UCRP Peer Comparisons

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It is natural to want to see how UC’s pension has performed in comparison to its peers, especially during periods of volatility and uncertainty. Comparisons are interesting, but are they useful? The Treasurer’s Office offers the following insight into the challenges of comparing of peer performance.

Asset Allocation

Asset allocation, meaning an allocation to markets, not to individual securities, is considered to be the principal determinant of investment returns. It is important to note that peer institutions have widely varying asset allocations due mainly to these two factors: 1) different financial condition (liabilities and funding policies); and 2) different risk tolerances. Comparisons of performance of pension plans with different asset allocations, even over long periods, can be invalid and misleading.

Asset Allocation and Returns

Even in trying to compare funds with “identical” asset allocations, performance results can vary. For instance, funds with inflows (contributions) as well as outflows (benefit payments) have more flexibility and can take more liquidity and market risk. In addition, funds with similar current allocations may have varied returns due to past asset allocation policies and inherent returns.

Finally, two institutions may have an identical percentage allocation to a particular asset class but very different returns due to the age and size (in dollars) of each unique program. This is especially applicable in real estate and private equity. For example, an institution that started a real estate or private equity program 10 years ago could be generating positive returns while an institution with a newer program would be generating negative returns due to the long lead time in seeing returns in the underlying investments.

Peer Group as “Benchmark”

The first type of benchmark, peer group comparisons, has been in place for a long time. But, keep in mind that peer group comparisons are not investable; they are ambiguous; they are not specified in advance; and the composition and source of returns are unknown to all. Therefore, although top-quartile performance (a peer group comparison) is a reasonable and viable investment objective, it is not a fair and appropriate performance evaluation standard. (Source: Thomas Richards, CFA) [Please refer to Appendix: Properties of Valid Benchmarks]
QUALITY OF PEER DATABASES  The following list of quality issues should be kept in mind when utilizing peer comparisons:
- Databases are privately maintained
- Self reporting by institutions results in limited quality control
- Inconsistent reporting of fees (some report gross (excluding fees) returns and some report net (including fees) returns)
- Inconsistent reporting of implicit vs. explicit fees (e.g., private equity)
- Varying number of observations each quarter
- Subsequent restating of returns, but not restating of previous reports
- Data is equal weighted rather than value weighted and obscures real universe

In addition, there are common biases observed in returns databases. Survivorship bias occurs as plans stop reporting and are removed from database. Selection bias and “instant history” bias may also occur. It is also interesting to note that different funds appear in different databases, meaning there is no single, authoritative source. And finally, something as simple as the size of a database can strongly influence percentile rankings. The meaning of a quartile ranking can lose impact when the inter-quartile spread is small.

“NOISE” AND MEASUREMENT  Investment returns are extremely “noisy” statistics and are subject to misinterpretation. In fact, ten year returns do not give a good idea of the value of any one particular portfolio manager. A pitfall in [peer] comparisons is that they invite inaccurate comparisons between institutions that vary depending on the time period being considered. (Source: Professor Robert Anderson, Chair of TFIR)

RELEVANT PERFORMANCE COMPARISONS  Comparisons must consider the structure of investment governance. The Regents approve investment policy and guidelines, asset allocation, benchmarks, and risk budgets. The Office of the Treasurer is responsible for implementing and managing the Regents asset allocation. Once an asset allocation is established, there are several types of relevant performance comparisons addressing the following questions:
- How well did Regents choose the asset allocation strategy?
- How well did Treasurer implement asset allocation?

RELEVANT PERFORMANCE MEASUREMENT  The most relevant measure of the Regents’ choice of asset allocation policy is long term investment returns versus growth of liabilities (adjusted for contribution policy). Performance attribution measures a fund vs. its policy benchmark and thus is a measure of the Treasurer’s implementation decisions. It measures decisions by the Treasurer to under- or over-weight asset classes relative to policy targets, and also decisions in choosing investment strategies, investment management firms, or individual securities. Risk attribution measures where risk was taken and whether returns are earned consistently.

Benchmark comparison information is included in the Investment Performance Summary report provided to the Regents each quarter. The Regents Committee on Investments meeting agendas and materials are on line at: http://www.universityofcalifornia.edu/regents/meetings.html

APPENDIX: PROPERTIES OF VALID BENCHMARKS
- Unambiguous. The benchmark should be unambiguous, which might seem obvious, but in many cases, performance standards and/or client expectations are ambiguous. A lack of specificity almost always leads to problems.
- **Investable.** A valid benchmark should be investable. Often, clients and consultants specify “top-quartile” performance as the manager’s benchmark. But because no one can guarantee such performance, it is not an investable alternative. It is a viable investment objective but not a valid benchmark.

- **Appropriate.** A valid benchmark should be appropriate and incorporate the prominent fundamental risk and performance characteristics of the manager’s portfolio.

- **Specified in Advance.** For a benchmark to be valid, it needs to be specified in advance. Again, this property might seem obvious, but numerous cases exist in which the performance standard was changed after the fact—by managers, consultants, and clients. This situation is most likely to occur when the manager’s benchmark is ambiguous and uninvestable.

- **Informed Opinion.** Finally, managers should have an informed opinion about the securities included in the benchmark. Otherwise, the manager could be held accountable for the performance of securities he or she knows nothing about.

- (Source: CFA Institute)