MIS-SELLING OF ALTERNATIVES BY INVESTMENT CONSULTANTS?

A Review of Methods Used to Promote Alternatives and Dress-up Performance

The Hidden Cost of Poor Advice: Local Government Pension Scheme (LGPS) Review - Part 3

"The review believes that advice alone is an inadequate basis for decision-making, if trustees are not in a position critically to examine the information on which it is based." - **Lord Myners, 2001**[1]

Introduction:

LGPS regulations require administering authorities to take 'proper advice' when making investment decisions. Investment advisers have a regulatory duty to act professionally in advising and reporting to clients and pension scheme members. This means acting with integrity and in clients' best interest.

However, in its latest report CLERUS make use of publically available information provided by local authorities to review the methods used by some investment consultants to promote so-called alternative investments (to LGPS). The report reveals that the performance assumptions used in 'asset-liability simulations' stands in stark contrast to the historic realised performance achieved for these types of investments and do not stand up to basic scrutiny.

In addition we illustrate how the cash-like benchmarks used to evaluate the performance of alternative investments are being set artificially low which flatter the reporting of performance versus benchmark by schemes and consultants. This raises important professional and ethical questions around the integrity of investment benchmarks for fund managers. It also undermines basic performance assessment principles and leads to excess incentive fees being paid to these investment managers by the scheme and tax payers.

Promotion of alternative investments by consultants

The triennial valuations (and subsequent 'asset liability studies') are used by investment consultants to recommend asset allocation and manager changes across client portfolios. A typical 'asset-liability study' consists of a Monte-Carlo simulation of different investment outcomes for different asset classes which are meant to help trustees better evaluate the risk and return characteristics of various investment strategies.

However as everyone familiar with these kinds of simulations will be aware, there is a large caveat to the output produced. This is because the results of the simulation are predominantly a function of the risk and return assumptions for the various assets, or investments, that are put in to the model in the first place (garbage-in-garbage out). As no one can predict future asset market returns, these models are therefore open to manipulation where biased assumptions can be fed into the model to produce desired forecasts.

CLERUS has identified some of the performance assumptions that lie behind recommendations to invest into alternative assets by consultants. For example, here is an extract of the public disclosure from one of the better performing Schemes, which has the necessary in-house expertise to challenge their consultant's assumptions:

> *"[The Consultants'] modelling work suggested that the Fund could diversify its portfolio by investing less in equities (reducing the current 65% weighting to 50%) and investing in alternative assets. The diversified strategy improved the bottom quartile funding levels compared to the current benchmark whilst maintaining the 'better' outcomes, therefore potentially increasing the median funding level to nearer 150% (from 147% as the median for the current strategy)."*[2]

---

[1] Institutional Investment in the UK: A Review. March 2001

[2] West Sussex Pensions Panel, Part 1, Agenda Item 4, p5: "Strategic Review of Pension Panel Arrangement (including investments)"

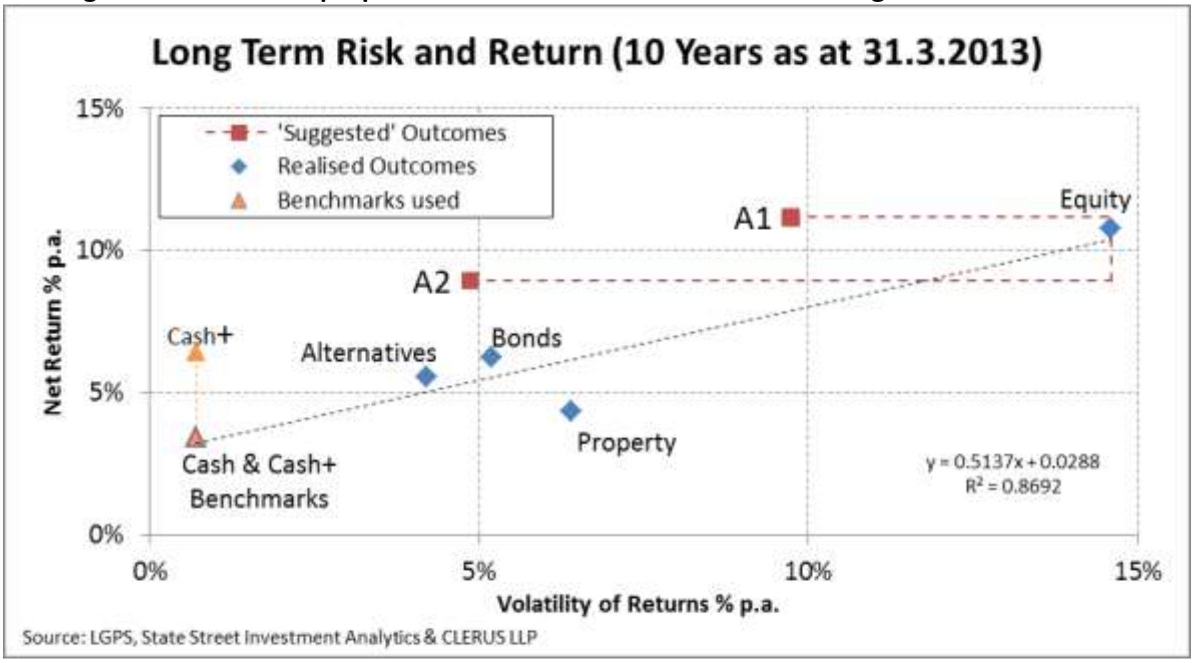
In this example, the 'modelling work' contains an implicit recommendation, which promotes to local authorities a need to make a change to investment strategy (to reduce equity exposure and increase exposure to alternative assets). The risk and return assumptions used to promote alternative assets across LGPS via this kind of simulations exhibit some minor variations across advisors. However the suggested 'outcomes' for alternatives and so-called 'absolute return funds' used to bring about this 'recommendation' can be summarised via two buckets ("A1" and "A2") below:

A1: Alternatives produce the same (or higher) return as equities but with two thirds of the risk
A2: Alternatives produce about 80% of the return of equities but with one third of the risk

Behavioural finance helps to evaluate this kind of investment proposition. The persistence of prior positive characteristics into the future should not usually be expected, unless one believes that capital markets are highly inefficient[3]. It is therefore no surprise that when we evaluate the historic return and volatility of the different asset classes over 10 years that we find no such free lunch.

Figure 1 below summarises this evaluation. We plotted the 'investment propositions' labelled A1 and A2, together with the annualised risk and realised returns for the main asset classes used by LGPS. The fitted (security market) line has been a reasonable estimate of the risk-reward trade-off available to investors over the past 10 years, explaining close to 90% of the variance in returns. The realised risk and return from the combined investment in assets classified as alternatives[4] also appear along the security market line, but with lower risk and return compared to bonds.

Figure 1: Investment proposition versus realised returns and manager benchmarks used



This means that the alternative investments that were recommended to Pension Schemes in the past did not benefit their portfolios as the consultants suggested they should. Instead, it helped increase deficits as already revealed in our previous reports[5]. Similar conclusions were also reached in a recent research report by Nomura[6] who analysed global hedge fund performance versus the returns of the SP500. They

[3] See for example Arbitrage Pricing Theory which suggests that by the time these attributes are broadly discovered the expected future return difference to other factors already have been, or is about to be, arbitraged out by investors.
[4] Here the combined allocation to Private Equity, Infrastructure, Commodities including Currency and so-called Absolute Return Funds including Hedge Funds, Fund of Hedge Funds and Diversified Growth Funds.
[5] The Hidden Cost of Poor Advice: http://www.clerus.co.uk/category/performance-review/
[6] The tortoise and the hare – Buffett's bet that passive will outperform alternatives: Nomura Returns Focus, 5.August 2014

found; i) 70-80% correlation to equity returns (i.e. no diversification), ii) negative alpha, and iii) risk reduction achieved versus SP500 due to reduced leverage, not skill.

The attraction of alternatives for a pension fund must therefore be predicated on the ability of advisors to identify in advance the small percentage of managers able to deliver the suggested risk and return targets. However if consultants have not been able to pick the winners in the traditional manager space, it is even less likely that they should be able to do so in alternative assets. Moreover, if such investments did exist over the past 10 years, then the manager selection criteria used were not able to identify them.

Ability to challenge poor advice

LGPS regulations require administering authorities to take 'proper advice' when making investment decisions. 'Proper advice' is somewhat vaguely defined as 'the advice from a person who is reasonably believed to be qualified by his ability in and practical experience of financial matters'. This definition keeps the door open for almost everyone. Based on these findings, this represents a clear gap in the regulations vis-à-vis Myners because there is no legal requirement for LGPS to carry out due diligence, or get an unbiased opinion, on the quality of advice received, prior to making investment decisions.

The Pensions Regulator states that the purpose of the trustee knowledge and understanding requirements is to enable decision-makers to understand, discuss and **challenge** the advice that 'experts' give them[7]. However the knowledge and skills framework signed up to by most LGPS does not seem to provide this required capability. Indeed many schemes can be observed repeating these unrealistic performance assumptions in their annual reports. This is no surprise as most of the 'training' provided under this framework is done by consultants and active investment managers who benefit the most from status quo.

Hiding poor performance

Figure 1 also highlights another serious issue in relation to the promotion of alternative investments. Having persuaded LGPS to invest into absolute return funds based on the spurious risk and return assumptions suggested by A1 & A2, a decision is then made to measure these recommendations against a cash or cash plus benchmark. This principle is the same as measuring an active equity manager against cash instead of an equities index! The contrast between the benchmarks used for performance assessment and the assumptions used to provide the original rationale for the change in investment strategy is highlighted by the orange triangles versus the A1 and A2 markers.

In plain English, we can summarise this process of benchmark debasement as follows:

1. Suggested outcome / rationale for change:
    - Improve overall investment performance, reduce downside risk
2. Actual implementation:
    - Reduce LGPS benchmark performance by allocating a percentage of assets from equities (or bonds) into cash (or cash+)
    - Increase the odds of improving performance relative to benchmark by not benchmarking investment decisions against suggested outcomes [the consultant is able to report better relative performance as risky assets are now being measured against cash, or cash+]
3. Impact on reporting by LGPS:
    - Performance relative to benchmark overstated by approximately 0.5% per annum (£5.1 billion)[8] despite overall investment performance having been reduced, downside risk increased
    - Real impact of investment decisions and recommendation not being measured or reported

[7] http://www.thepensionsregulator.gov.uk/guidance/guidance-trustee-knowledge-and-understanding.aspx
[8] Net Present Value over 10 years, calculated based on historic assets and adjusted by the Retail Price Index – see Table 2 overleaf

The extract below is from another local authority challenging this practise all the way back in 2008:

> *"…the majority of funds appear to benchmark most alternative asset classes against a cash, or gilt based, return – seemingly an inappropriate choice given additional volatility and substantially higher fees that tend to apply in this area. In simple terms, why accept these unless you are seeking to significantly improve upon a 'risk-free' return?"*[9]

This poor practise has a serious negative impact on investment governance. The provision of misleading performance metrics raises important professional and ethical questions. It also undermines basic performance assessment principles and leads to excess incentive fees being paid to investment managers.

It is staggering to see how LPGS are measuring the performance of the managers of their assets in alternatives. In particular, the latest pitch has been to encourage schemes into Diversified Growth Funds ("DGF's"), with the promise of "equity-like returns, but with less risk". These funds should as a minimum be benchmarked against an appropriate equity index (or percentage of equity index, such as 70% x FTSE 100 equity index returns plus 30% fixed income returns) rather than a cash-like benchmark.

Table 1: Percentage of LGPS assets in alternatives, measured against cash-like benchmarks, but expecting equity-like returns

Asset Classes and Cash Benchmarks	2013 Asset Allocation*	Benchmark type (%)		
		Cash	Cash +	Total Cash-like Benchmarks
Private Equity	2.4%	22%	5%	27%
Infrastructure	1.2%	43%	47%	90%
Diversified Growth Funds ("DGF's")	4.3%	45%	55%	100%
Hedge Funds etc.	3.6%	73%	27%	100%
Estimated assets by benchmark type (in percent)	**11.5%**	**5.6%**	**4.0%**	**9.6%**
Estimated assets by benchmark type (in £)	**£23.9bn**	**£11.7bn**	**£8.4bn**	**£20.1bn**

*Average across all LGPS as reported on 31st March 2013

Table 1 summarises the use of benchmarks for alternative assets in LGPS as at 31st March 2013. We find a total of £20.1 billion in alternative assets being benchmarked inappropriately. 100% of DGF's, 100% of hedge funds and 90% of infrastructure funds are being benchmarked against cash-like benchmarks , which seriously understates the risk of these assets and the returns being expected by schemes.

There is an impact on schemes for reducing their benchmarks, which can be defined in monetary terms. This impact is shown below in Table 2. We estimate that the use of cash-like benchmarks has reduced the expected benchmark returns by 0.5% (or £1.1 billion) per annum across the aggregate of all LGPS.

Table 2: Reduction in LGPS benchmark returns as a result of using cash-like benchmarks

Investment Proposition **Based on 10 years ending 31st March 2013**	**Per Annum (%)**	**Per Annum (Amount)**
A1: Alternatives produce the same (or higher) return as equities but with two thirds of the risk	-0.6%	**£1.3bn**
A2: Alternatives produce about 80% of the return of equities but with one third of the risk	-0.4%	**£0.8bn**
Average of A1 + A2	**-0.5%**	**£1.1bn**

Since 2008, the allocation to alternatives has increased and the performance of equities relative to cash has varied. However the same methodology to arrive at the £1.1 billion in Table 2 for the last year can be used for the previous 10 years and converted into a net present value ("NPV"). We estimate that this NPV

[9] Richmond.gov.uk: Pension Fund Committee, September 2008, Agenda Item 4e, p4 "Investment Performance Review 2007/08"

amounts to £5.1 billion, which has been calculated by applying the average annual impact to reported historic alternatives allocation, adjusted by RPI.

Reducing benchmark returns (to artificially flatter the reported performance relative to benchmark) does not in itself lower overall fund performance. However as we saw in Figure 1, the alternative investments recommended to LGPS did not produce equity-like returns. **Overall LGPS performance was therefore reduced by £5.1 billion in today's money but this impact was not reported by the Schemes**. This estimate does not include the cost of excess performance fees paid to alternative investment managers, due to the use of artificially low hurdle rates for the purpose of calculating performance fees.

Finally we note that the ability to reduce the reported benchmarks without detection, is made possible only because Schemes are not reporting the performance of asset allocation decisions (i.e. benchmark changes) as required by Myners.

Money doctor or quack?

We must finally ask why Investment consultants come up with these kinds of performance assumptions and benchmark recommendations, which do not stand up to basic scrutiny. One explanation might be that they do not themselves understand behavioural finance, or the investment products that they promote to clients. Another possible explanation is that the assumptions are designed to encourage portfolio churn which supports revenue generation via the provision of manager selection and asset allocation advice.

A typical transition from equities to alternative managers requires the selection of between three and five additional managers, and subsequent monitoring. This is good business for the investment consultants, however, as the data have shown, it is has not been so good for their LGPS clients or the taxpayer.

Conclusion:

LGPS regulations require administering authorities to take 'proper advice' when making investment decisions. However there does not appear to be anything 'proper' about the misleading risk and return assumptions used by some consultants to promote alternative investments to their LGPS clients. Instead CLERUS' review revealed that the performance assumptions used in 'asset-liability simulations' stands in stark contrast to the real life track-record experienced by pension funds in the UK and elsewhere.

At the same time, the report also questions the integrity of the benchmarks used to assess alternative managers. These appear to be set artificially low – versus the original performance assumptions – so as to flatter reported performance relative to benchmark by more than £5bn over the past 10 years across all schemes. However this 'accounting trick' makes proper performance assessment of alternative managers impossible and will typically lead to excess (performance) fees being paid by the individual scheme.

According to the Hymans study commissioned by Department of Communities and Local Government (DCLG) and in the event that the DCLG reform proposals are carried through, it would leave LGPS paying £301 million of annual fees, and 58% of total fees, to an 11.5% allocation to alternative investments (see Table 1). However, as the data have shown, these alternative investments have historically provided lower return than either bonds or equities, and were achievable by simple de-risking (see Figure 1). As previously argued, this leaves a huge governance deficit in particular as our review concludes that the investment advice provided in the area of alternative investments to LGPS does not stand up to basic scrutiny.

We recommend that local authorities take urgent steps to improve their investment governance by setting up a process to scrutinise new investment propositions generated by their advisors, and to evaluate existing performance benchmarks – if necessary, with the assistance of independent and qualified professionals.

Universe and data summary:

- 99 Local Government Pension Schemes in England, Scotland and Wales
- £208 billion in LGPS assets as at 31st March 2013
- Data sources: public data (annual reports, council committee minutes, etc.) going back 10 years
- Performance Data: 10 years (58 funds / 70% of Assets) and 5 years (73 funds / 84% of Assets)

Important Information:

4th Floor, Rex House, 4-12 Regent Street, London SW1Y 4PE, United Kingdom
E: henrik.pedersen@clerus.co.uk | T: +44 20 3356 2845 | M: +44 77 6765 6234
E: richard.rothwell@clerus.co.uk | T: +44 20 3356 2845 | M: +44 77 1433 9939
W: www.clerus.co.uk