

# The *Ambachtsheer* Letter

*Research and Commentary on Pension Governance, Finance and Investments*

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## U.S. PENSION FUND PERFORMANCE 1996-2000:

### WHAT'S THE REAL STORY?

*"What gets measured, gets managed".*

Anon?

#### Who Said It First?

"What gets measured, gets managed" is one of those dictums with a very high punch-per-word ratio. We first saw it as part of the logo of Stern-Steward, the New York-based corporate performance measurement firm that popularized EVA (economic value-added). However, where did they get it? It sounds like a classic Peter Druckerism, but we don't know if the great man was the first to utter the words.

The message of the dictum is obvious. In a world of agents and principals, the principals need to know how well the organization is being run on their behalf. Thus they need performance measurement. Likely, if performance is 'good', the agents will be rewarded. Conversely, 'bad' performance will ultimately have negative consequences for the agents. Thus it is how performance is measured that determines agent behaviour. The principals better hope that what is being measured is important to them.

#### The Evolution of Pension Fund Performance Measurement

In this context, we don't think that pension fund principals have been particularly lucky these past 30 years. It has taken a long time to develop a performance measurement discipline that meas-

ures results in a framework that reflects their interests. This *LETTER* traces the evolution of pension fund performance measurement by examining the behaviour of 156 U.S. pension funds with an aggregate value of \$1.9T in December 2000. Most of the focus will be on the 89 funds (\$1.3T) for which the performance measurement firm *Cost Effectiveness Measurement Inc. (CEM)* has 5 continuous years (1996-2000) of data.

We start by reporting the gross returns of these funds. For decades, with the returns neatly sorted into quartiles, that's pretty well all pension fund fiduciaries got see. The rule was simple: first quartile is 'good', fourth quartile is 'bad'. Then, eventually, the idea developed that it was useful to split total fund return into its 'policy' and 'implementation' components. Another idea that eventually took hold is that costs matter, leading to the calculation of 'net' returns.

It wasn't until very recently the really big idea surfaced that only performance relative to liability requirements ultimately matters to pension fund principals. Below we show how 'the performance story' changes depending on how 'performance' is measured. Specifically, we show that by introducing concepts such as 'asset mix policy', 'operating costs', and 'liability returns', the original '4-quartile horse race' story loses its relevance, and the real story emerges.