Monitoring standards

Karen Watkin talks about how to benchmark performance and assess value for money when monitoring default strategies over a 12-month period

How should the trustees of a defined-contribution (DC) scheme assess their default strategy's performance over a 12-month period? Longer-term benchmarking is simple, as default strategies generally aim to beat cash or inflation by a certain margin. That can be fairly measured over five, 10 or 20 years. But appropriate short-term benchmarks are harder to establish.

Equally, it's easy to assess the performance of a strategy's individual components by measuring each against a suitable asset-class benchmark. But taking those benchmarks together won't reflect a key aspect of the overall strategy: the efficacy of its investment design.

Although asset allocation can be measured against a composite benchmark, this fails to hold to account the trustees, consultants and the investment managers who took the decisions behind that asset allocation. If the benchmark mirrors the asset allocation, then the investment design is just being marked against itself – which is pointless.

At AllianceBernstein, we see the glide path design and strategic asset allocation of our target-date funds as vital added value. The best way to measure it is by constructing a simplified market benchmark consisting of equities and bonds. We do not think that this simplified benchmark should mirror the underlying asset allocation, as that will not reflect the risk profile of the strategy.

By constructing a simplified benchmark, we aim to highlight a given strategy's risk profile. This allows the scheme's trustees to assess the investment design's impact and measure the value added through strategic asset allocation. This gives a fair reading of how successful the decisions of trustees, consultants and managers have been.

So, after adopting a simplified benchmark, how do we judge whether the investment design is delivering value for money? An initial step is to evaluate each investment service against its cost. Are any higher costs justified? To decide this, trustees should ask two simple questions. First, could the same outcome be achieved at a lower cost? And, second, could spending more achieve a better outcome?

This helps trustees to determine the quality of the scheme's investment services. But it can still be hard to judge the scope and quality versus investment costs in the context of what else is available in the market. That's because of a lack of transparency regarding the public disclosure of the performance of default strategies – and especially of figures that take all costs into account.

Our recent market review suggested that very few master trusts make full public disclosures of their default strategies' investment performance, net of all costs. Some disclose only their strategic allocation and the performance of its components. Others don't appear to disclose anything.

While recent debate over value for money has centred on costs, that's only half the picture. To answer our second question (could a better outcome be achieved by spending more?), trustees need to assess the investment performance and outcomes of the different options available.

In doing so, trustees should also consider the total costs paid of other services – and the impact these have on members' outcomes. In too many default strategies, the platform or administration charges account for a much higher proportion of members' total costs than the investment services. This is despite the fact that it is the investment performance (net of fees) that will deliver members' outcomes in retirement.

This is partially a legacy practice. Buying decisions for DC schemes are still often led by administrative platforms, with investment decisions restricted to options available on those platforms. This can lead to selection of suboptimal investment strategies and unfair penalisation of asset managers who do not offer bundled services and have to focus on cost rather than value to compete.

Investment design should be the heart of a default strategy. Measuring its performance allows trustees to challenge the decisions that they, their consultants and their investment managers have made on behalf of their members. And a crucial part of that process is measuring value for money for members.

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