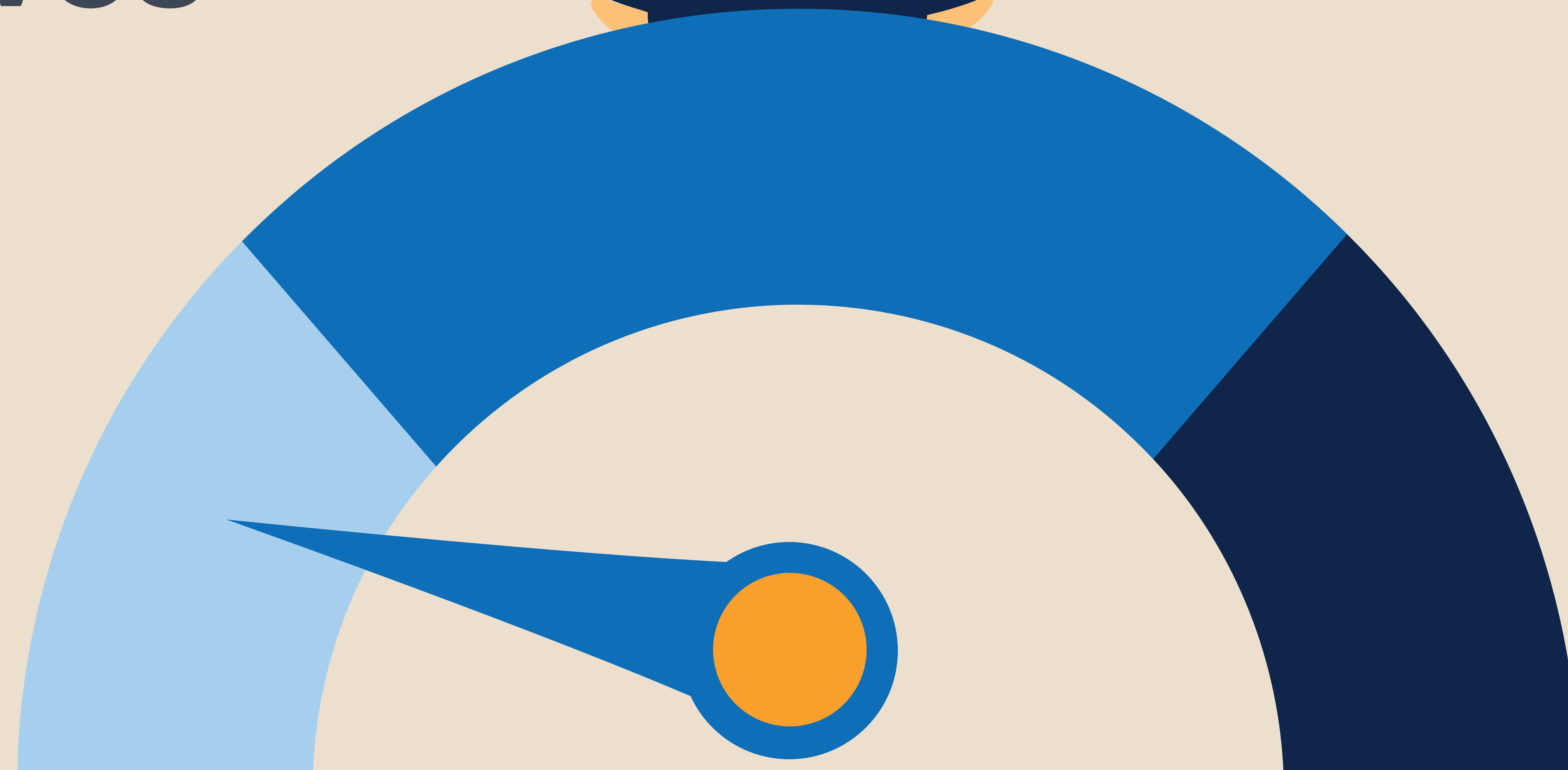
TECHNICAL SUPPLEMENT

Using the balanced scorecard to measure strategic objectives



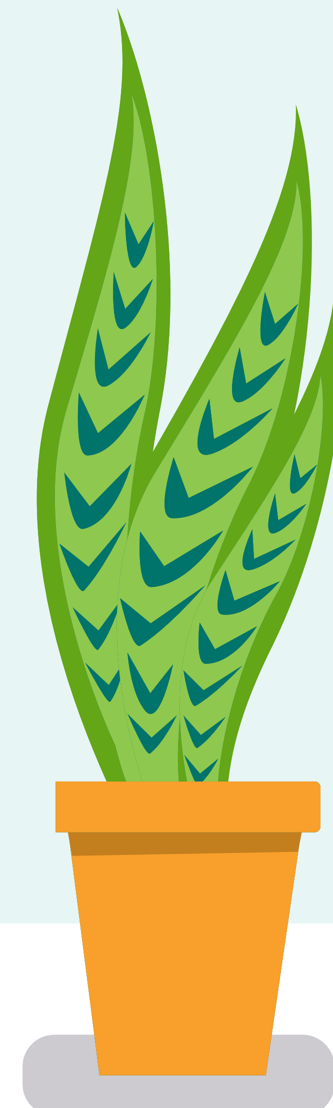
IC SELECT

In December, it will be three years since the Investment Consultancy and Fiduciary Management Market Investigation Order 2019 (the CMA Order) came into force for strategic investment objectives.

This order requires the trustees of defined-benefit (DB) pension schemes to do three things.

- Set strategic investment objectives for their investment advisers (IAs). This category includes both investment consultants and fiduciary managers;
- Review their IAs' performance every 12 months; and
- Review the strategic investment objectives at least every three years.

Furthermore, recent guidance from the Pensions Regulator suggests that all Trustees who set objectives in December 2019 must have formally reviewed them at least once by 10 December 2022.



In doing so, trustees will be better placed to assess the quality of the service they receive and to deliver better outcomes for their members.

Almost three years on, market feedback suggests that many pension schemes have yet to fully engage with the CMA's Order. Although most have agreed initial objectives with their IAs, the review of performance and objectives is often not implemented through a rigorous framework with real consequences for sub-par outcomes.

If we take the three core elements of a pension scheme – the covenant, funding and investment performance –the last of these is the only one that trustees can really influence. So trustees must do what they can to ensure that their IA is delivering for their members. To do that, trustees need to set the right objectives, measure performance against them and take the appropriate action in response to the outcomes.

Ending asymmetry

Until the CMA introduced its order, the relationship between pension trustees and their IAs was decidedly asymmetric. Advisers benefited from a much greater understanding of financial markets and their own performance within them. This imbalance meant that trustees often struggled to discern the best performers and, therefore, assess the quality of service they received..

A consequence of this has been that pension-scheme members have not always benefited as might have been expected from the strong performance of financial markets in recent decades. Although the sharp rise in bond yields in 2022 has improved the funding position of many pension schemes, 22% of UK DB schemes are still underfunded.[1]

It seems clear, therefore, that pension-scheme trustees have some way to go to ensure that they are fulfilling both the letter and the spirit of the CMA's order. Scrutiny is increasing here, however. From 1 October 2022, DB schemes' investment objectives will be under the jurisdiction of the Pension Regulator (TPR). This means that trustees are now subject to TPR compliance and monitoring processes.

How should objectives be set?

Recently, TPR has set out its expectations for pension schemes' strategic investment objectives. First, objectives should clearly define the expected outcome and the timescale over which it is to be delivered. Second, the objectives should be relevant to the services provided by an IA. And finally, the trustees should be able to measure the performance of these services.

At IC Select, we refine this arguing that strategic investment objectives should be realisable, actionable and measurable – encapsulated by the acronym RAM. The framework used to assess the objectives should meet this standard. To put a value on anything, you must first be able to measure it.

We believe that the best way of achieving RAM objectives is by using a 'balanced scorecard'. This is a framework in which the various aspects of an IA's performance can be assessed individually and then combined with appropriate weightings to give an overall assessment. These aspects can range from investment performance to quality of advice to environmental, social and governance (ESG) concerns. The 'balanced scorecard' approach is also recommended by TPR.

One point that TPR is keen to stress is the need to avoid IAs 'marking their own homework' when it comes to strategic objectives. This means trustees must ensure that they, not their advisers, are setting the objectives and assessing how well the IAs have performed against them.

[1] PPF 7800 Index: 30 August 2022

Understanding the balanced scorecard

Since they were popularised and developed by Robert S Kaplan and David P Norton in the 1990s[2], balanced scorecards are widely used in many areas of business. But their use by UK pension schemes has so far been limited. In the Netherlands, however, balanced scorecards have been used by pension schemes to assess their advisers for many years, with considerable success.

The balanced scorecard is so called because it balances quantitative and qualitative elements. The scorecard is designed by setting out a number of factors that relate to the overall performance of the IA. For a typical pension scheme, these factors might be financial performance, advice, ESG and relationship.

The factors can then be broken down into several areas, as shown below. For example, the factor *financial performance* might be broken down into three areas:

- achieve investment objectives
- manage risk appropriately
- manage costs effectively.

Meanwhile, the *advice* factor might be broken down as follows:

- develop a long-term investment plan
- provide clear written and oral communication
- deliver effective and timely reporting.

Each of these areas will be weighted. In the financial performance factor, for example, *achieve investment objectives* might be given a 60% weighting, with *manage risk appropriately* at 25% and *manage costs effectively* at 15%.

[2] The Balanced Scorecard—Measures that Drive Performance (hbr.org)

Factor	Weight (TBA)	Area	Weight (TBA)
Financial Performance	20%	Achieve investment objective Manage risk appropriately Manage risk effectively	60% 25% 15%
Advice	40%	Development of long-term investment plan Clear written and oral communication Effective and timely reporting Other services contributing to effective management	60% 15% 15% 10%
ESG	10%	Investing in line with Trustees ESG requirements Providing best industry practice in ESG investment Achieve best internal culture of ESG practice at investment adviser	60% 10% 30%
Relationships	30%	Provide appropriate training Understand the Trustee's needs	40% 60%

The third step is to break each area down into measurable objectives. As an example, achieve investment objectives can be readily broken down into specific performance measures. Objectives are weighted within each area, just as each area is weighted within each factor and each factor within the overall scorecard. Below we show an example of how the objectives are set for each area.

Areas of 100% weight	Objective	Weight	Assessment method
Achieve the investment objective	Outperform the liability benchmark by y% over rolling three-year period Manage the assets in line with all constraints in the investment schedule and report and breaches in a timely fashion to the trustees	95% 5%	Quantitative Pass/Fail
Development of long-term investment plan	Agree and document long-term investment with the Trustees Develop an appropriate journey plan to achieve the long-term funding objective	50% 50%	Questionnaire Questionnaire
Investing in line with Trustee's ESG requirements	Engage with x firms on ESG issues and demonstrate improvement in y% Implement climate impact report by dd/mm/yyyy Ensure all underlying managers have appropriate ESG approaches and where they do not that progress is being made in improving this position	50% 30% 20%	Pass/Fail Pass/Fail Quantitative
Providing appropriate training	Run at least three training seesions on topics to be agreed by The Trustees	100%	Questionnaire

Here, it's important to recognise that not all of these objectives will be quantitative. In many cases, the measurement will be qualitative, reflecting the trustees' experience with the IA in areas such as communication and advice. Measuring both quantitative and qualitative aspects of an IA's performance allows trustees to make a more informed decision as to the service they are receiving.

Quantity and quality

As also can be seen above, when using the balanced scorecard, trustees can use different methods to assess quantitative and qualitative objectives. Objectives can also be assessed on a simple pass/fail basis. The balanced scorecard allows for all three approaches to be integrated into the final assessment.

With a quantitative measure, the achievement of the objective can be converted into a score between 1 and 10. For example, if the objective is to outperform a liability benchmark by 2.6 percentage points (ppts) over a rolling three-year period, achieving that target might be scored as a 7. Outperforming by significantly more – say 3.0 to 3.1 ppts – could be rated an 8, while a 9 would be outperformance of 3.2 to 3.5 ppts. Any outperformance above that would be a 10.

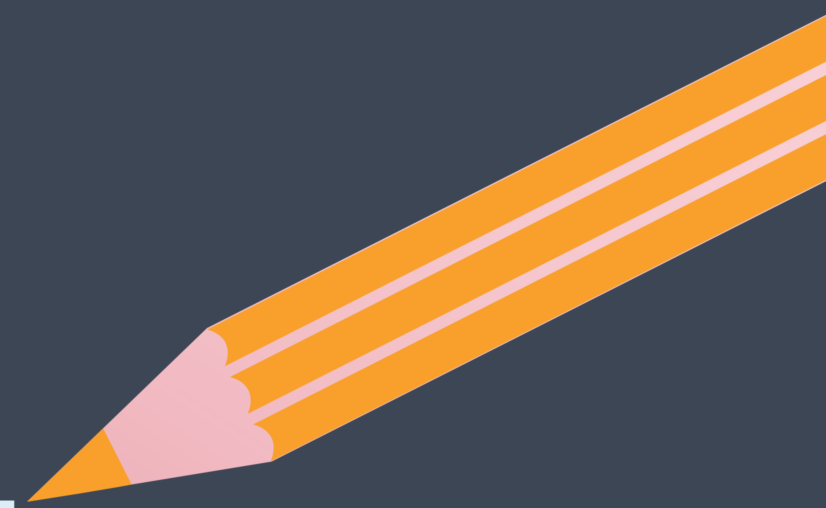
In this framework, then, a score of 7 would indicate that the objective has been achieved, with the higher scores reserved for IAs who have exceeded expectations.

Conversely, failure to outperform the benchmark by the desired amount would result in successively lower grades – perhaps in bands of 30 basis points, so that outperformance of 2.6 to 2.3 ppts would be a 6 and less than 2.3 to 2.0 ppts would be a 5. Negligible outperformance – say, less than 0.8 ppts – would be rated zero, as would any underperformance of the benchmark.

Qualitative objectives can be measured by a trustee questionnaire, using multiple-choice answers that can then be converted to a numerical score. As an example, trustees might assess an objective of *providing clear communication and reporting* by answering a question such as "The reporting provided by the IA was clear, comprehensive and easy to understand".

A response of *strongly disagree* would result in a score of 0 while *generally disagree* would merit a 3. As with the quantitative objectives, meeting expectations would lead to a score of 7, in this case through a response of *generally agree*. Exceeding expectations – as in *strongly agree* – would result in a score of 10.

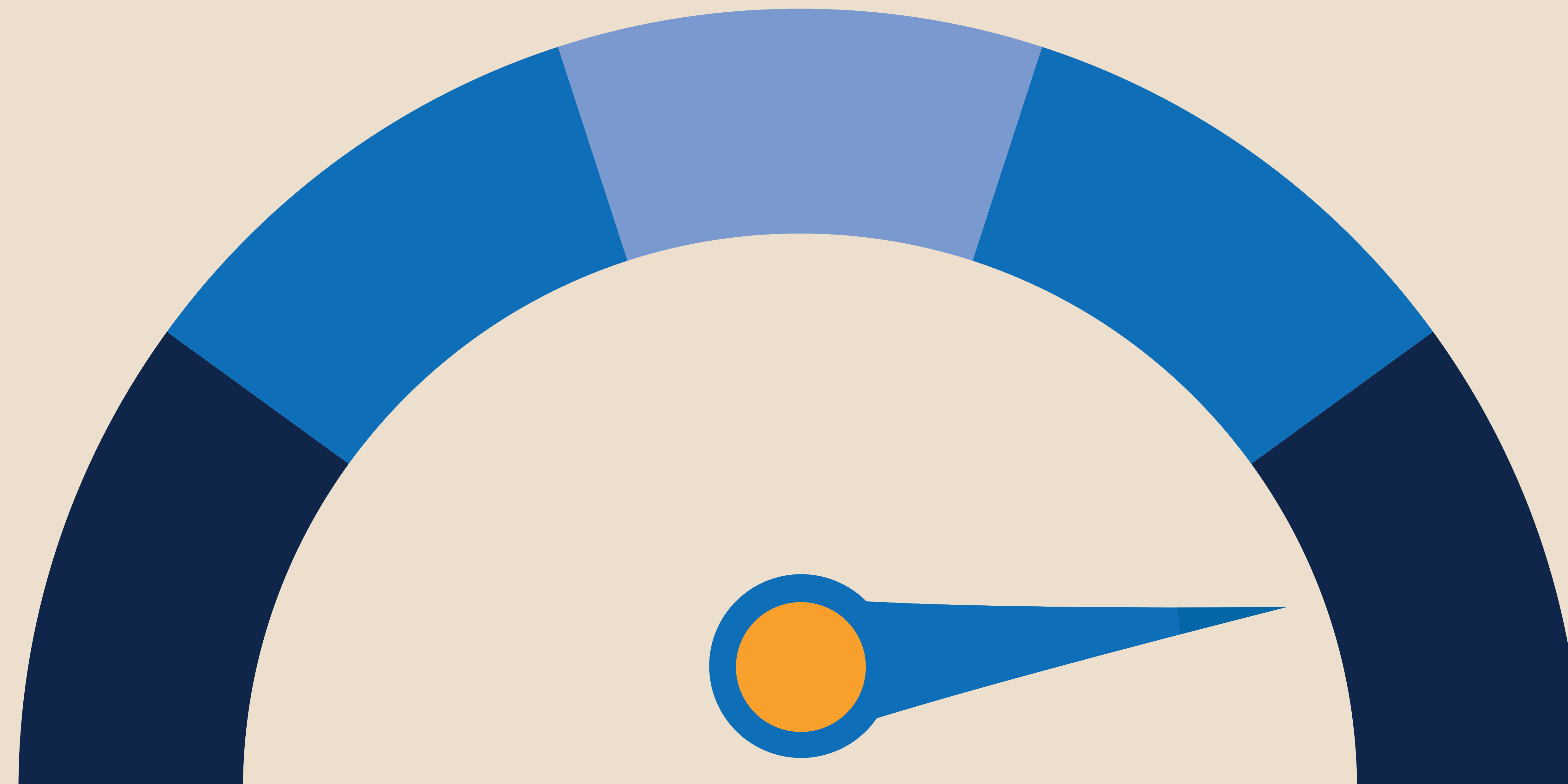
Note that a well-designed questionnaire does not allow trustees to duck the question through a neutral response. There should be no score of 5 out of 10. Fence-sitting is not conducive to a clear and fair assessment of an IA's service.



A dynamic tool

A balanced scorecard should always be dynamic so that it can change as a scheme's requirements evolve. This dynamism is achieved by altering the weightings of objectives, areas or factors within the overall framework.

For example, in the first few years of a fiduciary-management arrangement, trustees might place less emphasis on investment performance than on advice. Once the relationship has evolved, however, trustees might want to shift the focus from advice to investment performance. That would be reflected in a greater weighting for the investment performance factor – which might increase from (e.g.) 30% of the total score in the early years to 60% thereafter.



Bringing it all together

When the objectives for each area are scored, they then give an overall weighted score for that area. The weighted scores for the areas give a score for the relevant factor, and the weighted factor scores give a representative overall score for the IA's performance.

This allows the IA to be assessed against both the pension scheme's specific objectives and the performance of other IAs. The balanced scorecard offers a convenient way of doing both. As its use spreads through the industry, peer-to-peer comparisons will become much easier. And because the balanced scorecard breaks down into a granular level of detail, it allows trustees to identify particular shortcomings and areas of strength: in performance, service and – crucially – costs.

Trustees can use the results of the balanced scorecard to draw up an action plan for the year ahead. The adoption of the balanced scorecard should entail higher standards across the pensions industry, with a fairer, more transparent and more competitive marketplace in the provision of advice and other investment services.

This process should create a virtuous circle, in which objectives and assessment lead to improved investment governance, superior investment performance and more assured outcomes for scheme members. This improvement in performance is not merely theoretical. Research indicates that good investment governance can add considerable value – up to 2% a year, according to the Journal of Asset Management.[3]

Finally, a balanced scorecard's granular measurement of IAs can also provide trustees the opportunity to renegotiate fees where delivery has fallen short of expectations – allowing them to achieve further value for money for their members. As we at IC Select never tire of reminding our clients, what gets measured gets done.

[3] Clark, G.L. and Urwin, R. (2008) Best-Practice Pension Fund Governance. Journal of Asset Management, 9, 2-21. http://dx.doi.org/10.1057/jam.2008.1