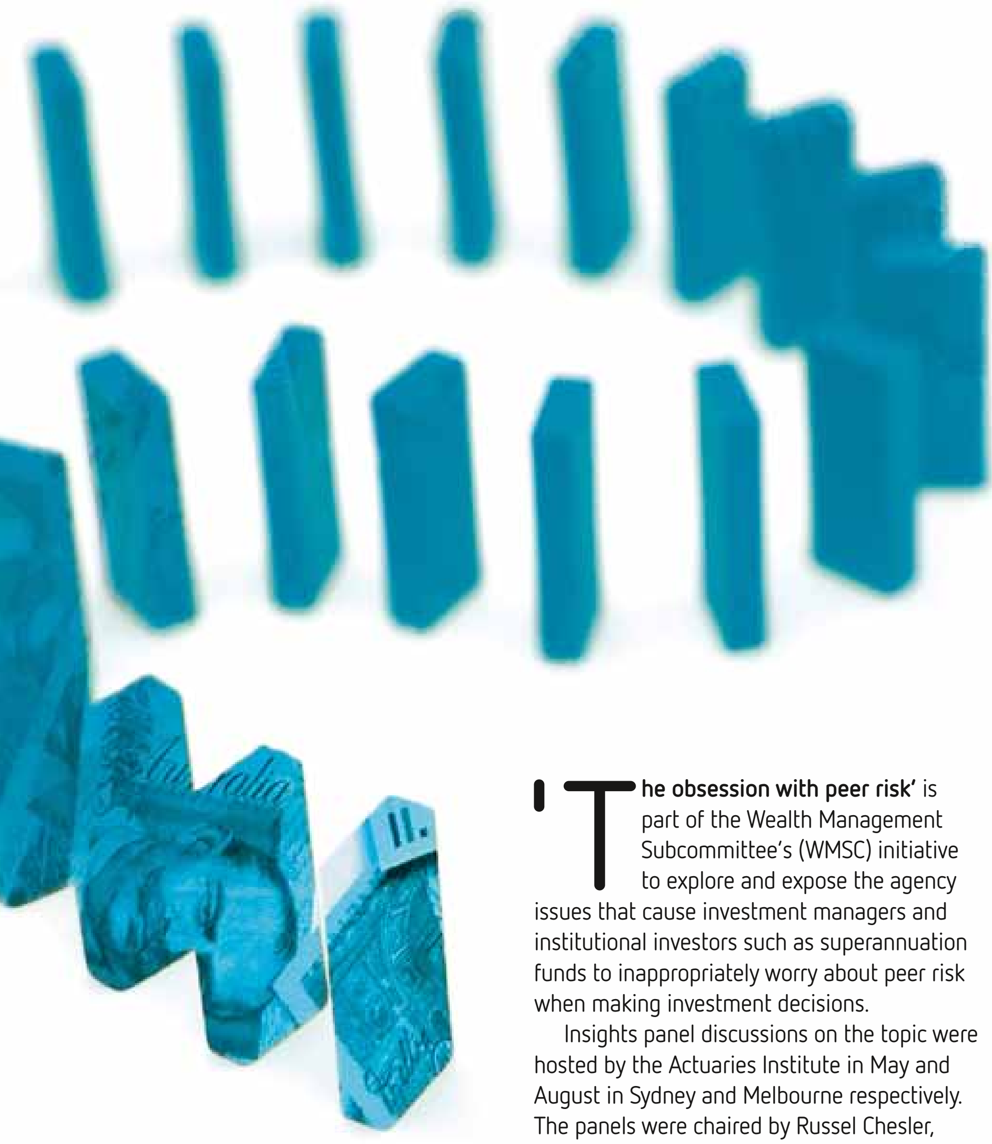
The obsession with peer risk



Update from the Wealth Management Sub-Committee of the Life Insurance and Wealth Practice Committee – a previous article on this topic was published in the May edition of ***Actuaries*** magazine

'The obsession with peer risk' is part of the Wealth Management Subcommittee's (WMSC) initiative to explore and expose the agency issues that cause investment managers and institutional investors such as superannuation funds to inappropriately worry about peer risk when making investment decisions.

Insights panel discussions on the topic were hosted by the Actuaries Institute in May and August in Sydney and Melbourne respectively. The panels were chaired by Russel Chesler, Executive Director, Sunstone Partners and panel members included:

- **Chris Condon,** Principal, Chris Condon Financial Services
- **Jack Gray,** Adjunct Professor, Centre for Capital Market Dysfunctionality, University of Technology and Director, Brookvine
- **Alistair Barker,** Investment Manager, AustralianSuper
- **Jeff Bresnahan,** Chairman, SuperRatings
- **Brett Elvish,** Founder, Financial Viewpoint

Both sessions were well attended by both actuaries and guests and the feedback received on each session was very positive. A summary of the key themes raised by the panel and the audience follows.

FUND MANAGER BUSINESS RISK

The panel discussed the issues faced by fund managers that periods of short-to-medium term underperformance can result in 'business risk' from clients terminating mandates. It was considered that this generates considerable agency risk. It was suggested that it takes 'moral courage' to ignore this risk. An example was given of GMO losing two thirds of its business in the period leading into the tech bubble. Jeremy Grantham was derided by industry commentators and even by some internal staff. It took leadership and enormous courage not to cave into the pressure. The backing by a strong Board is crucial in these times. It is only at times like these that principles are tested and it is rare to find a manager who has that level of courage to tell you to take money back when investment markets are overvalued. If you do, then treasure the relationship.

ASSET ALLOCATION BY SUPERANNUATION FUNDS

Much of the debate during the sessions surrounded the perception that superannuation funds (both retail and industry) held very similar asset allocations and possibly exhibited herding behaviours. The reasons suggested were much the same as those observed above for fund managers, i.e. where decision-makers were more concerned with business risk (or career risk) than with the investment outcomes for members.

But the panels did not form a consensus as to whether this perception was accurate. Jeff Bresnahan of SuperRatings mentioned evidence that suggested that asset allocations were quite different. Is this indeed the case? How and where is it occurring? Are members better off? Is the industry better off?

There was also much discussion about the extent to which superannuation funds were adjusting asset allocation in the face of changing market conditions. Most returns of diversified funds have struggled to match returns available from cash, even over quite long periods. Would a more aggressive approach to changing asset allocation have helped? Did peer-obsession hold funds back from making such adjustments? Or is this much harder to do in real time than Harry Hindsight would have you think? What skills are needed to do this? And, is it realistic to think that superannuation trustee boards can exhibit them? These, and more, questions are suggested for future research.

The growth of self-managed superannuation funds (SMSFs) was also discussed. Peer risk plays a very different role (if any) for SMSFs. This aspect was only briefly mentioned, but does raise questions such as: What has been the experience of SMSFs (based on evidence, not anecdote)? How much of this is due to luck and conservatism? Can institutional investors learn from how SMSFs make asset allocation decisions?

OPTIMAL NUMBER OF INDUSTRY SUPER FUNDS

There are currently around 100 Industry Superfunds. Some of the panel were of the view that this number is not optimal and the current consolidation in the market will continue. One member even suggested that we should only have two default funds like Sweden, or one as is the case in Canada. This is based on the premise that the membership base is reasonably common across all funds and that members have very similar requirements. There is no logical reason why a health worker should have different super and investment requirements to construction workers. The more moderate view is that the Super Fund arena will look more like the banking and insurance sector in the next five to 10 years with six to eight main players, together with some niche specialist funds. An example of a specialist fund that could emerge is a pre and post-retirement fund aimed at members who are 50 and over. On the other hand, the view was expressed that a vibrant evolution of ideas requires many agents acting independently and in competition.

No consensus was reached in the sessions, other than perhaps the view that if peer-obsession is truly pervasive, then the arguments in favour of consolidation are powerful.

PRACTICAL THINGS BOARDS AND INVESTMENT COMMITTEES CAN DO TO MITIGATE THE STRONG FOCUS ON PEER RISK

Take a step back and don't forget the key long-term objective. Too much focus on the short-term returns is a distraction. Always ask the question – are we tracking to our long-term objectives and, if not are we happy to hold or close our position? This requires an element of courage and conviction.

Courage is needed in order to look beyond agency costs which can influence investment decisions. For example, temporary under-performance can lead to members leaving the fund, which in turn influences investment decisions even though the chosen investment strategy may outperform over the longer term. Should a not-for-profit fund be concerned about losing impatient members, or doing the right thing for those members who stay?

In practice it is also important for the CIO and Trustees to take control of the agenda to make sure the right questions are asked. Research has shown that the amount of time a committee spends on a decision is in reverse proportion to the complexity. It is necessary to understand what the key issues and decisions are, and what should be addressed at a trustee governance level, and what should be delegated to management. Ultimately governance is around identifying what the key decisions are and how potent they are to investment results.

Trustees should ensure that investment objectives are always measurable and assessable. The panel cited that a recent review found that 300 out of 415 surveyed funds' objectives did not meet these criteria. For example the objective of 'moderate to high return over medium to long-term' is not measurable or easily assessable.

The panel was asked what the optimal size is for an investment committee and what types of people should be on it. The panel suggested that five to six is about right. The key criterion is that they have enough confidence and respect in the other individuals to foster serious conversations. It was suggested that investment committees shouldn't be 'sucked in' to the day-to-day considerations of investment professionals. Instead they should focus on higher level considerations such as the investment logic, investment psychology and economic history. The Board members need to have the right type of character and the right temperament. They can't just be 'ordinary' people – it's not IQ, but a different sort of character that is required.

Helping investment committees and superannuation trustee boards make better decisions may be an area in which the Actuaries Institute can become involved. This is an area that the WMSC will investigate.

NEXT STEPS

The WMSC is currently determining a framework to continue exploring this topic and the wider initiative of agency risk. Members are invited to submit their views and suggestions on this topic to the Institute – ActuariesMag@actuaries.asn.au

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