and the possible returns that may be achieved
- Appropriate diversification of the scheme's investments - in other words not 'putting all your eggs in one basket'

Whilst trustees can outsource the investment functions and decisions, they cannot however outsource the responsibility.

All investment decisions taken by trustees are in light of appropriate advice taken from professional advisers such as the scheme actuary and investment consultants. What is clear is that whilst trustees can outsource the investment functions and decisions, they cannot outsource the responsibility.

"'Tisn't beauty, so to speak, nor good talk necessarily. It's just IT." *(Rudyard Kipling)*

It might be argued that where before there was an expectation to see boxes checked, there is now a growing demand by trustees to check the working behind the tick. Trustees must establish, operate and maintain adequate internal control mechanisms for the purpose of monitoring that the scheme is being effectively administered and managed in the interests of the members and beneficiaries under the scheme rules.

And, to be optimal, those control mechanisms should take advantage of the new generation of IT solutions currently becoming available to the pensions industry.

Take, as an example, the requirement to diversify, and tie it to the approach defined by the Pensions Regulator in Q4 2010 to regulating Employer-related investments (ERI), often called 'self-investment' which limits investment in any employer.

One of the side effects of the financial crisis was that it exposed many forms of risk which the previously rising markets camouflaged. With the benefit of hindsight many of these risks were obvious and their rediscovery has created an understandable concern amongst regulators to improve corporate governance and oversight of scheme's assets needs. The collapse of financial markets coupled with a series of high profile bankruptcies has raised the question of diversification and dependency and whether all of a scheme's eggs are in one basket residing with one broker, custodian or counterparty or indeed the corporate sponsor, with respect to the employer covenant.

Turning from the general to the specific, one of the features of the new regulatory approach mentioned above is that it's not just about direct investment in an employer's shares but also restricts indirect investments through, for example, trusts that may hold such shares, through other types of securities: options, single stock futures, ETFs, and so on.

You don't need to understand IT, just how to use it

Without extensive IT identification, valuation and analytical systems it is extremely difficult, arguable impossible to be able to gather the level of information about the content of an investment portfolio that the regulator now requires. It's not simply a process of drilling down to discover the holdings of all the managers but to actually drill down again to see if, through any of those instruments, there is any further exposure - across all asset types and complex derivatives.

What's the Alternative?

The reference to 'complex derivatives' in the previous paragraphs, brings the new world of alternative investments to mind, an area, increasingly explored by trustees who recognize that while "points win prizes", performance keeps promises. And a well-managed portfolio of alternative investment managers should deliver excess performance largely uncorrelated with the direction of shares - and often with lower risk.

By 'alternative investment managers', we often mean hedge fund managers and for many trustees, these three words conjure up a nervous frisson akin to being presented with one's first oysters - are they desirable and/or will they cause us to be ill?

Why, for some, are hedge funds frightening?

Reasons to be Fearful

- Is it because hedge fund performance is often too strong at a time when preservation is the accepted goal? How trustworthy can a manager be if he's making 25% these days?
- Is it because hedge funds tend to be funded by small flexible partnerships rather than by institutionalized committees?
- Is it because there have been a series of well-publicised collapses from Long Term Capital Management to Madoff? (But note, Madoff was a crook not a hedge fund manager; sitting

in a dealing room makes you no more a hedge fund manager than sitting in a garage makes you a car).

- Is it because, by their nature, many hedge fund strategies are more complex than traditional investment strategies and thus more difficult to understand? And thus in some cases, to value?
- Or is it primarily because, despite assurances to the contrary, hedge fund managers and hedge fund strategies are perceived to add risk to a pension scheme portfolio rather than reduce the thrill of the roller-coaster ride?

Sitting in a dealing room makes you no more a hedge fund manager than sitting in a garage makes you a car.

The pension fund industry is clearly in the process of a major evolution in its use of alternatives and in particular, hedge funds. There are implications on portfolio allocations, whether schemes allocate to complex investments such as hedge funds and how they achieve their hedge fund exposure. However, since the Madoff scandal and the unravelling of the credit markets, few financial institutions have been more publicly vilified than hedge funds. Whilst the merits are clear, the associated risks may not be fully understood. But it can be with the right tools and, as Bill Gates said in 1997, "Technology is just a tool."

Is Ignorance bliss?

There are two distinct pressures on trustees. Firstly, there are commercial pressures to improve the returns on assets therefore having to take a more sophisticated approach to investing. At the same time the regulator is pressing for greater oversight and knowledge of investments. Lessons learnt over the recent past have illustrated that knowing your managers and knowing what your managers are doing, is not the same thing. And costly uncertainty can apply to exposure.

There were professional investors who at crisis points over the last few years have not known their exposures to Lehman Brothers stock, whether they owned (albeit indirectly) Greek or Irish Government debt, or indeed the impact on their overall asset values of BP's Deep Water Horizon oil spill. Ignorance is not bliss on this occasion and the transition to a state of knowledge and understanding is easily achieved - although the IT required is itself complex.

The Last Word on Transparency

There is no longer a holistic view of underlying inventory. Multiple data sources and the challenges from using out-of-date valuations of an increasing complex market means that historic reliance on custodians and other service providers in the investment chain are no longer viable options.

Whether it's the treasurer, CFO, trustee or pension's manager, regularity and precision in an open and auditable way is paramount. As a result, schemes must, for the first time, understand and manage how all their individual fund allocations fit into their portfolio of investments in aggregate. With the right technology this is certainly achievable, enabling schemes to analyse all the holdings of their constituent allocations together, both traditional and alternative, as if they held all the underlying positions directly.

Independently from their investment advisors, schemes must strengthen oversight capabilities through the provision of an independent audit trail of investment activity, exposures, restrictions and compliance failures. Holdings need to be interpreted proactively to deliver a completely new level of insight and authority to trustees. Total transparency, consistent information, cross manager visibility and instant access to the right data at the right time will empower all scheme stakeholders to turn information into insight.