Russell Research

The evolution of investment decision-making

2012 Survey of 300 Defined Benefit Pension Funds

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About the Research
In 2009 Russell conducted its first survey of investment-decision making structures at UK defined benefit pension funds. This study updates and extends the analysis, highlighting trends, new observations and recurring issues over the intervening two years.

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The evolution of investment decision-making

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EXECUTIVE SUMMARY

INTRODUCTION
Against a backdrop of increasing complexity in pension fund investment arrangements, Russell conducted its first survey of investment-decision making structures at UK defined benefit pension funds in 2009. This survey updates and extends the survey of 2009, and identifies material changes over the intervening two years.

KEY THEMES
From our 2009 survey and subsequent work in the UK and elsewhere, a number of key themes have emerged and continue to develop. In particular, discussions tend to quickly come to questions around how delegation can be made to work effectively in practice, the challenges in separating the oversight role from the executive role, and increasing need for nimble decision-making in rapidly evolving market conditions. This survey is no different, providing further empirical evidence to support anecdotal views. We have organized our report around five key themes:

1. Structures for greater delegation are being put in place
The survey shows an increase in both the creation of investment committees and the appointment of fiduciary managers, both entities to which the trustee body can delegate a range of investment decisions. Investment committees have been the preferred approach for larger schemes, with the increased appointment of fiduciary managers being driven by smaller schemes.

Within this, it is clear that the role of the investment committee varies considerably between schemes, with participants defining the role in a variety of ways covering the spectrum from working group with little delegated authority to empowered decision-making entity.

Overall levels of awareness of fiduciary management have increased since the 2009 survey, with smaller schemes in particular finding the concept increasingly attractive. Accordingly, usage by smaller schemes has increased notably from 15% to 26% of smaller scheme respondents. Participants cite similar perceived advantages of and potential concerns around fiduciary management as they did in 2009. Interestingly, the key potential concern that the trustees lose control of investment decision-making in such an arrangement is not reported as an issue in practice by those participants who are currently using fiduciary management.

2. Delegation is in decline
Despite the increased prevalence of investment committees and fiduciary management arrangements, there is very little evidence of empowering those entities to take investment decisions at any level – for example trustee boards retain control of manager selection in 75% of cases and the trustee is named as decision maker by at least 70% of respondents for each decision area that we asked about.

This behaviour is really about the challenges of separating the oversight role from the immediate decision-making role. In our 2009 survey, there was greater evidence of delegation (albeit still limited) but also some evidence that it was less than clear who actually ‘owned’ the decision, as respondents typically named more than one decision-making entity. Interested readers observed that this may have been because respondents wished to acknowledge the role of others who may have had a role, eg in forming a recommendation or offering an opinion, and we might need to tighten the question to allow for this. So in the latest questionnaire we added the
It is true of course that the trustee body is ultimately responsible for all investment decisions (and indeed any others decisions made in the course of managing the Trust's business), and accordingly must review the effectiveness and skill of its delegates. But this is different to the trustee body being immediately responsible in each case. Perhaps we have more work to do in how we word the question, but it seems to us that this is further evidence of the challenges faced in defining what it means to be in a non-executive oversight role versus an executive decision-making role.

3. Time spent on investment issues appears meagre
In this survey, we asked respondents not only to indicate how often they met but also how long meetings typically lasted so that we could measure the number of hours per annum that trustee bodies and their investment committees are spending on investment issues. The time spent appears meagre, particularly in the context of limited delegation, at an average of 15.6 hours per year taking into account both trustee and investment committee time. Even for the largest and most complex schemes the figure rises to only 26 hours, barely half an hour a week\(^1\) to determine the strategic arrangements including LDI or other overlays, the portfolio structure, and the selection and monitoring of managers for multi-billion pound schemes.

4. A ‘squeezed middle’ is emerging
We analysed the resources available to schemes, either via internal hiring or through outsourcing, and compared these to the complexity of the investment strategy being pursued. Mid-size schemes tend to have strategies that are as complex as those of the largest schemes in our sample, but have not resourced up as much a large schemes (they have 2/3rd of the internal resources of larger counterparts), or outsourced as much as small schemes to cope with this complexity. They also don't spend as much time on investment issues as the large schemes (1/3 less on average). Matching their investment ambition to the resource they have available is clearly a key challenge for this group.\(^2\)

5. Confidence levels remain high
Trustees remain confident that their decision-making structures remain fit-for-purpose (confidence levels were greater than 80% for each confidence-related question), and in particular the previous relative concern around the ability to respond to rapidly evolving circumstances has abated. This is something of a conundrum, as there is little evidence of any change in investment committee meeting frequency (quarterly remains the norm) or increased levels of delegation to entities better able to respond in ‘real time’.

We surmise that this is perhaps a trick in the timing of the field work for the two surveys. In the summer of 2009, the experience of the equity market marching downwards following Lehman was very fresh. In this survey we conducted the survey in July and early August 2011, before the Euro crisis really got going with the attendant volatility and bearishness in equity markets. If the increased confidence

\(^1\) To put this time into context, we make a tongue-in-cheek comparison: some people can spend over 35 minutes a week making cups of tea, equating to over 27 hours a year!

\(^2\) This echoes a Dutch study (Risseeuw and ter Wengel, 2001) which found that mid-sized funds had a similar mismatch of governance resources and investment ambitions.
really is all in the timing, then perhaps it simply arose through the fading of bad memories. This would be worrying, because it would not be based on any real improvement in decision-making structures.

CONCLUSION

Objective and dispassionate self-assessment of a pension scheme's decision-making processes is very difficult to achieve, not least because of the subjective nature of any assessment and the limited points of comparison; it's far easier to measure tangible investment outcomes. This challenge remains with us, but should not stop us from trying to improve our decision-making processes.

At its core, the determination of an efficient decision-making structure involves making trade-offs between complexity and resource, between increasing internal resource and outsourcing, and between delegating decisions and retaining direct control. This report summarises our interpretation of the current trade-offs being made by pensions schemes based on the survey data, and the trends over the last two years.

Our aim with this survey is not to determine what is 'right', but to provide objective data for comparison and context as trustees determine their own approach. This survey is a continuation of our research into governance and provides an additional tool to help schemes make an objective and dispassionate assessment of their decision-making practices.

We are grateful to all those who participated for their time.

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3 See Russell Research pieces, “Mind the governance gap” and “Investment decision-making: introducing a new benchmarking framework”
SECTION 1: INTRODUCTION

Over July and early August 2011, IFF carried out telephone interviews with representatives of 300 UK defined benefit pension schemes of various sizes, selected at random.

Exhibit 1: Participants by Size of Scheme

In our 2009 survey, around half the participants were smaller schemes of less than £100m. We grouped the remaining schemes together under the label ‘large schemes’, and for some analyses, also separately identified the ‘largest schemes’ as those with assets in excess of £500m. We have maintained the same groupings for this survey to facilitate comparison, and also introduced a ‘medium sized’ grouping, comprising those schemes of £100-£499m in size, when introducing certain new metrics.

As in 2009, the bulk of the respondents were pension fund managers, with the remainder being made up of internal CIOs, trustee chairmen or investment committee members.
SECTION 2: INCREASING USE OF DELEGATION STRUCTURES

The survey shows an increase in both the creation of investment committees and the appointment of fiduciary managers, both entities to which the trustee body can delegate a range of investment decisions. Investment committees have been the preferred approach for larger schemes, with the increased appointment of fiduciary managers being driven by smaller schemes.

Exhibit 2: Use of investment committees and fiduciary managers

<table>
<thead>
<tr>
<th>Scheme size</th>
<th>Investment committee</th>
<th>Fiduciary management</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2011</td>
<td>2009</td>
</tr>
<tr>
<td>All schemes</td>
<td>48%</td>
<td>38%</td>
</tr>
<tr>
<td>Large schemes</td>
<td>69%</td>
<td>58%</td>
</tr>
<tr>
<td>Small schemes</td>
<td>22%</td>
<td>20%</td>
</tr>
</tbody>
</table>

INVESTMENT COMMITTEES

The proportion of large schemes with investment committees has increased notably from the 2009 survey (from 58% to 69%). Within this, however, it is clear that the role of the investment committee varies considerably between schemes, with participants defining the role in a variety of ways covering the spectrum from ‘working group with little authority’ to ‘empowered decision-making entity’.

Exhibit 3: Role of the Investment Committee: Watchdog or Executioner? (2011)

The proportion of large schemes with investment committees has increased notably from the 2009 survey (from 58% to 69%).

We asked respondents to articulate how the role of the investment committee is different to the role of the full trustee board concerning investment matters. Exhibit 3 groups the respondents’ characterisation of the investment committee’s role into ‘Watchdog’ (monitoring responsibilities) or ‘Executioner’ (decision-making responsibilities). The remaining groupings are either ambiguous or indicate that the role of the investment committee has not been well defined. With the exception of ‘Committee reviews / makes specific investment decisions’, which is arguably a little
ambiguous, respondents tend to characterise the investment committee’s role as more watchdog-like.

Exhibit 4: Investment committee membership (2011)

<table>
<thead>
<tr>
<th>Background</th>
<th>Trustee body</th>
<th>Investment committee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Professional trustee</td>
<td>0.4</td>
<td>0.4</td>
</tr>
<tr>
<td>Member-nominated trustee</td>
<td>2.7</td>
<td>1.3</td>
</tr>
<tr>
<td>Company nominated trustee</td>
<td>3.8</td>
<td>2.4</td>
</tr>
<tr>
<td>Other background</td>
<td>0.1</td>
<td>-</td>
</tr>
<tr>
<td>Non-trustee</td>
<td>-</td>
<td>1.0</td>
</tr>
<tr>
<td>Total</td>
<td>7.1</td>
<td>5.1</td>
</tr>
<tr>
<td>With finance/investment expertise</td>
<td>2.6</td>
<td>2.8</td>
</tr>
</tbody>
</table>

Typically, any professional trustees on the trustee board and those trustees who have some financial or investment expertise are included in the investment committee, with only half the member-nominated trustees making it. Non-trustees are also often incorporated onto the investment committee, bolstering the level of investment expertise. These patterns of delegation to expertise rather than representation are broadly similar across size bands, and are similar to the patterns revealed in the 2009 survey.

FIDUCIARY MANAGEMENT

Overall levels of awareness of fiduciary management have increased since the 2009 survey with only 1 in 10 respondents having never heard the term this time, compared to 1 in 5 in 2009. Although this rise is driven by increased awareness levels at larger schemes, it is the smaller schemes that are finding the concept increasingly attractive (see exhibit 6). Accordingly, usage by smaller schemes has increased notably from 15% to 26% of smaller scheme respondents as shown in exhibit 2 earlier.

Exhibit 5: Awareness of Fiduciary Management

Overall levels of awareness of fiduciary management have increased since the 2009 survey... it is the smaller schemes that are finding the concept increasingly attractive with use increasing from 15% to 26%.
Participants cite the same perceived advantages of and potential concerns around fiduciary management as they did in 2009, regardless of whether they find fiduciary management an attractive concept or not. Interestingly, as illustrated in exhibit 7, the key potential concern around trustees losing control of investment decision making under fiduciary management arrangements is not reported as an issue in practice by those participants who are currently using fiduciary management.

Exhibit 7 shows the top answers given by respondents based on unprompted answers. The percentages levels for the “All” category do not always fall between the levels for the other two categories as some schemes did not report whether they use Fiduciary Management or not.
SECTION 3: DELEGATION IS IN DECLINE

Despite the increased prevalence of investment committees and fiduciary management arrangements, there is very little evidence of empowering those entities to take investment decisions at any level. In fact, the degree of delegation has declined substantially relative to the 2009 survey, with respondents indicating that trustees retain sole decision-making authority in most instances across a range of different decisions.

Exhibit 8: Groups responsible for various investment decisions

In the exhibit above, as you move down the list the decisions move from strategy-oriented to implementation-oriented. One might expect to see a greater degree of delegation by the trustee to its investment committee or other entity as you move down the list. However, even for manager selection decisions 75% of the respondents indicated that the trustee retains direct control of this decision.

Moreover, respondents were much less inclined to name other parties as having a role or degree of influence in decision-making, as indicated by the bars in the above exhibit not extending as far to the right in 2011 as they did in 2009.

There was, as you would expect, some evidence of greater delegation where investment committees were in place or where schemes had more complex strategies. However, the broad pattern was similar across all schemes, with the trustee named as decision maker by at least 70% of respondents in every case, simple or complex, investment committee or not.

ULTIMATE VERSUS IMMEDIATE RESPONSIBILITY

The lack of delegation is really about the challenges of separating the oversight role from the immediate decision-making role. In our 2009 survey, there was greater evidence of delegation (albeit still limited) but also some evidence that it was less than clear who actually ‘owned’ the decision, as respondents typically named more than one decision-making entity (and hence the bar in exhibit 8 extended well to the right of 100%). Interested readers observed that this may have been because

The trustee is named as decision maker by at least 70% of respondents in every case, simple or complex, investment committee or not.

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4 Some respondents (such as universities, museums and hospitals) replied with answers such as the Cabinet Office, Parliament, Local Government/ Council. We have classified this response as “public sector”.

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respondents wished to acknowledge the role of others who may have had a role, eg in forming a recommendation or offering an opinion, and we might need to tighten the question to allow for this.

In the 2011 questionnaire we added the word ‘ultimately’ to the question, so that it read ‘which of the following people ultimately decide …’ rather than just ‘which of the following people decide…’. The effect was that most respondents named the trustee body as sole decision-maker in response to each of these questions – even many of those who indicate that they have a appointed a fiduciary manager – and hence the dramatic change in the picture between 2009 and 2001 as shown in exhibit 8.

It is true of course that the trustee body is ultimately responsible for all investment decisions (and indeed any others decisions made in the course of managing the trust’s business), and accordingly must review the effectiveness and skill of its delegates. But this is different to the trustee body being immediately responsible in each case. Perhaps next time we should ask who is actually responsible rather than ultimately responsible, but it seems to us that this is further evidence of the challenges faced in defining what it means to be in a non-executive oversight role versus an executive decision-making role. This theme persistently emerges in any conversation we have with trustees and their delegates, and if as an industry we are to succeed in developing effective delegated decision-making structures it is a challenge that we must address.

ACCOUNTABILITY

The corollary of the increased direct control by trustees is of course that there is much greater clarity and accountability in decision-making structures: respondents were much less inclined to name multiple decision-makers for each decision area. But if this greater clarity comes at the expense of leveraging the resource available to trustees, and/or without meaningful allocations of trustee time and resource and resource in place of delegation, then it is not clear that it is a step forward in the quality of the decision-making structure.

Trustees should identify as objectively as possible what value direct control brings to their decision-making ability. For example: did it result in better or more timely decision-making? How often have they challenged or not carried forward recommendations made to them by their advisers or committees? Where they have not, has that decision added or detracted value?
SECTION 4: TIME SPENT ON INVESTMENT ISSUES APPEARS MEAGRE

In this survey, we asked respondents not only to indicate how often they met but also how long meetings typically lasted so that we could measure the number of hours per annum that trustee bodies and their investment committees are spending on investment issues. The time spent appears meagre, particularly in the context of limited delegation, at an average of 15.6 hours per year taking into account both trustee and investment committee time. Even for the most complex schemes the figure rises to only 26 hours, barely half an hour a week. To put these figures in tongue-in-cheek context, many people can spend over 35 minutes a week making cups of tea!5

Exhibit 9: Average time (hours pa) spent on investment issues by trustees and their investment committees

A similar pattern emerges if we break out time spent by scheme size: the largest schemes spend on average 25.7 hours a year on investment issues, and the smallest 7.5 hours.

The ‘most complex’ schemes are those that have indicated that they run largely active strategies with multiple specialist managers, and make extensive use of alternatives and overlay or derivative-based strategies. 30 minutes a week appears meagre, especially where there is little evidence of delegation beyond the trustee body as discussed in the previous section. If there really is little delegation, then this 30 minutes a week is being stretched to cover a great deal.

Some have observed that while their trustees retain control of the final decision or at least power of veto, for example on manager selection, in fact this amounts to rubber-stamping recommendations made by advisers or sub-committees. The ‘time spent’ statistics may be less alarming under such circumstances. However, it does open the questions around what value is being added by the trustee retaining this direct control, particularly if they do not exercise their power of veto.

5 Assume four cups of tea a day, each taking 2 minutes to make, in each working week, equates to 27 hours pa.
SECTION 5: A ‘SQUEEZED MIDDLE’ IS EMERGING

We analysed the resources available to schemes, either via internal hiring or through outsourcing, and compared these to the complexity of the investment strategy being pursued.

Exhibit 10: Size, resources and complexity

<table>
<thead>
<tr>
<th>Size</th>
<th>Resource Internal expertise*</th>
<th>Fiduciary Management</th>
<th>Time spent (hours p.a.)</th>
<th>Complexity index (0-100*)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small (&lt;£100m)</td>
<td>2.5</td>
<td>26%</td>
<td>7.5</td>
<td>44</td>
</tr>
<tr>
<td>Medium (£100m - £499m)</td>
<td>3.7</td>
<td>7%</td>
<td>16.7</td>
<td>62</td>
</tr>
<tr>
<td>Large (&gt;£500m)</td>
<td>5.0</td>
<td>7%</td>
<td>25.7</td>
<td>69</td>
</tr>
</tbody>
</table>

*Internal expertise is the sum of the number of investment or finance professionals within the trustee body and the investment committee (where it exists), and the number of in-house executive full-time equivalents. The higher the score, the more internal expertise is available. The complexity index is a measure of complexity on a scale 0-100 where the most simple strategies are scored 0, and the most complex 100.

Mid-size schemes tend to have strategies that are as complex as those of the largest schemes in our sample, but have not resourced up as much as large schemes, or outsourced as much as small schemes to cope with this complexity. They also don’t spend as much time on investment issues as the large schemes.

Matching their investment ambition to the resource they have available is clearly a key challenge for this group. At its core, the determination of an efficient decision-making structure involves making trade-offs between complexity and resource, between increasing internal resource and outsourcing, and between delegating decisions and retaining direct control. These trade-offs appear to be at their most finely balanced for the ‘squeezed middle’.6

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6 This echoes a Dutch study (Risseeuw and ter Wengel, 2001) which found that mid-sized funds had a similar mismatch of governance resources and investment ambitions.
SECTION 6: CONFIDENCE LEVELS REMAIN HIGH

Trustees remain confident that their decision-making structures remain fit-for-purpose – 88% of respondents believe that their current structure is suitable to meet future challenges – and, as shown in exhibit 11, they assess their current structures as being effective across a range of criteria.

Exhibit 11: Self-assessment of decision-making effectiveness

In particular, the previous relative concern around the ability to respond to rapidly evolving circumstances has abated – in 2009 the proportion of respondents who did not indicate confidence in this aspect of their decision-making was 40%, and this has dropped to almost 30% in 2011. This is something of a conundrum, as there is little evidence of any increase in investment committee meeting frequency (see exhibit 12) or increased levels of delegation to entities better able to respond in ‘real time’, as discussed previously.
We surmise that this is perhaps a trick in the timing of the field work for the two surveys. In the summer of 2009, the experience of the equity market marching downwards following Lehman was very fresh. In this survey we conducted the survey in July and early August 2011, before the Euro crisis really got going with the attendant volatility and bearishness in equity markets. If the increased confidence really is all in the timing, then perhaps it simply arose through the fading of bad memories. This would be worrying, because it would not be based on any real improvement in decision-making structures. The challenge of creating a framework for the objective and dispassionate assessment of decision making remains with us.
SECTION 7: CONCLUSION

Investment governance is very important and generates much interest, but the topic of reviewing decision-making practices rarely makes it to the top of most pension schemes’ agendas. Part of the reason is that objective and dispassionate self-assessment is very difficult to achieve in practice and requires us to overcome two common challenges:

- **The measurement difficulty** Most investors focus on investment outcomes which are far easier to measure than reviewing processes – the drivers of the outcomes – which requires a more subjective assessment.
- **Human nature.** Our natural tendencies, such as our over-confidence bias, conspire against us.

However, these features should not stop us from trying to assess our processes, especially given the increased complexity, range of opportunity and desire for dynamism in pension fund investment strategies today.

Our 2009 study and subsequent benchmark framework provide an objective point of reference for pension schemes to measure their decision-making practices and gives them areas for consideration when looking to improve their processes. This latest study provides pension schemes with additional reference points and provides further guidance on areas which may benefit from greater attention.

Our aim with this work on governance is not to determine what is ‘right’, but to provide objective data for comparison and context as trustees determine their own approach. We hope that this information provides decision makers with additional tools to help them make an objective and dispassionate assessment of their decision-making practices.

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7 We are grateful to the large number of senior-level executives that were willing to give up their precious time to respond to our survey on this topic.

8 See Russell Research pieces, “Mind the governance gap” and “Investment decision-making: introducing a new benchmarking framework”.
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