



COST OR COST-EFFECTIVENESS:

WHICH DRIVES PENSION PLAN PERFORMANCE?

“Information is data endowed with relevance and purpose.”

Peter Drucker

Disclosing Costs

Legislators and regulators around the world have finally discovered that costs in pension plan management matter. The fact that an additional 100 basis points in annual pension fund costs can reduce ultimate pensions by 20% is sinking in. So, appropriately, there are now moves towards developing a global standard for cost disclosure.

For example, the Cooper Review has recommended a more thorough approach to cost disclosure for Australian superannuation funds. The U.S. Department of Labor now requires disclosure of 401(k) plan costs. Costs have been a big issue in the design of the new National Employment Savings Trust (NEST) in the UK. Cost disclosure is an anticipated requirement for Canada's new Pooled Registered Pension Plans. The Dutch have been debating pension cost disclosure in their usual thorough way for some time now, with agreement on a national disclosure protocol imminent.

In that context, this *Letter* is about pensions costs and how they are best measured and disclosed. However, as the title above indicates, the *Letter* also warns that costs are only half the story in the management of pension plans. We also need to measure the value (or lack of it) that these expenditures are producing. In other words, cost-effectiveness metrics offer a more holistic view of how well pension organizations are serving plan

participants. Further, these metrics should be calculated separately for the two distinct functions of pension organizations: investing and benefit administration.

Investment Costs

From a pension fund perspective, investment costs fall into three broad categories. They are, in order of measurement difficulty: investment oversight/administrative, investment management, and transactions-related:

- Investment oversight/administrative costs are either fully incurred inside the pension organization, or are outsourced to outside providers through contracts that stipulate the fees to be paid.
- Investment management costs may also be incurred inside the pension organization, or paid out to outside investment managers. A complication here is performance-based fees, which are typically an important cost element in hedge fund and private markets investment mandates. Capturing these fee components and allocating them to specific strategies and measurement periods offer serious measurement challenges.
- Transaction costs are the most difficult to measure because explicit brokerage fees are typically only part of the transaction cost story. Often, the real transaction cost story lies in understanding the bid-ask spread for the