

The Ambachtsheer Letter

Research and Commentary on Pension Governance, Finance and Investments

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MEASURING WHAT PENSION FUNDS SHOULD MANAGE:

FINDINGS FROM THE CEM DATABASE

*“If you can measure it, you can control it
If you can control it, you can change it.”*

-B.F. Skinner

Measuring What Should Be Managed

Some critics think that behavioral psychologist B.F. Skinner’s fervent belief in measurement as a self-improvement tool was a little overdone. Few people, however, dispute the relevance and power of management philosopher Peter Drucker’s aphorism that in organizations, “what gets measured gets managed”. How should we apply Drucker’s dictum to the management of pension funds? We address that question in this *Letter*.

Drucker’s dictum immediately confronts pension fund governors and managers with two important questions: (1) what is the purpose of our organization, and (2) how do we know it is achieving that purpose as well as can be done? The broad answer to the first question might be ‘to convert retirement savings into post-work income’. The second question prompts a further question: what is a reasonable performance standard against which to evaluate how well that purpose is being achieved? Stating the obvious, meaningful performance measurement requires an operationally-useful answer to this latter question as well.

This *Letter* asserts that converting retirement savings into post-work income requires doing two things well: (1) investing the accumulated retirement savings and (2) paying out the right pension amounts to the right people, on time. Some pension organizations only do the first, others only do the second, many do both. Again, stating the obvious, the pension investment and the pension administration functions should each be subjected to

its own well-structured performance measurement discipline.

Measuring What Should Be Managed in Investments

Whether stated explicitly or understood implicitly, every financial asset pool has a purpose (i.e., an explicit or implicit set of future payment obligations or liabilities). Further, there are always lower- and higher-risk strategies that could achieve that purpose. This reality translates directly into two key investment performance measurement questions that should be posed regularly: (1) what return is our lowest-risk fit-for-purpose strategy producing? and (2): if a higher-risk strategy is chosen, what mismatch risk is being undertaken, and what incremental payoff is this higher-risk strategy producing? Implicit in these questions must be the recognition that the measured returns should be net of the costs required to produce them.

Through the services of *CEM Benchmarking Inc.*, some four-hundred asset pools from around the world aggregating to some \$5 trillion are now in a position to answer these kinds of questions on a regular basis. Table 1, for example, sets out the average gross fund return, the matching average lowest-risk fit-for-purpose strategy return, and the annualized volatility between the two return strategies for the asset pools in the database with complete 2004-2008 five-year histories. The table uses a simple label of *liability return* for lowest-risk fit-for-purpose strategy return. Stated in