

‘Investment Monitoring in Practice’

**a report into the findings of the
Euraplan Investment Monitoring Survey 2002**



Leaders in Fund Monitoring and Pension Accounts

An independently researched report conducted by:

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1.0 EXECUTIVE SUMMARY

The past five years have seen a major trend towards the pension fund industry assuming far more responsibility for itself and its activities than has ever been the case before. In particular, the previous prevailing notion that issues relating to investor protection could be taken for granted and did not need to be subjected to careful monitoring by the pension fund, is rapidly dying out as the industry argues for greater scrutiny, more extensive cross-checking and further comprehensive control.

Euraplan works on the leading edge to assist pension funds to generate fundamental and significant levels of control in the financial areas of investment monitoring and accounting. As a result, Euraplan has a profound professional interest in understanding key trends and perspectives in pension fund behaviour.

In 2001, Euraplan undertook a major independent survey into the attitudes held by trustees of pension funds on a wide range of key issues. The report arising from this survey made a carefully researched contribution to the debate, analysing how pension fund trustees' attitudes were changing and what new priorities trustees were pursuing. It was clear, as subsequent experience has confirmed, that the days when being the trustee of a pension fund was a mere formality are over. Today, almost every regulatory development in the pension fund industry adds to the burden of responsibility for pension fund trustees. Deciding to become a trustee today is far from being a formality. It is an important professional commitment that involves the trustee becoming thoroughly accountable for decisions that he or she will make both as an individual and with other trustees.

This new survey of 2002, also commissioned by Euraplan, focuses on the equally important subject of investment monitoring.

In many respects, there is a link to the subject of the 2001 survey, for monitoring investments is one of the most important responsibilities trustees undertake as part of their duties of stewardship.

After all, the only reason trustees are able to discharge their obligations to pay pensions is because they have complete control over the assets of their fund. These assets together with the income they yield are used to fund the pensions and other benefits due to the beneficiaries of the fund. Pension funds often make losses when they invest, and the entire purpose of the investment consultants who advise trustees is to take every reasonable step to ensure that where losses do occur they are minimised, and that they do not have an adverse effect on the pension fund's ability to fund its own obligations.

In addition to avoiding losses, trustees try to maximise the yield on these assets to assist the funding of the fund. *It is a naturally logical step from seeking to maximise the yield of investments to seeking to verify that the income from these investments has been properly collected and channelled and that realised values have been checked against the actual expected values.* Investment monitoring is therefore not an appendix to the investment management process but an integral part of it.

What specific options do pension funds have for investment monitoring and what attitudes and approaches to it are they adopting? These and other key issues are explored in this survey.

As the survey reveals, pension funds seeking to monitor their investments have two fundamental choices.

1. They can delegate the responsibility for investment monitoring to a third party such as a custodian or an investment manager.
2. They can monitor their investments themselves.

Ultimately, the decision comes down to a question of priorities. Do the trustees believe that a relatively small expenditure on this matter (relative to the total value of the pension fund's assets) is worth making, or are they happy to place a high level of trust in third-party organisations?

Euraplan, as a vendor of investment monitoring solutions, does of course have a view about the importance of taking responsibility for one's own investment monitoring. It is important to emphasise, however, that this survey was commissioned and managed in an entirely non-partisan fashion. The results of the survey are summarised in the following section, with accompanying comment provided by Euraplan.

As far as the principal findings of the survey are concerned, Euraplan believes they should be regarded as follows:

- There is a very significant trend towards UK pension funds taking investment monitoring much more seriously than has ever been the case before.
- Almost all pension funds regard investment monitoring as an important and integral part of their professional activities.
- The Myners Report 'Institutional Investment in the United Kingdom: A Review', published on 6 March 2001, has evidently had a major effect on the tendency for pension funds to regard investment monitoring as an even higher priority than how they saw it in the past.
- At present there are about as many pension funds in the UK that handle their own investment monitoring as there are pension funds which delegate the function to third parties.
- Income monitoring, an element of investment monitoring that is absolutely essential to the proper operation of a fund, is being comprehensively disregarded by as many as one in two pension funds.
- Many pension funds which do delegate investment monitoring to a third party only do so because they believe that they have inadequate resources to do the job in-house. The clear implication of this point is that if they could handle it themselves they would prefer to do so.

The survey was sent to UK pension fund managers. Euraplan received a 4 percent response out of the 1,040 surveys sent out. This is a good response for this kind of survey. We believe the depth and detail of the responses provide an excellent overview of the state of attitudes towards investment monitoring among UK pension funds today.

The funds which have participated in the review range from small £15 million funds to those with over £4 billion in assets. 64% of respondents were commercial funds and the rest from local authorities.

2.0 FINDINGS & ANALYSIS

Our survey reveals that the importance of investment monitoring has risen over the past five years. 84% of our survey's respondents believe that investment monitoring is viewed as more important today than in the past (refer to Fig.1).

When we asked whether the Myners Report had had a significant impact on the industry with regards to the attitude towards investment monitoring, over two thirds believed it had. However, interestingly just under a third of the respondents thought that the Myners report had only had a slight impact on the pension industry's attitude towards investment monitoring. One can conclude that this group believe that the importance of investment monitoring has grown without any assistance from the Myners review and that the Myners Report has piggybacked on existing reforms (refer to Fig.2).

The survey then turned to ask about trustees' knowledge of investment monitoring. 81% of respondents understand the importance of investment monitoring, but over half stated that they were happy to delegate the responsibility for it to a third party.

However, this question also reveals that 12% of the respondents are reviewing their situation and 7% admit to knowing very little about investment monitoring and take it for granted that it will be handled by a third party (refer to Fig. 3). It is difficult to conclude otherwise than that this is a most disconcerting finding, in the light of 84% of respondents believe that investment monitoring is more important today than it was in the past.

It would appear that there is a significant discrepancy between those pension funds which believe investment monitoring to be a major – and growing – importance and those which are actually acting on this belief.

Again, this supports the notion that maybe trustees do not have enough time to review all aspects of the pension fund, or perhaps they lack the in-depth knowledge required to assess the situation correctly.

The survey then turned its attention towards what pension funds believe make up the service of investment monitoring. There is relative unanimity among most respondents that investment monitoring is made up of the following components:

- Reconciliation between Custodian and Fund Manager(s)
- Income Monitoring
- Tax Recoverable Monitoring
- Corporate Action Monitoring
- Investment Accounting Reports

It needs to be said that Euraplan's own activities highlight time and time again instances where the investment monitoring being relied upon by Trustees is not actually being monitored or checked. When year-end comes around, big holes are found in investment reports. As many of us are aware, it is the quality of information contained in that report which is important. Surprisingly, income monitoring received only just over 50% of the respondents' votes, showing that one of the most financially important monitoring functions is being comprehensively disregarded (refer to Fig. 4).

However, when we investigate those who do reconcile income, the survey shows that they value income monitoring on both fixed interest and equities equally. Actually fixed interest comes out as marginally more important than equities (refer to Fig. 6).

The survey also highlighted that the majority of pension funds still see value in reconciling both market value and book costs (refer to Fig. 5). This could be for one of two reasons, either they find it difficult to move away from the old practices of depending on the book value of the fund, or they view unrealised gains and losses as invaluable to their assessment of the fund's value.

We then moved on to examine how investment monitoring takes place within pension funds. The overall spread was fairly even with third parties, entirely in-house and partly in-house each receiving about 30%. The interesting side to this section is that only 5% of respondents trust the figures they are given, and everyone else is checking their investment monitoring results.

The survey also shows that the most important check is the reconciliation between the fund managers and the custodian (refer to Fig.5 and 7). For the respondents who do the investment monitoring entirely in-house, they tend to use one full time member of staff to perform this role.

When the pension funds undertake part of the investment monitoring in-house, the activities done in-house and the ones performed by the third party are likely to vary significantly. Income and tax monitoring can be done by either party, however the comments from the respondents show that they tend to do the reconciliation between the fund managers and the custodian themselves. This again highlights a lack of trust between the funds and their third party investment monitoring suppliers. One respondent did state that they found little advantage to making detailed checks, but continued the check as a matter of prudence.

The types of third party organisations used in the above question were equally custodians, fund managers and others. The other category consisted of The WM Company, investment advisors, CAPS, fund administrators and professional statisticians (refer to Fig 8).

When the investment monitoring is delegated entirely to a third party and the funds check areas of the third party's performance, the usual areas that are checked are reconciliations between the fund managers and the custodian, income and tax monitoring, market value and performance.

The majority of funds in this case use Euraplan, CAPS, the WM Company, actuaries or professional statisticians as the third party with fund managers coming a close second and then custodians the least popular option (refer to Fig 9).

Where the funds outsource the investment monitoring function to a third party and do not check their performance, they use an equal number of the organisations mentioned previously (refer to Fig 10).

It is the final part of the 'how' question which highlights some interesting figures. We amalgamated all the replies of who used what type of organisation to perform

investment monitoring and the results seem to disprove an accepted trend in the industry.

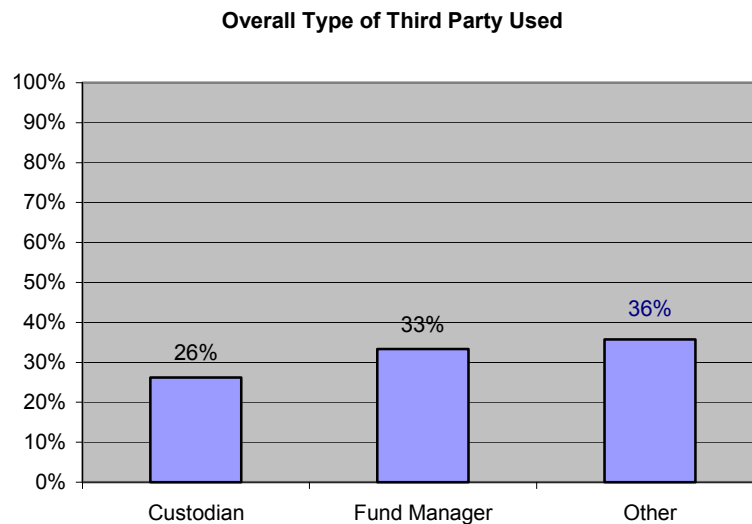


Fig. 11

Over the last five years global custodians have rapidly emerged into the industry, taking on more and more clients. However, they are the smallest category on the above graph, with most funds still relying on the many organisations that make up the 'Other' category. A couple of conclusions can be drawn from these figures. The first conclusion is that perhaps funds are still not willing to entrust large international companies with such an important function and instead choose small specialist UK based firms. Or indeed, it could just be that the growth of the custodians has not yet eclipsed the historical methods of performing investment monitoring.

The survey then goes on to ask the 64 million-dollar question, how satisfied are you with your investment monitoring service? (refer to Fig.12). We asked for an explanation of each part of the investment monitoring process; enquiring whether the funds were 'Very Satisfied', 'Reasonably Satisfied' or 'Not Satisfied'. Two sections received glowing results, the investment accounting reports and the reconciliations between the fund managers and custodian. On the whole this is not very surprising as these are viewed by the funds to be the most important parts of the service and expertise in these areas is a crucial criteria for being hired.

The rest of the results are slightly bleaker, as most funds are only reasonably satisfied with their corporate action, tax recoverable and income monitoring. Several funds are not satisfied with these monitoring functions at all. With the growing importance of these services and the spotlight created by Myners, reasonable satisfaction is just not good enough.

In relation to reconciliation between the custodian and fund managers, the results were slightly better, with a healthy percentage of respondents being very satisfied with specific reconciliation (refer to Fig. 13 and 14). However, once again these 'healthy' percentages are still only around 50%.

The survey then addressed value-added services, investigating what value-added services pension funds take from their third party suppliers.

The results showed that WM and CAPS were the most popular choice for performance measurement. More radical value-added services also appeared. Pension funds mentioned Foreign Exchange Monitoring and Stock Lending as services they receive from their third party suppliers, along with cash management, commission recapture and transaction cost analysis.

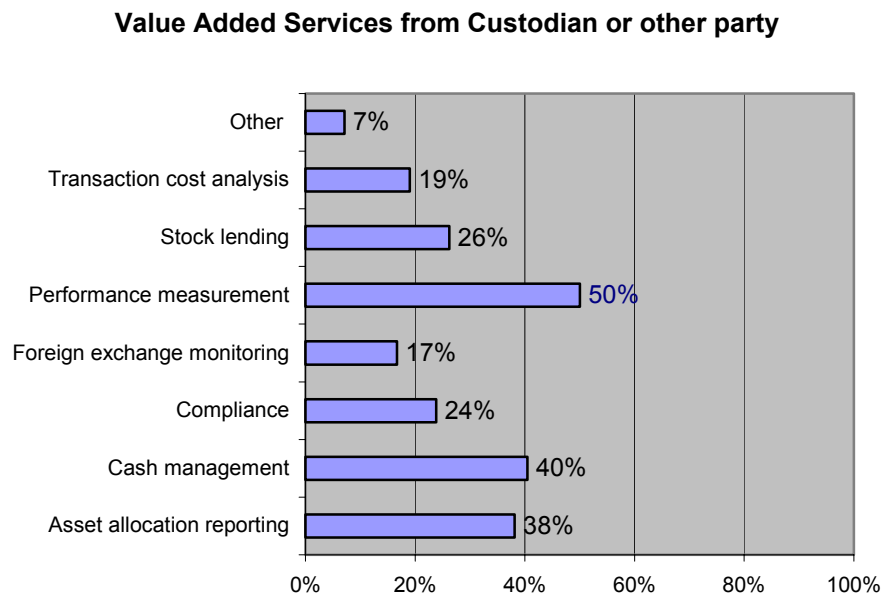


Fig. 15

These results are encouraging from the point of view that pension funds are using the technology and tools in the industry in order to save costs, make money and highlight inconsistencies.

The survey then turned its attention to the service provided by custodians. This is an area which is often criticised. Euraplan wished to investigate exactly where the service was failing, especially since more and more funds are migrating to global custodians for their investment monitoring services.

The first question dealt with the issue of bundling services. We asked whether the custodian provided their investment accounting service separately from their custody service or whether the fund had to take both services for a single cost. The unbundled services came out slightly on top (refer to Fig. 16). But it is worrying that so many custodians do not reflect transparency in their costing, and therefore do not give the funds a clear idea of how much they are paying for each of the services. This can have a severe effect on the smaller funds, which may only wish to pay for the custody element, and so are not offered the choice by all the global custodians.

The next topic addressed was the use of technology in providing the end service to the pension funds. The survey found that even though most custodians still provide hard-copy reports, the on-line report systems are making an impression on the industry with all users finding the systems easy to use (refer to Fig.17 and Fig.18). The same was said about designing custom reports on the on-line reporting systems (refer to Fig.19 and Fig.20).

Over half of the funds that replied to the survey use an in-house computer system to help monitoring their investments (refer to Fig. 21). Out of all of the computer systems mentioned, Euraplan's systems were the most prolific with 36% of the respondents using Euraplan's IT solutions (refer to Fig. 22). On the other hand, of the funds that do not use an IT system in-house (45%), the majority of them had not considered using one over the past two years (refer to Fig. 23). This is perhaps surprising when compared to the previous question where only 5% of funds said they don't check their investments in-house, revealing that 33% of funds who do check their investment monitoring in-house do so manually. This might naturally lead one to question how effective that check actually is.

Of those funds that have considered an in-house system but decided not to proceed with it, the main reasons given for not proceeding were that of costs and effectiveness (refer to Fig. 24). The latter always tends to be the case, which is surprising in an industry where fund managers, amongst other service providers, are very highly paid. This again leads us to the conclusion that although investment monitoring is viewed as extremely important, it is not always seen as important enough to dedicate an appropriate level of expenditure to it.

This view is reiterated in the question concerning transaction cost analysis. 40% of funds do not monitor transaction costs. Of the ones that do, the majority only monitor brokerage costs (refer to Fig. 25). Funds tend to use irregular monitoring methods and the investment managers are actually monitoring themselves, which is basically considered as self-policing. Both of which are arguably useless. The reason given for not monitoring such costs, is primarily because it is seen as too difficult; demonstrated in the fact that the more complex costs to monitor i.e. spread, impact and timing are infrequently monitored. Specialist providers can independently monitor all transaction costs, but a service cost is inevitably incurred.

The survey concluded by asking the funds whether they were satisfied with the client service provided by their third party providers (refer to Fig. 26 and Fig. 27). On the whole the funds are satisfied with the response times to queries and the required changes to the third parties reports. Nevertheless, there is cause for concern that a small percentage hardly ever get a response to a standard query. 10% of respondents believe that their investment monitoring provider amends its systems too slowly for their needs or for some funds they do not know if they can do it or not. This leads us to question why these respondents remain with their investment monitoring providers at all.

The last question of the survey asks how long the pension funds take to interpret the data from the investment monitoring supplier for inclusion within the accounts. 14% said that they did not know or were unsure, which demonstrates that there is no audit trail of year-end or quarter-end work. Most funds spend 1 to 8 hours, which is impressive. In contrast, some funds take up to 5 days. The purpose of this question was to see how effective the reporting from the

investment monitoring suppliers is. We conclude that in the main the reports are effective, but there is still improvement required.

Katherine Johnson, Associate Director at Euraplan manages the business development of an investment monitoring system designed specifically for the pension industry and comments:

'I have found the analysis of this survey illuminating. It has endorsed several concerns that myself and others in the industry have shared; primarily that funds are not entirely happy with the service and figures they receive from the majority of investment monitoring suppliers.

However, it is the surprising aspects of this survey's findings that I find particularly interesting. For instance, it is a significant finding that respondents feel that investment monitoring is important regardless of The Myners Report, I also find it surprising that global custodians remain a relatively small player in the investment monitoring industry.

Yet overall, I find it comforting that pension managers took the time to complete such a comprehensive questionnaire; it shows that they are positively willing change to occur in this area'.

The Appendix section of the report illustrates graphical analysis of all survey findings.

3.0 APPENDIX

Q1 Which of the following statements best represents your opinion on how UK pension funds view investment monitoring today in comparison to the past?

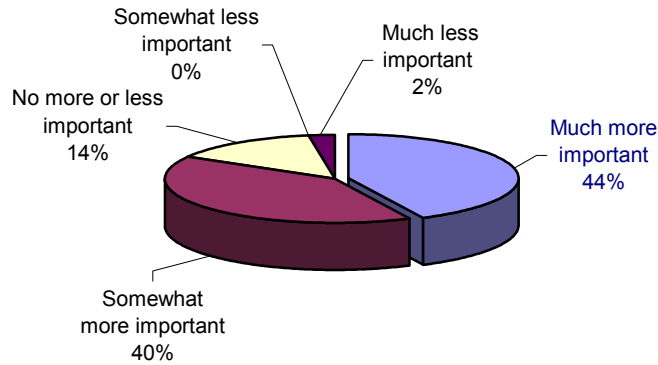
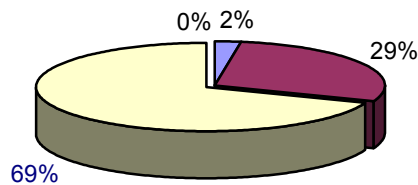


Fig. 1

Q2 Which of the following statements best represents your view on the impact of the Myners Report* with regards to the attitude of UK pensions funds towards investment monitoring?

* *Institutional Investment in the United Kingdom: a Review*



- No effect whatsoever
- Creates a slight tendency for pension schemes to see investment monitoring as something they should regard as a higher priority
- Creates a significant tendency for pension schemes to see investment monitoring as something they should regard as a higher priority
- Don't know

Fig. 2

Q3 Which of the following statements best describes the current attitude of your pension fund trustees have towards investment monitoring?

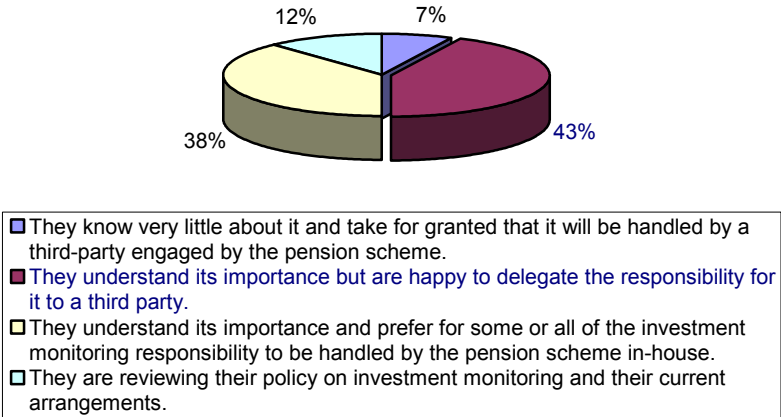


Fig. 3

Q4 Please tick any of the following boxes to identify activities that you regard as part of the investment monitoring process.

Note: Respondents could tick more than one applicable activity in response to this question.

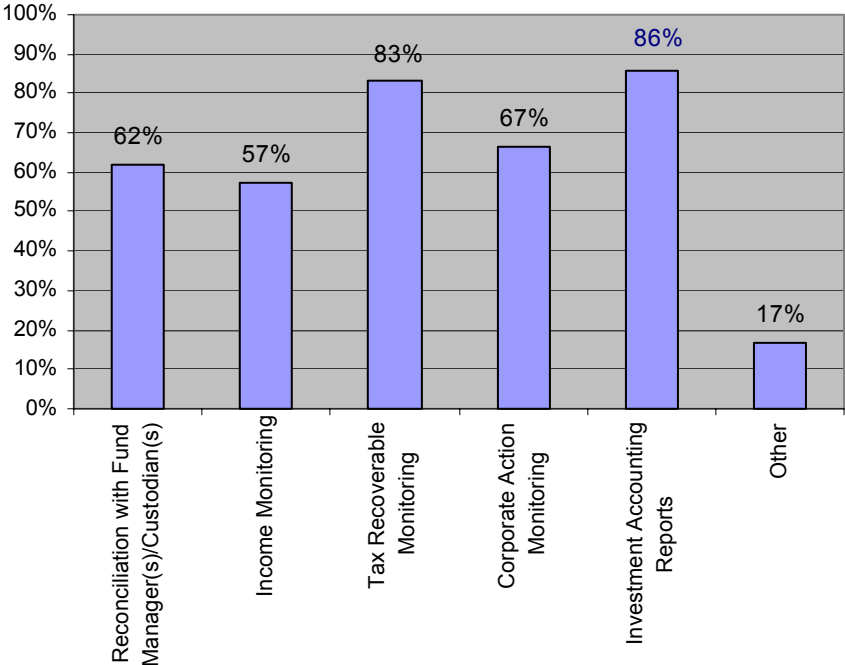


Fig. 4

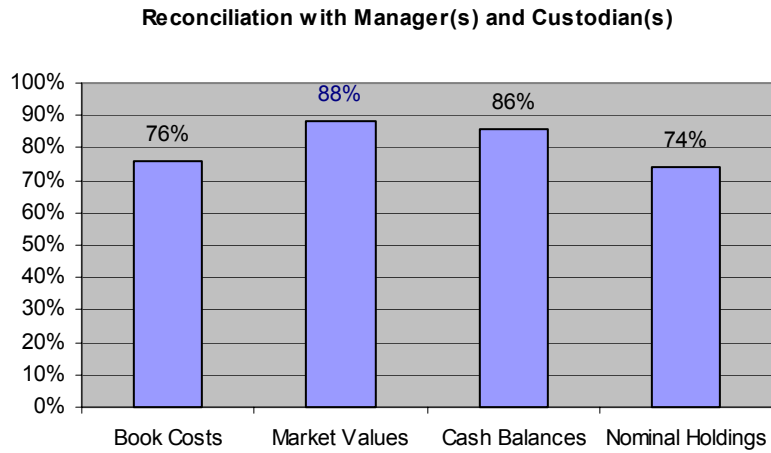


Fig. 5

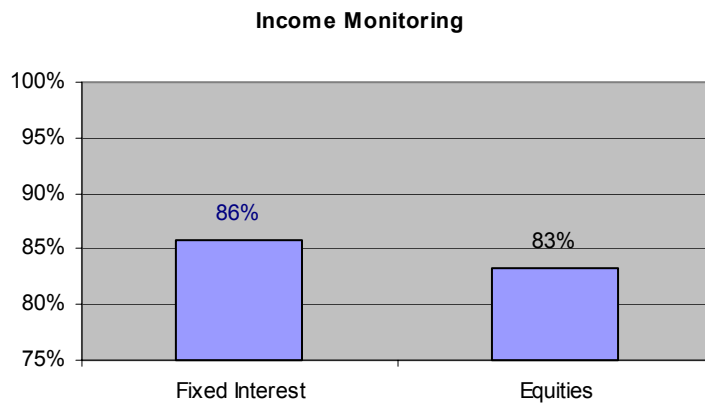


Fig. 6

Q5 Please chose from the following questions, the one which best describes how investment monitoring takes place in your organisation.

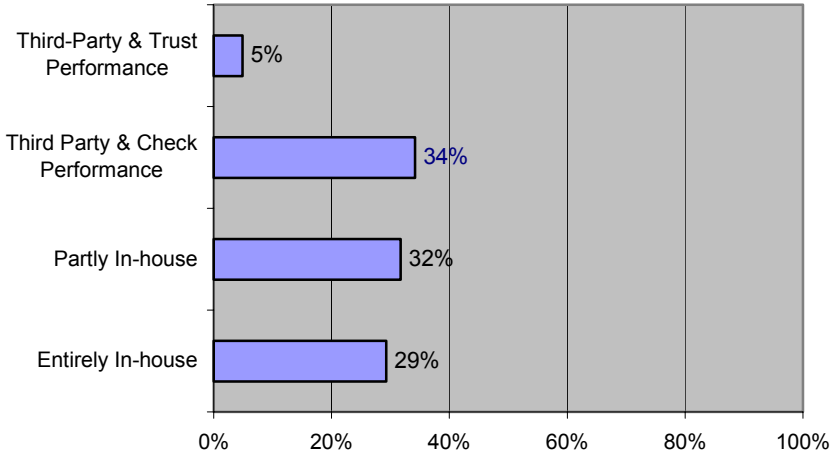


Fig. 7

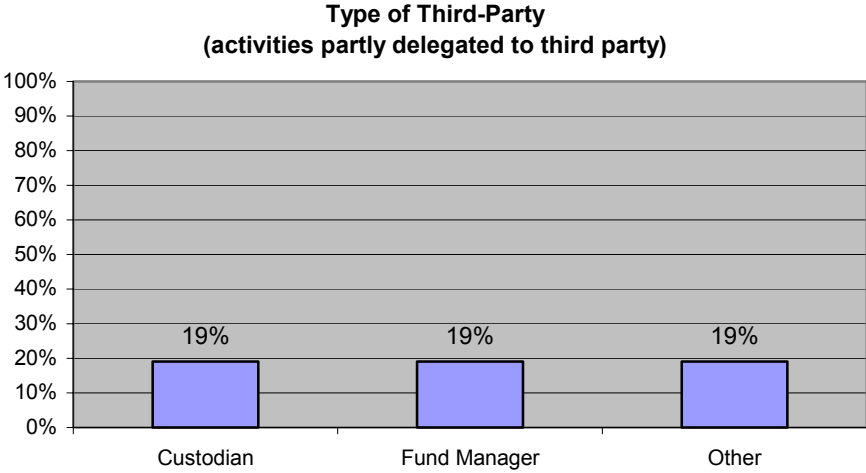


Fig. 8

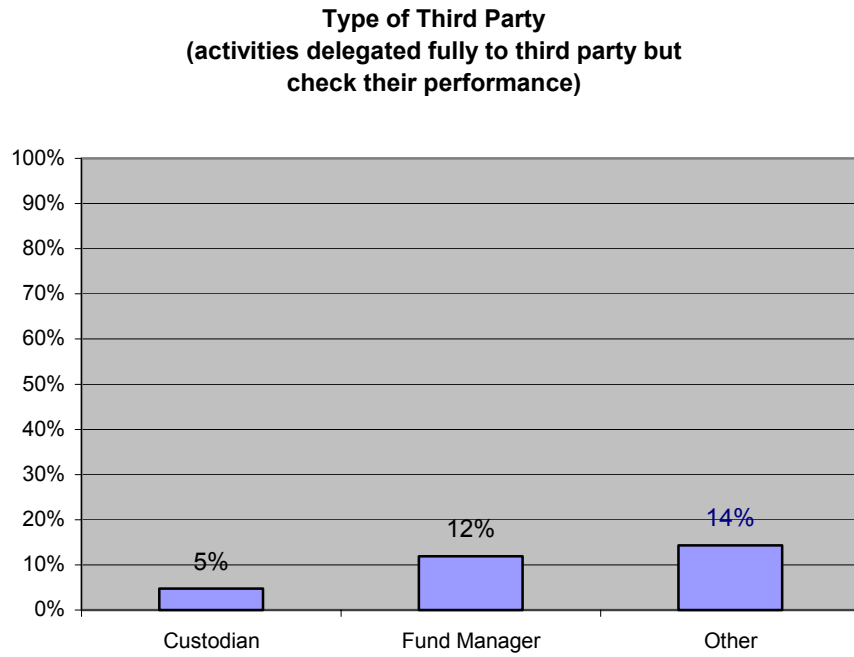


Fig. 9

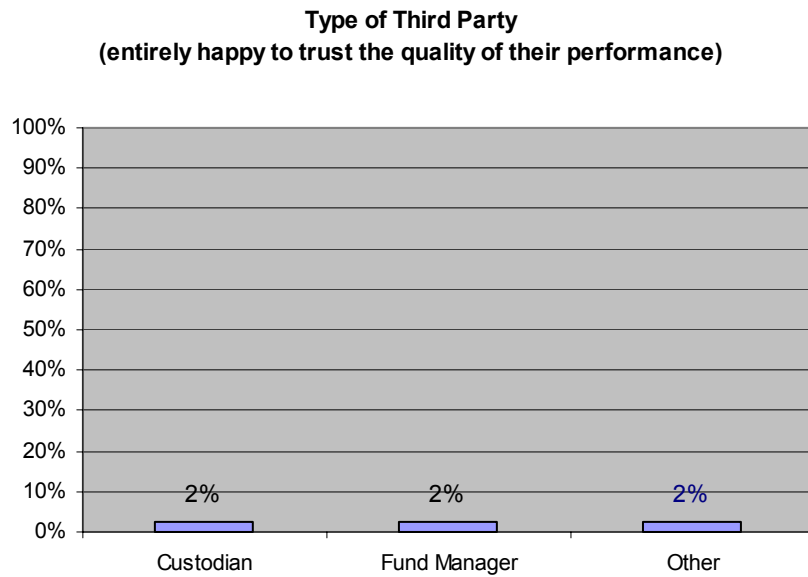


Fig. 10

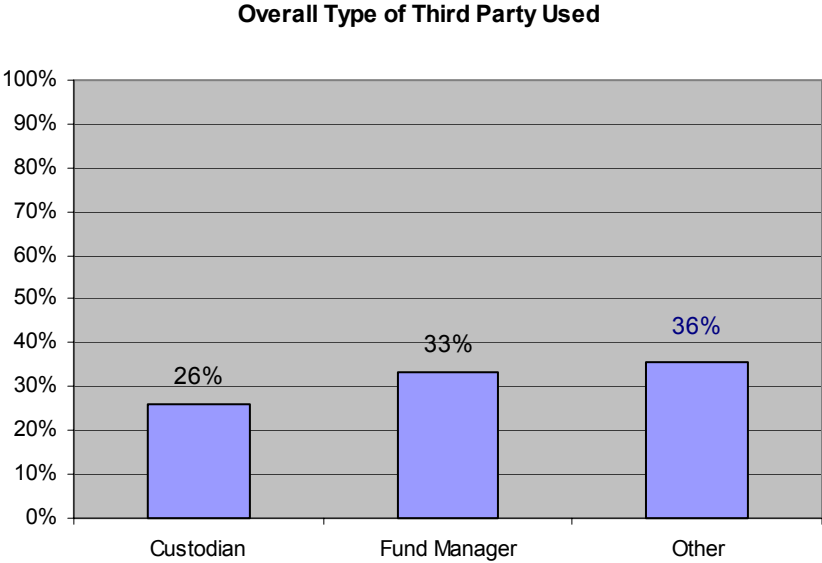


Fig. 11

Q6 Currently how satisfied are you with the following elements of your investment monitoring?

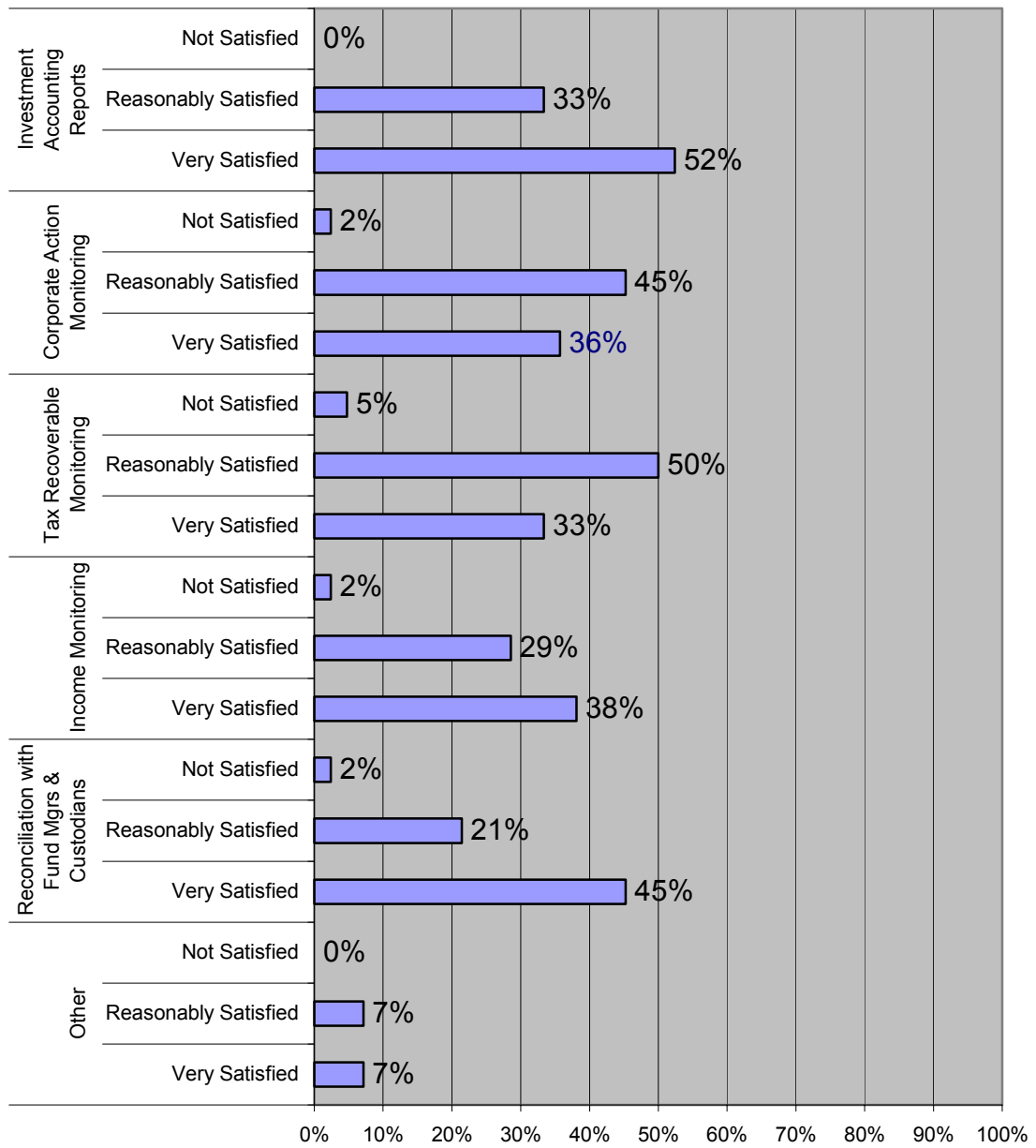


Fig. 12

Reconciliation with Fund Managers

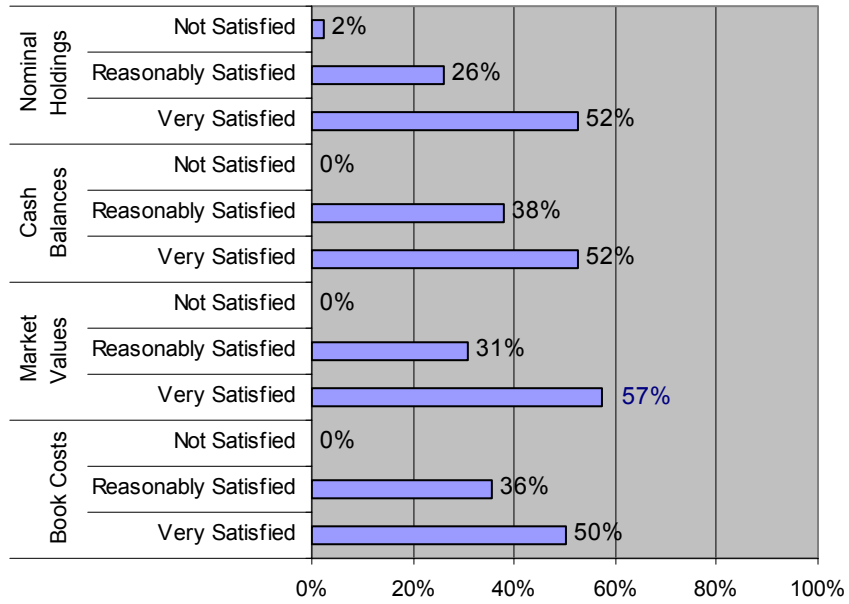


Fig. 13

Income Monitoring

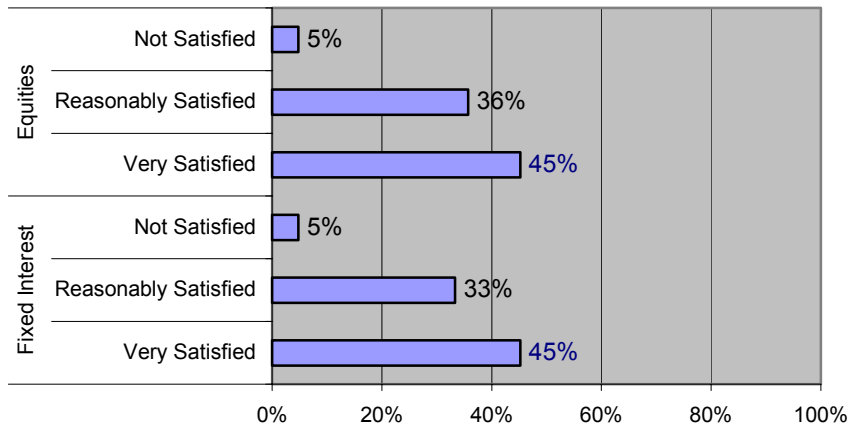


Fig. 14

Q7 Which (if any) of the following value-added services do you obtain from your custodian/or other party?

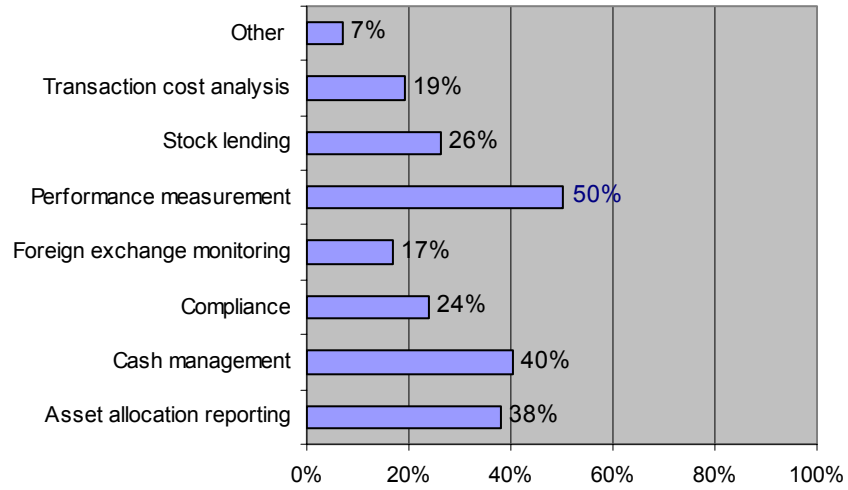


Fig. 15

Q8 If your custodian offers you an investment accounting service, in which of the following two forms do they provide it?

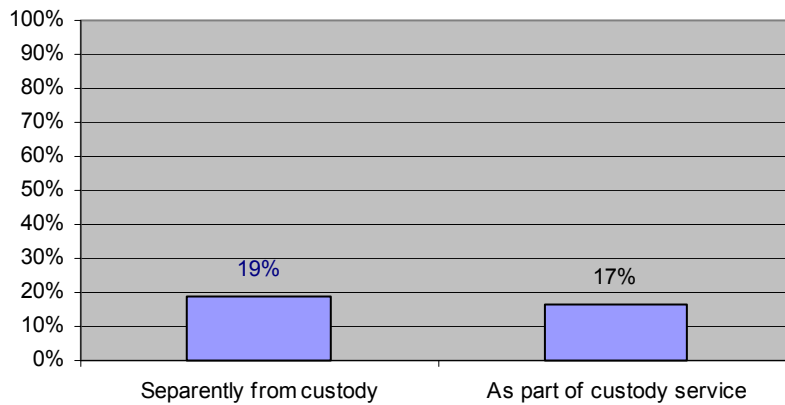


Fig. 16

Q8 A In which of the following two formats is the investment accounting service supplied?

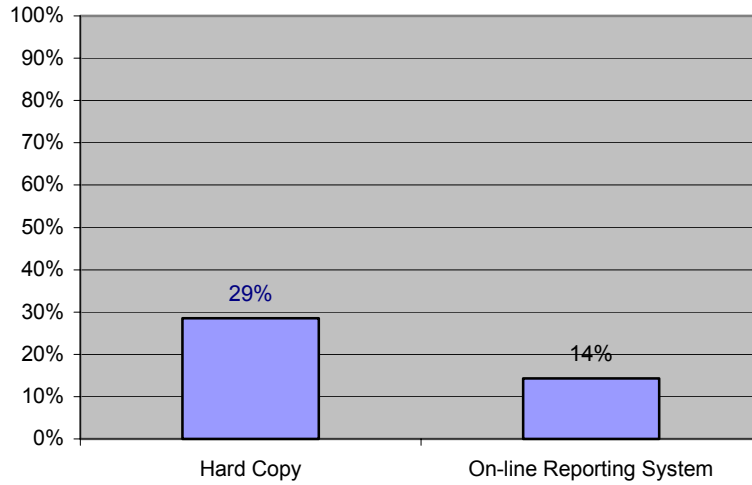


Fig. 17

Q8 B If you ticked on-line reporting system above, which of the following three statements best corresponds to how you regard the usability of the system?

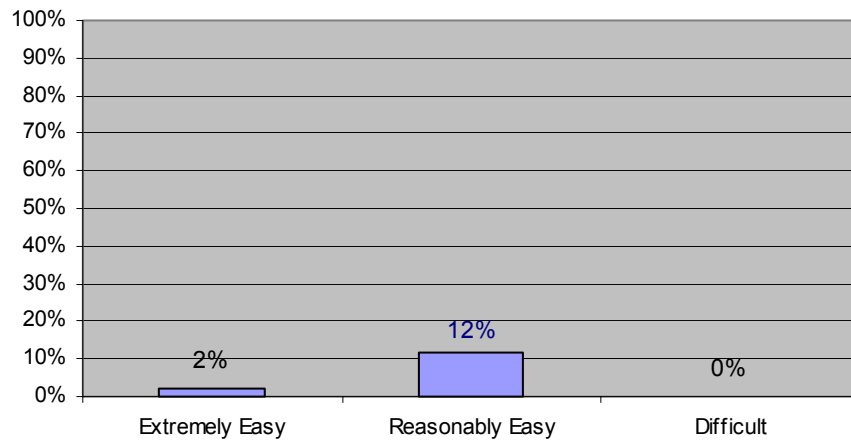


Fig. 18

Q8 C Does the on-line reporting system allow you to design your own reports? YES/NO (if No, go to Question 9)

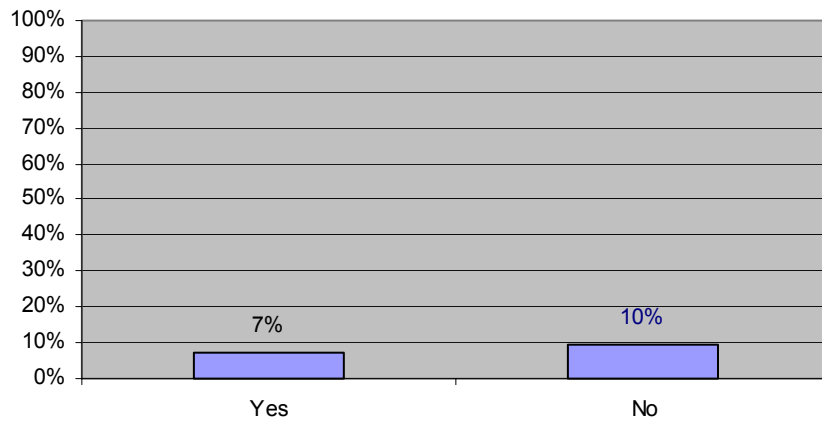


Fig. 19

Q8 D If YES, which of the following statements best represents your view of the ease of designing your own reports.

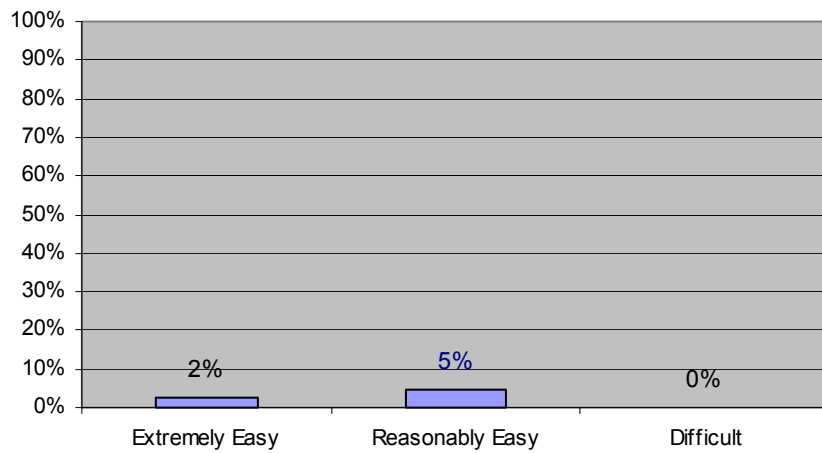


Fig. 20

Q9 Do you currently use any type of computer system in-house to handle all or some of your investment monitoring requirements? (if No, go to Question 9B)

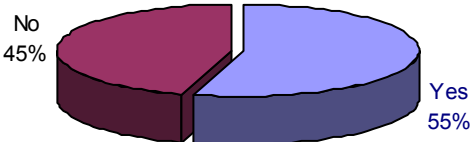


Fig. 21

Q9 A If YES, what is the brand name of this system?

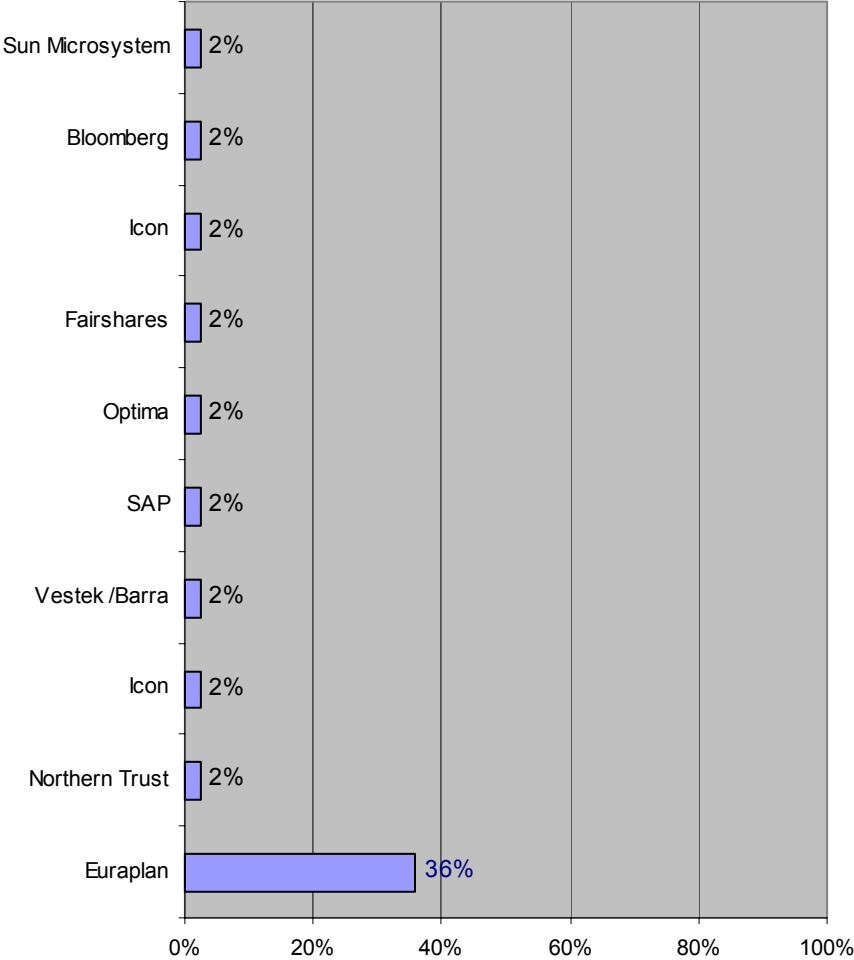


Fig. 22

Q9 B If NO, have you considered using a computer system in-house to handle some or all of your investment monitoring requirements at any time during the past two years?
(if No, go to Question 10)

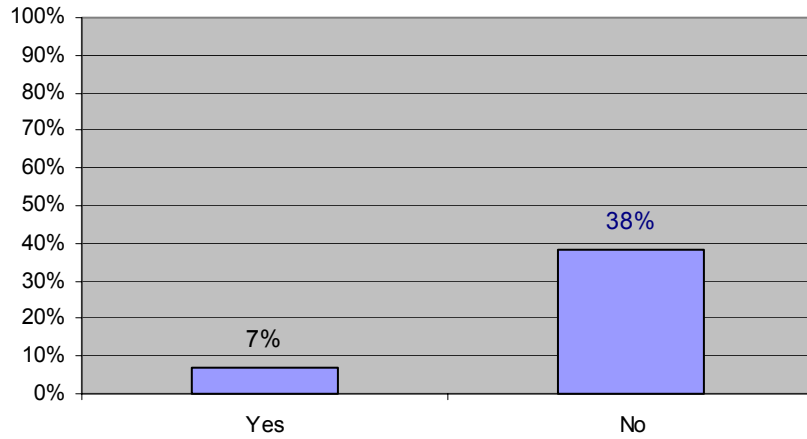


Fig. 23

Q9 C If you answered YES above, which of the following statements best represents your current attitude to using a computer system for this purpose?

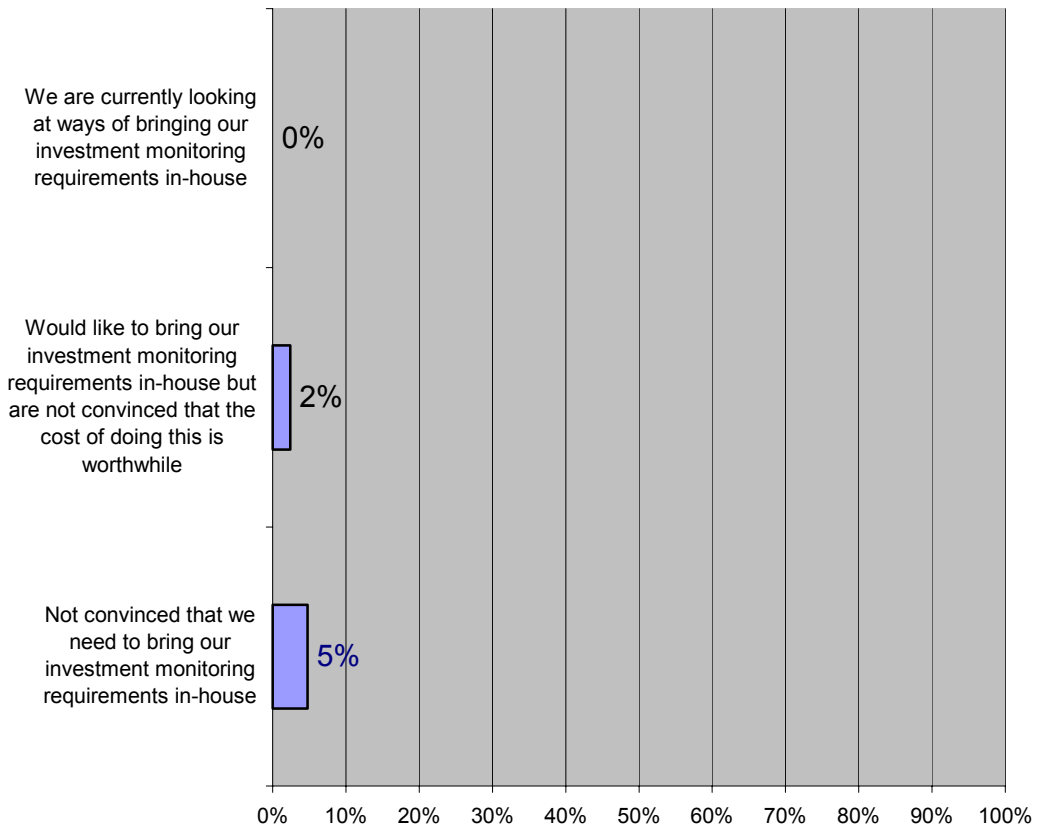


Fig. 24

Q10 Please state which (if any) of the following transaction costs you monitor on a regular basis.

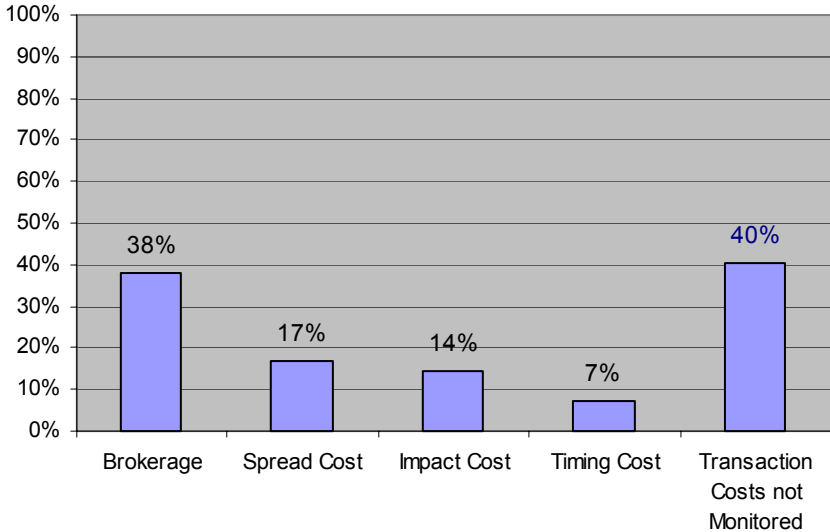


Fig. 25

Note: This section is only applicable if you outsource your investment monitoring to a Third Party.

Q11 Within which of the following time-frames do you usually receive a reply to a standard query made to your investment monitoring supplier?

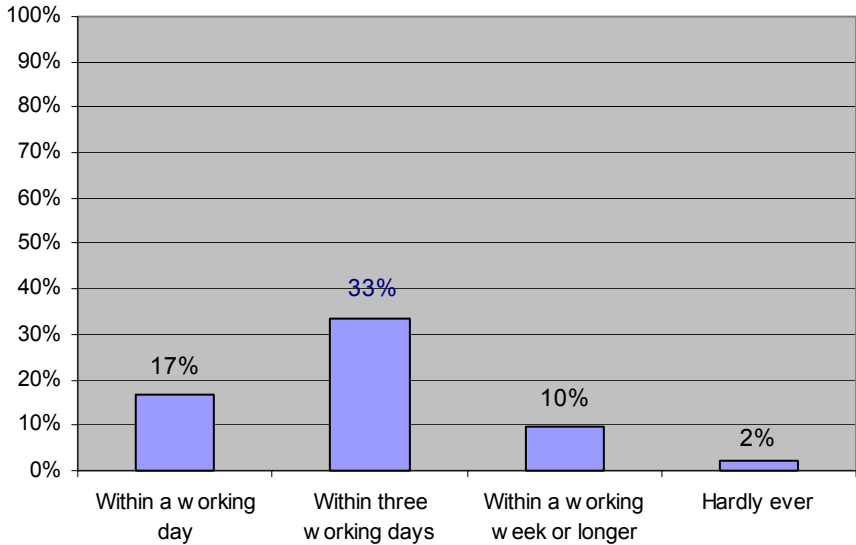


Fig. 26

Q12 Within which of the following time-frames do you usually receive a reply to a *unique* query made to your investment monitoring supplier? (for example the provision of an ad hoc report or service.)

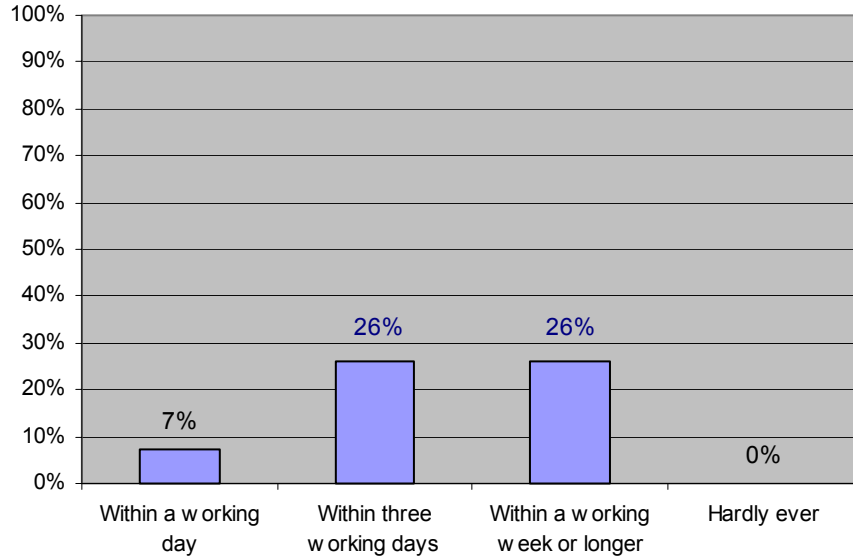


Fig. 27

Q13 How promptly does your investment monitoring supplier amend its systems to comply with industry changes?

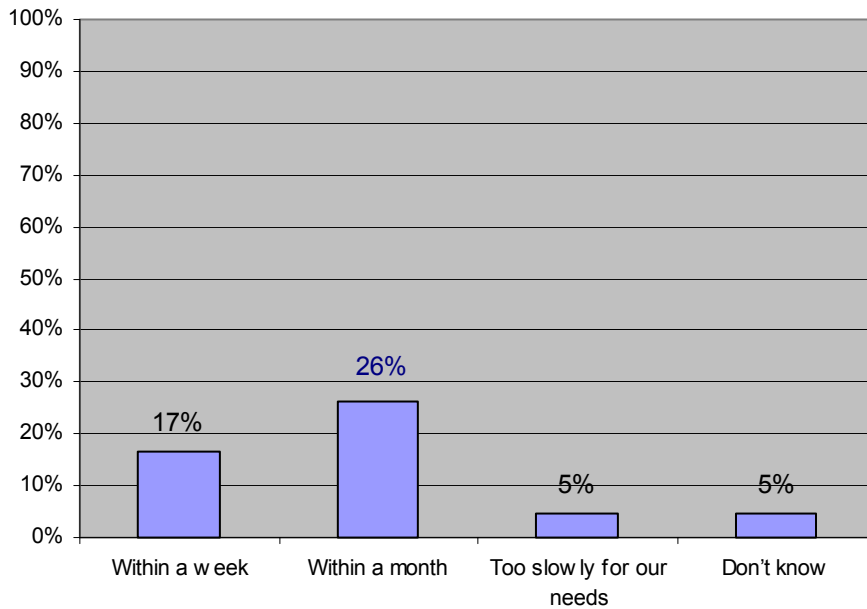


Fig. 28

Q 14 How many man-hours does your department typically spend per month taking figures from the investment monitoring supplier and converting them into meaningful reports for your Trustees or into figures to include in your accounts?

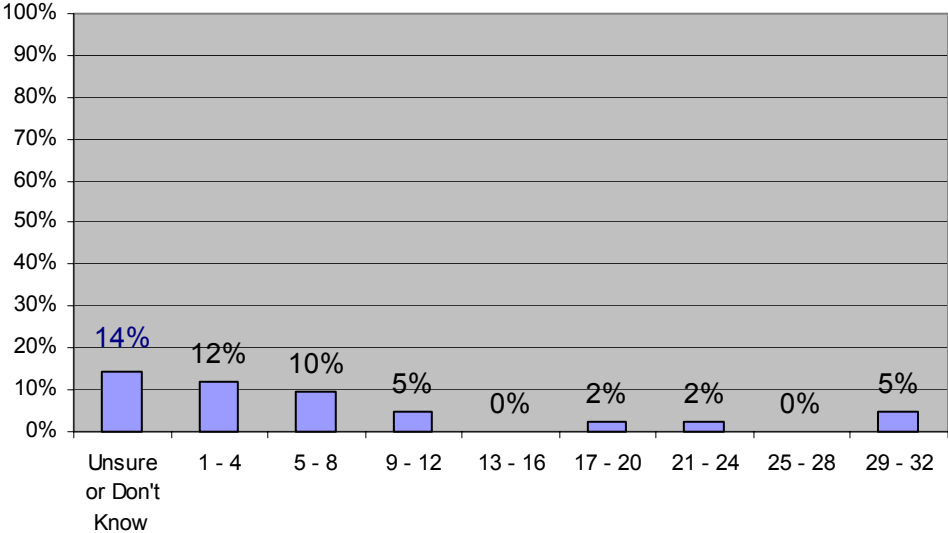


Fig. 29

Q15 Which of the following pensions or industry-related journals do you spend more than ten minutes reading at least once a month?

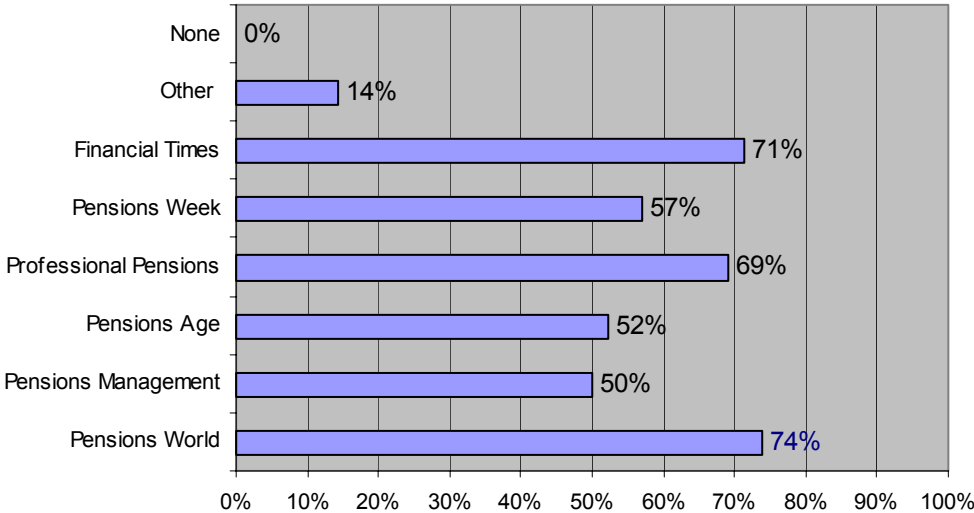


Fig. 30