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Good Practices in Social Security

Good practice in operation since: 2009

Enforcing the prudent person principle in investment management

A case of the Social Security Department

Social Security Department
Guernsey

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Summary

The Guernsey Social Security Department administers an insurance buffer fund of Pounds Sterling (GBP)722 million (US-dollar (USD)1,161 million).

The Department has, historically, had very high allocations in listed equities. As the global economic crisis took hold, the fund suffered an 18 per cent fall in value in 2008. This was followed by a 22 per cent recovery in 2009, fully restoring the fund to its pre-crisis valuation.

The experience caused the Guernsey Social Security Department, with the assistance of newly appointed investment advisers, to reconfigure its strategic asset allocations in order to reduce this level of volatility. The main objective is to seek equity-like returns with lower than equity risk.

The Department has re-positioned the investment portfolio, shifting the emphasis from relative return towards absolute return. Risk of a negative overall return still remains through the return-seeking equity exposure, but this will have a reduced allocation which will not exceed 45 per cent of the portfolio. The value at risk (VAR) has been halved, from 12 to 6 per cent.

The 2010 return on the fund was 12.43 per cent.

CRITERIA 1:

What was the issue/problem/challenge addressed by your good practice?

Having experienced an 18 per cent reduction in the valuation of the Social Security Reserves in 2008, albeit fully recovered in 2009, the Guernsey Social Security Department decided to re-configure its strategic asset allocation with a view to avoiding negative results of this magnitude in future, while still seeking an investment return close to the long-term return on equities.

CRITERIA 2:

What were the main objectives and the expected outcomes?

The main objectives were and are, on a three year rolling average, to achieve equity-like returns with lower than equity risk.

CRITERIA 3:

What is the innovative approach/strategy followed to achieve the objectives?

The Department has undertaken wholesale changes, including the appointment of new investment advisers in 2009. The investment mandates of the three fund management firms in 2009 have been very substantially changed, reduced or removed as the Department has moved from a traditional, balanced portfolio to a number of niche, specialist fund managers. The Department now has six fund managers, responsible for eight separate investment mandates. These include a firm with a dynamic asset allocation mandate, a firm administering a structured equity product, two firms specialising in global equity (including emerging markets), a specialized bond manager and a loans manager. The move to the new allocations is 80 per cent complete and will be concluded during 2011.

CRITERIA 4:

Have the resources and inputs been used in an optimal way to implement the practice?

The Department is a small organization which outsources its investment functions. The implementation phase, which is not fully complete, has increased the workload on the Department's elected members and senior staff, first in building the relationship with the new investment adviser, approving the strategic asset allocations and then appointing managers for the separate investment mandates. Professional fees for the investment advisers, transition costs and the more numerous fund managers increased the overall fee costs by 36 per cent comparing 2010 against 2009 (GBP2.81 million cf. GBP2.07 million).

CRITERIA 5:

What impact/results have been achieved so far?

The value at risk in the investment portfolio has been reduced from 12 per cent in 2009 to 6 per cent in 2011. A VAR of 6 per cent indicates that there is a 95 per cent probability that the annual loss in value in the portfolio will not exceed 6 per cent. Or, put the other way, there is a 5 per cent probability of the funds losing more than 6 per cent in value. This statistic has limitations, not least because it relies on a normal distribution for modelling and that normal distribution is not the reality. Furthermore, once in the 5 per cent territory, then the losses may be much deeper than 6 per cent. But those very real issues should not detract from the fact that the Department has reduced its value at risk by one half, without significantly compromising its investment objective of "equity-like returns".

The return on the Funds for 2010 was 12.43 per cent (gross of fees). The annualized returns on the Funds are shown below:

1 year	12.43 %
3 years	3.96 % per annum
5 years	6.09 % per annum
7 years	8.66 % per annum

The above returns, in particular the annualized return over seven years, look very respectable bearing in mind that they include the 17.95 per cent loss in 2008 at the height of the global economic crisis.

CRITERIA 6:

What lessons have been learned?

The lessons learned are perhaps more a reminder of old lessons forgotten. If the fund managers have not called the top of the market and moved the allocations, then once the fall in market values accelerates the institution has to hold tight, not sell, and wait for the upturn. Provided that the investments are in quality assets, the lesson from history is that market value will return. But until it does, the governors of the scheme will be in a very exposed position. Those that have endured this recent experience may well now be less comfortable with relative return mandates and more attracted to absolute return and prepared to sacrifice an element of long-term return in order to avoid deeply negative short-term returns. An important development in the Department’s thinking has been the recognition of the principle that the best way to make money is to avoid losing it. The current strategy is informed by an objective of avoiding significant and permanent capital loss. This is achieved primarily through the activities of diversification and rotation of capital through the asset classes.

Debate on the merits of active or passive fund management will endure. The Guernsey Social Security Department has experienced both. The Department's portfolio is all actively managed, reflecting its current view on that debate.

CRITERIA 7:

To what extent would your good practice be appropriate for replication by other social security institutions?

The extent to which Guernsey's practice could or should be replicated by other social security institutions will depend on the current configurations of their investment portfolios. Many of the schemes are already expertly managed and will have nothing to learn from Guernsey's experience. Others may have room for improvement and may pursue a similar approach. The particular investment constraints of a scheme will also be material, for example the extent to which external investment is permitted.