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Red Paper - Investment Scorecard

A key factor in good fund governance



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Fund Objectives – An Updated Approach

Traditional Approach has Drawbacks

Fund governance has been a topic that has been the subject of significant debate and discussion recently. Certainly, many consultants and academics are increasingly of the view that good (or great) fund governance can provide a strong platform for the delivery of superior risk-adjusted performance.

Although the role that the setting of fund objectives might have in a strong governance regime has been raised in the debate, objectives often remain fairly imprecise, standardised and generally targeted at matching long-term peer or CPI+ returns. At the same time, funds often have implicit objectives, such as downside risk, that are never clearly expressed or quantified, but are often measured as part of the monitoring function.

A recent academic paper written by Clarke (Oxford University) and Unwin (Watson Wyatt), identifies 5 major challenges that funds with good (or great) governance frameworks believe they face. One of those challenges was called “Alignment with a Clear Mission”. In the words of Watson Wyatt, this can be described as such:

“Institutional funds have difficulty with their mission. A particular complication for pension funds is their shared purpose. The role of a pension fund is to produce value propositions for both members and sponsors, but sometimes it is difficult to satisfy both needs. A clear statement of goals is an important step to building alignment between the parties, so that the appropriate investment risk profile and strategy can be identified. Best-practice funds tend to have not only a clear primary objective, but also a number of defined secondary objectives that enable all parties to match operational goals with the mission.”¹

Most importantly, mis-specification of all fund objectives is likely to increase the probability of not meeting the fund’s true objectives. As a result, trustees may be generally unhappy with performance results, even when stated objectives are met.

The correct specification of objectives, therefore, is absolutely critical in ensuring investment policy is correctly designed to provide the highest probability of meeting those objectives.

The QIC Approach

In recognition of this important issue, QIC has adopted an ‘Investment Scorecard’ approach with a number of multi-sector clients and will be introducing the concept in due course to clients in our multi-sector funds.

An Investment Scorecard provides the trustee, in consultation with QIC, with the opportunity to specify multiple, prioritised and sometimes conflicting, goals for the Fund. This allows the client to express and quantify all objectives explicitly.

In conjunction with the client, a range of various levels or ‘hurdles’ for each priority, which represent Excellent, Good, Poor or Fail levels are also specified.

Once a draft Investment Scorecard is completed, the multi-sector manager or consultant is able to provide clients with a number of proposed investment portfolios, which might trade-off the probabilities of meeting various priorities. In this way, both proposed objectives and investment portfolios can be varied in order to find a suitable portfolio which is most likely to meet important objectives.

¹ Best Practice Investment Governance – Going from good to great, Watson Wyatt Worldwide 2008.

A typical, simplistic (and incomplete) example appears below.

Investment Scorecard Objectives					Priority
	Excellent	Good	Poor	Fail	
Probability of CPI + x% over rolling periods					1
Fees					1
Probability of negative returns					2
					2

Practical Benefits

The adoption of the Investment Scorecard approach has proven to provide a number of improvements over the traditional approach to objective setting.

The Scorecard provides a framework in which investment policy can be objectively evaluated. Potential asset allocation changes, investment opportunities, changes in market pricing and other issues in the context of how Fund objectives are affected can be assessed and evaluated.

In particular, the development and implementation of Investment Scorecards allows:

- trustees and other interested parties to carefully enunciate a fund’s true objectives, regardless of the number or inconsistencies, and prioritize them,
- the Scorecard to become an important piece in a good governance framework, by building clear alignment of goals between trustees and investment staff,
- the ability to move away from optimization or backward looking approach to investment policy setting to a more forward looking approach,
- a fund’s investment professionals and consultants the ability to explicitly link investment policy with objectives, and provides a platform to illustrate how changes in investment policy can be impact the probability of meeting each Fund objective,
- the success of the investment process to more easily measured and therefore becomes more transparent and accountable,
- as a result, a Fund is likely to experience an increased probability of reaching objectives by explicitly managing to them.

Potential Challenges

One of the most important challenges that may arise as a result of the Scorecard approach is the recognition that objectives, particular Priority 1 objectives, may not be achievable.

For example, there may be times when expected returns from assets are so weak that the ability to generate a CPI+4% return over the next 3 or 5 years is very challenging, regardless of investment policy.

This may particularly be the case after a period of strong returns from markets or during a recessionary period.

The recognition that failure of an objective is fairly likely is not only unpleasant for fund staff, consultants, trustees and members, but there may be some considerations with respect to fiduciary and regulatory responsibilities.

Nonetheless, being aware of future potential returns must surely demonstrate a higher commitment to fiduciary responsibilities than blindly accepting long term past returns as a guide to the future.

To QIC, this is one of the most important challenges that the adoption of a forward looking Investment Scorecard approach has raised, and we look to discussing potential solutions.

For further details, please contact your QIC Relationship Manager.

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