# Investment

# Critical Reviews

**22nd June 2023**

# Agenda

1. Introduction
2. Regulation and the Code of Practice
3. What should be included in an investment critical review?
4. When should the investment critical review be done?
5. Who should do the investment critical review?
6. How should Trustees proceed?

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# Introduction

- Critical reviews form part of a scheme’s overall system of governance
- However, the format of investment critical reviews is not prescribed
- People will take different views, interpretations and approaches
- The investment critical review process and complexity will differ from scheme to scheme
- In many cases, however, it should be a straightforward process

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# EU (OPS) Regulations 2021
## Chapter 2 – Outsourcing and Investment Management

- Covers the appointment and monitoring of service providers
- States that the arrangement entered into by the Trustees shall not be undertaken in a manner that would:
  - Impair the quality of the system of governance
  - Increase the operational risk to the scheme
- The Trustees should ensure the proper functioning of any activity that is subject of such an arrangement and should monitor the activities of that service provider.

# Pensions Authority Code of Practice
## Investment Contracts and Overseeing Investment Performance

***Section 20 (Outsourcing)***

*For every outsourced activity and engagement of service providers, there must be a written description of the activity, the person undertaking it, and the process for performance review.*

***Section 83***

*There must be a **written contract** in place for each investment manager appointed by the trustees. Details on generic content for outsourcing contracts can be found in paragraph 21.*

***Section 86***

*At the outset…, the trustees must specify in writing how they will define satisfactory performance and must also specify the steps that will be taken in the event that the **performance turns out to be unsatisfactory**.*

***Section 87***

- *Trustees must conduct regular performance reviews and must seek independent advice where appropriate.*
- *Investment performance must be monitored on a quarterly basis and reviews conducted at least once annually. These reviews must evaluate **investment performance** in the light of previously agreed investment objectives, performance benchmarks, investment return targets, and pre-specified levels of risk tolerance where applicable.*

# Quarterly Monitoring and Annual Reviews

- Quarterly monitoring is likely to be a high-level numbers check
- An annual review is likely to be more detailed – particularly for active investment management
  - May involve commentary on the investment manager’s performance relative to benchmark
- These reviews primarily relate to **investment performance**
- Trustees may be in a position to conduct these annual reviews themselves
- Some Trustees groups, however, will seek external advice / support
- If there is an investment consultant in situ, they will likely be best placed to conduct the quarterly / annual review – indeed, this may already be part of their ongoing service to Trustees

# Pensions Authority Code of Practice
## Overseeing Investment Performance – Critical Reviews

***Section 87***

*A critical review is an **in-depth review of an investment service** conducted against the **criteria that were first applied when appointing** the investment manager…. The critical review forms the basis for a decision by the trustees as to whether to retain the current investment manager or consider their replacement.*

*A critical review does not automatically require that the trustees initiate a tender process. Such a process must be initiated, however, if the performance assessment gives rise to substantial issues of concern, including **concerns regarding value for money**.*

*Critical reviews must be conducted at least once every three years (except as noted below), **or earlier if circumstances arise** which suggest that an investment manager's ability to meet their agreed investment mandate is negatively affected or impaired.*

*Based on circumstances existing as the end of the three-year period approaches, the trustees may also **use their discretion to extend the period for critical review** of investment performance to a total of five years. If this is done, the rationale underlying such a decision must be documented and the decision must be **based on clear and relevant information**.*

***Section 88***

*When an incumbent investment manager is retained following a critical review, the trustees must clearly document why they chose this course of action.*

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# What might be involved in an investment critical review

- A critical review is an ***in-depth review of an investment service***….
- ***…..conducted against the criteria that were first applied when appointing the investment manager***
- Performance is definitely still in scope…..
- …but the investment service is broader than just performance
- The investment manager’s credentials and capability are important

# Reviewing the Investment Service

## Credentials & Capability

**Why was the investment manager considered in the first instance?**

Generic information about the firm

## Performance

**What was the investment manager hired to do?**

Customer-specific

# Credentials and Capability

Reputation & Brand

Scale

Investment Philosophy

Depth of Resources

Quality of People

Incorporation of ESG Factors

Compliance & Regulation

Tactical Asset Allocation

Additional Services

# Performance

Investment Performance

Operational Performance

Client Service

Advice & Implementation

Value for Money

# What this might mean in practice

- The Credentials and Capability aspect may be straightforward to address since this may form part of a retainer service provided by the scheme’s investment consultant (assuming they are conducting the critical review)
- The investment consultant would need to have ongoing due diligence or manager research coverage on each of the investment managers
- The Performance aspects can also be led by the investment consultant but some input will be required from the Trustees and their representatives
- So, the critical review does not have to be an onerous exercise
- It is possible, however, that the value-for-money aspect may necessitate some interaction with other investment managers
- More complicated mandates are also likely to require more specialist input from the party conducting the critical review

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# When should the critical review be done?

- The intention is that the critical reviews should form part of the ongoing governance arrangements of the scheme – and must be conducted at least once every three years
- The first review should be completed by April 2024
- The three years, however, can potentially be increased to five years
- The review must be conducted earlier, however, if circumstances arise which suggest that an investment manager's ability to meet their agreed investment mandate is negatively affected or impaired

# When can the period of critical review be extended to five years?

- ***The trustees may use their discretion to extend the period for critical review***
- ***However, ….. the decision must be based on clear and relevant information***
- This may mean that, with limited information, you can determine with a reasonable degree of confidence that the investment manager is performing in line with, or above, expectations
- Possibly in the following circumstances:

| | |
|---|---|
| Single asset class mandate | Performance is clearly in line with target / objective |
| Service delivery is acceptable | Manager’s capability gives no cause for concern |
| The Trustees have some evidence that the pricing is reasonably competitive | |

- These criteria could well be met for many passive mandates
- More likely where there is an independent investment consultant in a retained role

# When can the period of critical review be extended to five years?

- For more complicated investment manager appointments, it may be harder to justify the extension
- For example, where the investment manager's mandate includes one or more of the following:

| |
|---|
| A mandate based on a composite benchmark spanning multiple asset classes |
| High allocation to a variety of growth assets - potentially, actively managed |
| Provision of strategic advice (fullness of the consulting process) |
| Discretion to apply tactical asset allocation |
| Significant de-risking of asset allocation over time |
| Complicated fee structures (rebates / performance-related fees) |

- The Trustees may need to consider whether it is appropriate to defer the critical review where there is no investment consultant or no independent oversight of the investment managers
- Trustees may also wish to consider whether it is appropriate to defer the ***first*** critical review where an investment manager has been in situ for a very long time

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# Who should do the investment critical review?

- In some cases, particularly if there is no investment consultant, the Trustees may seek to complete the critical review themselves
- In most cases, the scheme’s existing investment consultant will be well placed to conduct the critical reviews
- The investment consulting firm should have adequate and recent due diligence on each of the investment managers – covering both their credibility / capability and their performance
- Where there is no investment consultant, or in situations where the investment consultant is connected to the investment manager (for example, in delegated or fiduciary management arrangements), the Trustees may seek to appoint an independent party to conduct the critical review
- In some cases, there may be merit in Trustees appointing a single party to conduct both the investment and administration critical reviews
- For example, for bundled DC solutions where there is one entity providing both services – it will be difficult to split out certain aspects of the services provided and to unbundle the pricing

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# How should Trustees proceed?

- Trustees will need to consider how the critical reviews will be incorporated into the ongoing governance of the scheme
- It may be challenging to allocate time given the other demands on Trustees
- The initial steps might include:
  - Schedule the critical reviews for discussion at a Q3 or Q4 trustee meeting
  - Review the structure / nature of the investment manager mandates to assess the scope of the investment critical review
  - Discuss preference for timing and, if required, consider and document the rationale for deferral
  - Seek input from the scheme's investment consultant
  - Decide whether an independent third-party advisor will be required
- The Trustees should document their approach and process as they go as well as the outcome from the critical review

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