Investment governance

Market observations of investment models for defined benefit pension and endowment trusts

Challenges faced by plan sponsors

The last few years have seen investment markets face various challenges, requiring pension plan sponsors to closely monitor and attend to their defined benefit (DB) portfolios. The risks to investment markets have arisen from divergent sources — economic, geopolitical and natural — affecting every asset class. Navigating choppy markets has required pension plans to bring in a wide range of investment professionals and dedicate sufficient time to be able to manage risks and take advantage of new market opportunities.

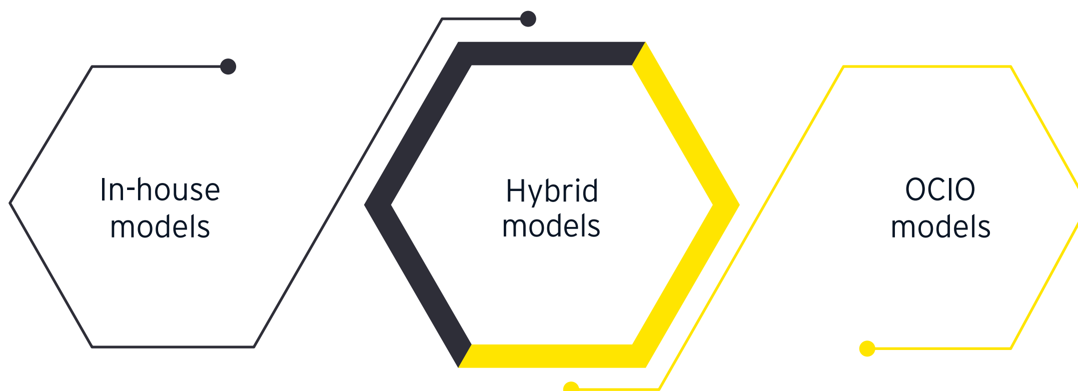
Generally, one of the best ways of increasing the investment governance has been for pension plans to employ different investment professionals, who can act nimbly and manage the portfolio on a daily basis. This type of in-house operating model has worked particularly well with properly resourced teams that have also been able to evolve their governance structure to match the pension plan's particular needs and the changes in investment markets.

There is no one-size-fits-all investment operating model for pension plan sponsors; the "perfect" investment governance model is inevitably going to face various limitations, and your thinking therefore needs to allow for the best model that can be achieved in light of these restrictions. Many plan sponsors are looking to increase their awareness across the spectrum of investment operating models and potentially evaluate the effectiveness of their current model. Often, such evaluation serves as confirmation to company leadership and board members regarding the effectiveness of the current model.

However, for some, change is necessary in situations where it can be difficult for sponsors to build a sustainable, large investment team within a specified cost budget and attract the talent that is needed to navigate changing investment markets. In recent years, the US has seen an increase in the number of credible outsourced chief investment officer (OCIO) solutions. The role of the OCIO is to provide dedicated, specialist investment skill that the plan sponsor can leverage to manage their investment risk and return objectives. A growing number of plan sponsors have found this type of third-party arrangement beneficial to reduce the strain of investment talent acquisition (without facing key person risk), while providing the benefits of economies of scale and specialist investment knowledge.

Historically, smaller plans had more reason to appoint an OCIO — the cost of a large investment operation was prohibitive for small asset pools. But with recent public announcements of large US pension plans, this also may be changing. While an OCIO model might not be the most appropriate model for all companies, these appointments could create pressure for investment management leaders to validate their current models.

The two models below cover the far ends of the spectrum of investment operating models that we see today with US pension plans. In between these two are many varieties that are curated specifically for the context and circumstances of each plan sponsor. In the following sections of this article, we'll outline the various characteristics of the main investment operating models we see today, as well as considerations for plan sponsors in selecting a model.



Investment operating model types

In-house operating model

This model maintains the pension investment work within the company and is by far the most common investment operating model we see utilized among large US pension plan sponsors. The key drivers behind the implementation of these models are:

Speed of implementation

With increasing complexity in investment markets, asset managers see value in capitalizing on favorable market opportunities swiftly and effectively. With an in-house pension investment team, there are few communication lags between plan sponsor and investment team, allowing for the investment implementation to respond to the plan's and sponsor's strategy quickly.

Transparency of decision-making

Plan sponsors also appreciate in-house investment operating models because of the transparency it brings. Proper governance structure and reporting process can help management have clear sight of investment actions taken, as well as the associated costs involved with the investment management.

Flexibility and control

With an internal investment operating model, the plan sponsor can properly monitor and manage the pension plan investments and modify or veto strategies as they see fit. This allows the sponsor to support proper integration between plan design, administration and investment functions, and can ultimately help to confirm that fiduciary responsibilities are being fulfilled.

Outsourcing considerations

With so much focus on in-house models, it is intriguing to understand and evaluate the benefits of giving up control on execution of investment strategy to a third party. The key point is that an OCIO can relieve sponsors of the day-to-day tasks associated with managing investments, whether that be tasks involved with longer-term decisions, such as portfolio construction, or shorter-term and often time-consuming investment execution tasks. Freeing up these resources allows company staff to focus their efforts on the company's core operations, especially for plan sponsors whose pension strategy includes winding down their programs and transferring retiree annuity streams to a third-party insurer.

Delegation of investment to OCIOs has seen huge growth in recent years. From 2017 to 2022, OCIO service providers have more than doubled their assets under management (AUM) for DB pension plans globally, from ~US $529b to ~US $1.1t based on the 2022 Outsourced-Chief Investment Officer Survey. With the average AUM for the top five in the space increasing at the same rate from
~US $67b to ~US $132b over that same span of time.[1]

On a worldwide scale, OCIO expansion has been evident for some years. In the US, we are now seeing the number of players in this space increase, while the large, established firms continue to increase their capabilities to suit a wider range of investment preferences.

[1] https://www.ai-cio.com/surveys/2022-outsourced-chief-investment-officer-survey/.

Hybrid models

Situated between an in-house and a fully outsourced investment operating model, are a vast multitude of hybrid approaches that utilize different aspects of the spectrum ends. The blending of such models depends on the wants and needs of a plan sponsor.

One such type of model is one where a third party is contracted in an investment advisor role. The Employee Retirement Income Security Act of 1974 (ERISA) defines this type of arrangement as a 3(21) fiduciary, where the third-party investment professional provides guidance and recommendations to the plan sponsor, however, the sponsor has final authority on investment decisions to be made with the trust. This is different to the OCIO model, which falls under the category of an ERISA 3(38) fiduciary, in which there is a transfer of decision-making responsibilities from the plan sponsor to the investment professional.

With a 3(21) fiduciary arrangement, the plan sponsor can benefit from the control, flexibility and efficiency of an in-house model while still benefitting from the specialist investment knowledge that you would get from an OCIO in an outsourced model.

Another such model is a partially outsourced model, where the plan sponsor outsources a portion of the pension assets while managing the other portion in-house, particularly for certain risk-seeking assets that are more difficult to source and evaluate.

There are numerous variations of these models that can help the plan sponsor maximize risk-adjusted return while maintaining proper investment governance.

More operating model considerations

So far, we've described general advantages we have observed in using the variety of retirement investment operating models and why pension plan sponsors have implemented them. In addition to those advantages, there are specialized reasons or goals that may lead a plan sponsor to find one of the models more favorable than another.

Alternative investment observations

The value of diversification and left-tail risk management has been exceptionally valuable in every market downturn. Plan sponsors have less tolerance to withstand shocks in these downturns and are increasingly looking to alternative assets as a way of managing volatility.

Unhelpfully, many alternative assets are very heterogeneous and require multiple specialist skills to source and research. Some in-house teams have managed to hire dedicated talent and build teams that focus on these.

For some sponsors, and particularly plans with less than US $1b in assets, it is difficult to find the required talent. Others face the risk of losing key talent, or the time frame required to make the investment may be too short to justify an external hire. Outsourcing can help with the implementation of the portfolio, allowing investment committees to focus on strategic decision-making.

Seeking alpha

When faced with large pension deficits, plan sponsors have sought investment expertise to source and diversify alpha. Contracting an OCIO for this work can be beneficial, and we have observed that they could provide the following:

- Access to their broad knowledge of capital markets
- Access to specialist investment managers and products
- The benefits of economies of scale to negotiate underlying investment management fees

ESG and DEI implementation

There is now greater consideration of environmental, social and governance (ESG) and diversity, equity and inclusion (DEI) factors and how they can be integrated into pension plan systems. Plan sponsors are increasingly trying to put themselves at the forefront of these conversations. They are looking to achieve a strong commitment to ESG and DEI principles and would like to incorporate the management of such strategies within their portfolios. There are no historical precedents for doing this, particularly as ESG risks are much harder to quantify, and DEI commitments have only in recent years gained considerable traction. In addition, it is widely acknowledged that management of these risks will require significant collaboration between asset owners and asset managers. In theory, OCIOs are positioned well to manage these risks and help drive investors' collective ESG and DEI ambitions.

ERISA considerations

Under ERISA, plan fiduciaries are required to make decisions in the best interest of the plan participants and beneficiaries. Any changes in investment model, investment managers and asset allocation must be done with careful consideration and proper due diligence.

A transition in between the spectrum of investment models requires not only a robust process of selection, but a careful selection and a commitment to a thorough transition.

Conclusion

The requirement for managing pension investment risk is changing rapidly. Relying on models and relatively static investment strategies may no longer be ideal, as the economic environment appears to be going from one crisis to another — where each crisis is different to the last. With that in mind, there has never been a better time to evaluate a pension plan's governance, and implementing an investment governance model that is future-fit and aims for the best opportunity of success in the future.

Contacts

Please contact us if you would like to know more on how we can support you in your investment governance strategy ambitions!

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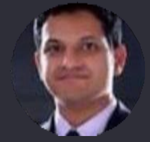

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