HEALTH WEALTH CAREER

ESTABLISHING MORE MEANINGFUL VALUE ADDED TARGETS

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Most investors continue to believe in active management in most asset classes. However, one's conviction may be challenged when value added targets are not met and next steps are unclear. This dilemma can lead to a number of difficult questions:

1. Should the manager be fired for missing the target?
2. Should we wait for performance to improve?
3. Should we probe and challenge the manager with more detailed questions?
4. Was the performance target reasonable?
5. Would other managers have achieved our performance target?

In general, value added targets represent the additional levels of return, over and above a passive benchmark, that an investment manager is expected to contribute. For example, a Canadian Equity manager may have a value added target of 200 basis points above their benchmark (i.e., S&P/TSX Capped Composite). This means that the manager, based on their investment decision-making research and portfolio construction processes, capital markets experience, or any proprietary insights, anticipate providing an average annualized return of 2% over and above the market index benchmark (or the return from a passively managed index fund). By industry convention, value added targets are typically assessed over rolling 4-year periods and before investment management fees so it is important that such targets consider the level of fees paid. We expand on this point later.

ARTICULATING THE PURPOSE OF VALUE ADDED TARGETS

Before setting value added targets, investors should first define their purpose. We suggest identifying targets with two distinct purposes: *minimum acceptable* and *aspirational*. Some investors may prefer a single "best-estimate" target which may lie between these two targets.

MINIMUM ACCEPTABLE

A "minimum acceptable" target is a threshold at which some action would be taken if the performance target is not achieved over an appropriate time horizon. Falling short of the "minimum acceptable" target often means that the manager is losing value on a net-of-fee basis. Possible courses of action are discussed at the end of this paper.

ASPIRATIONAL

Aspirational targets are a set of more aggressive stretch objectives that a manager should strive for, but with the reasonable expectation that there is a lower probability of achieving. Interestingly, the performance targets specified by many investment managers in their marketing literature are notably higher than what may be considered to be appropriate aspirational value added targets. Articulating manager value added targets as aspirational can help facilitate communication and better manage expectations amongst stakeholders. Investors may need to occasionally ask their manager to reaffirm or revise their value added targets to ensure expectations are aligned.

FRAMEWORK FOR DETERMINING APPROPRIATE VALUE ADDED TARGETS

Once the purpose of the value added targets has been determined, the appropriate level needs to be defined. Targets will vary depending on the asset class under consideration and the risk and fees associated with each fund.

The following approaches may be used to define appropriate value added targets:

1. Manager performance history against passive benchmarks;
2. Appropriate targets based on the level of active manager risk;
3. The level of active management fees; and
4. Value added targets marketed by the manager.

Each of these approaches is discussed below with regards to Canadian Fixed Income, and Canadian, U.S., International, Global and Emerging Markets Equities.

1. PERFORMANCE HISTORY

While historical returns should not be the sole determinant of value added targets, reviewing past performance helps avoid setting targets that are unachievable or too easily achieved.

The following table summarizes the average rolling 4-year value added, on a monthly moving basis, by the median and 25th percentile managers under different asset classes in comparison with the Mercer Pooled Fund Universe for the past 15 years, from December 31, 2001 to December 31, 2015.

ROLLING 4-YEAR EXCESS RETURNS (ANNUALIZED) December 31, 2001 – December 31, 2015		
ASSET CLASS	AVERAGE VALUE ADDED BY THE MEDIAN MANAGER	AVERAGE VALUE ADDED BY THE 25TH PERCENTILE MANAGER
Fixed Income (FTSE TMX-U)	0.2%	0.4%
Canadian Equity (S&P/TSX Capped)	0.7%	2.4%
US Equity (S&P 500 $CAD)	0.1%	1.8%
International Equity (MSCI EAFE $CAD)	0.6%	2.6%
Global Equity (MSCI World $CAD)	1.0%	2.8%
EM Equities (MSCI EM Free $CAD)	0.7%	2.3%

As may be seen, the median manager has added value across all asset classes, with significant average value added generated over time by the average 25th percentile manager.

As a starting point, we suggest beginning with a minimum acceptable value added target based at or below the median of past performance amongst peer managers within the respective asset classes. Further adjustments may be considered to reflect the level of manager risk and fee levels.

2. VALUE ADDED TARGETS AS A FUNCTION OF MANAGER RISK

Past performance is not necessarily indicative of an appropriate value added target; we believe that value added assumptions should also consider the level of risk taken by a manager.

To establish a risk based value added target, we suggest considering:

1. The expected *Tracking Error* associated with a manager mandate; and
2. An appropriate *Information Ratio* expectation.

Tracking Error is defined as the standard deviation of the difference in returns between a fund and its relevant benchmark. Higher value added expectations may be placed on mandates with higher tracking error since the fund is exposed to higher levels of investment risk relative to a given market benchmark.

Information Ratio measures the average return in excess of a benchmark relative to the amount of unsystematic risk (or Tracking Error) the manager employed to attain performance results.

As a starting point, we would suggest the minimum acceptable value added targets based on the following Information Ratios. Multiplying the targeted Information Ratio by the Expected Tracking Error for a mandate provides a risk-based value added target:

	IMPLIED VALUE ADDED EXPECTATIONS MINIMUM ACCEPTABLE TARGET		
	REASONABLE INFORMATION RATIO	**TYPICAL TRACKING ERROR**	**ESTIMATED MINIMUM ACCEPTABLE TARGET**
Fixed Income	0.10	1.0%	0.10%
Canadian Equity	0.10	5.0%	0.50%
US Large Cap Equity	0.10	5.0%	0.50%
International Equity	0.15	5.0%	0.75%
Global Equity	0.15	5.0%	0.75%
EM Equity	0.20	5.0%	1.00%

3. VALUE ADDED TARGETS AS A FACTOR OF MANAGEMENT FEES

Investors adopt active management with an expectation that they will be compensated for taking active risk. Accordingly, we believe that value added targets should take into consideration the incremental active management fees (i.e., the difference in fees between an active and passive mandate), establishing higher targets where higher incremental fees apply.

Incremental fees typically vary by asset class and by mandate size. We would suggest the following guidelines assuming an asset base of $25 million for a small mandate and $100 million for a larger mandate:

	MULTIPLE OF INCREMENTAL ACTIVE FEES	
	SMALLER MANDATES	LARGER MANDATES
Minimum acceptable	1.5 times	2 times
Aspirational	4.5 times	6 times

Based on median fees for active and passive management taken from Mercer's Pooled Fund Survey as at December 2015, resulting value added targets may be established as follows:

Small mandates ($25M investment)

ASSET CLASS	ANNUALIZED FEES		ESTIMATED VALUE ADDED TARGETS	
	ACTIVE MANDATE	PASSIVE MANDATE	MINIMUM ACCEPTABLE	ASPIRATIONAL
Bond	28 bps	10 bps	27 bps	81 bps
Canadian Equity	39 bps	13 bps	39 bps	117 bps
US Equity	50 bps	13 bps	56 bps	167 bps
International Equity	70 bps	12 bps	87 bps	261 bps
Global Equity[2]	70 bps	13 bps	86 bps	257 bps
EM Equity[2]	95 bps	15 bps	120 bps	360 bps

Larger mandates ($100M investment)

ASSET CLASS	ANNUALIZED FEES		ESTIMATED VALUE ADDED TARGETS	
	ACTIVE MANDATE	PASSIVE MANDATE	MINIMUM ACCEPTABLE	ASPIRATIONAL
Bond	20 bps	7 bps	26 bps	78 bps
Canadian Equity	30 bps	7 bps	46 bps	138 bps
US Equity	44 bps	7 bps	74 bps	222 bps
International Equity	59 bps	10 bps	98 bps	294 bps
Global Equity[2]	59 bps	8 bps	102 bps	306 bps
EM Equity[2]	90 bps	15 bps	150 bps	450 bps

[2] Fees estimates are based upon two global equity and one emerging market equity Canadian-domiciled indexed investment vehicles.

4. MANAGER'S VALUE ADDED TARGETS

Investment managers typically communicate their ability to add value through marketing materials. For investors with limited resources, this may be considered a simpler approach to setting value added targets provided the investment manager is able to furnish qualitative and quantitative data supporting their value added claims. As noted earlier, we find that most managers' communicated performance targets are notably higher than what may be viewed as aspirational targets.

We recommend articulating manager value added targets in the Statement of Investment Policies and Procedures (SIPP) for reference purposes, and labelling them as aspirational to effectively manage expectations of the governing bodies that oversee the management of the plan(s). Based on past experience we believe manager-specified targets are generally difficult to reliably achieve.

ASSESSMENT OF VALUE-ADDED RESULTS

Careful and thoughtful establishment of value-added targets will be very helpful in monitoring investment performance; however, a thorough assessment of a manager based on historical value-added results should also take into account additional considerations. These include the following:

- How well does the benchmark align with the manager's investment style?
- How much of the value-added result was due to the manager's typical style biases (e.g., value bias, small cap bias, no gold exposure, corporate credit bias, etc.), and how much was due to "true" value-added after taking into account investment style?
- Was there anything unique or unusual about the historical time period over which value-added was assessed which might have had an inordinate positive or negative impact on value-added? Might a longer historical time period provide an improved indication of manager skill?
- Was the value-added (or lost) attributable to a number of manager decisions, or was it primarily the result of a single decision, or small number of key investment decisions?

Answers to these questions will provide greater insight into the value-added results and enable investors to better judge the performance of their managers.

SUMMARY

The foregoing discussion lays out a number of important approaches to assist investors in defining appropriate value added targets. It is unlikely that each approach will result in exactly the same target; therefore discretion must be applied at the end of the process to land on a set of value added targets that are appropriate for a given plan.

While value added targets depend on multiple factors, the table below offers general guidance on the minimum acceptable and aspirational targets ranges.

ASSET CLASS	MINIMUM ACCEPTABLE TARGET	ASPIRATIONAL TARGET
Fixed Income	15-30 bps	30-60 bps
Canadian Equity	50-75 bps	150-200 bps
US Large Cap Equity	40-60 bps	100-150 bps
International Equity	75-125 bps	150-250 bps
Global Equity	75-125 bps	150-250 bps
EM Equity	100-150 bps	200-300 bps

We recommend assessing managers against value added targets over at least rolling four year periods.

Where the minimum acceptable target has not been met over a four year period, we suggest that investors commit to completing a thorough due diligence review of the manager's mandate. The scope of the due diligence may depend on the extent of the underperformance, the market environment and related factors – including style factors – that may have contributed to underperformance, along with any manager issues or uncertainties that may have arisen.

Where the minimum acceptable target is not met for six to eight consecutive quarters following the initial due diligence review, we suggest that investors commit to performing further due diligence by assessing other available manager alternatives within the asset class (if they have not already done so).

While underperformance versus value added targets may result in a manager being placed “on watch”, we do not recommend that investors commit to manager termination solely based on performance versus value added targets. Rather, we believe that manager termination should be based on both quantitative and qualitative considerations. Investors should retain the flexibility to retain or replace their manager independent of past performance.

Finally, to increase the value of the overall manager monitoring process, we recommend establishing minimum acceptable targets and documenting aspirational targets within a SIPP. From our perspective, clear communication of manager targets and a commitment to further oversight when targets are not achieved may further increase the likelihood of higher returns on a go-forward basis.

For further information on the content of this article, please contact your Mercer consultant.

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