



Pension Benefit  
Guaranty Corporation

# **Review of the PBGC Smaller Asset Manager Pilot Program**

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## **REVIEW OF THE PBGC SMALLER ASSET MANAGER PILOT PROGRAM**

The Pension Benefit Guaranty Corporation (PBGC) established the Smaller Asset Managers Pilot Program (SAMPP) to provide opportunities for smaller investment management firms to manage some of the agency's fixed income assets. Performance measurement for investments under the pilot program began August 1, 2016. This report summarizes PBGC's experience under the pilot program. The report provides investment return performance (net of fees) of the pilot program relative to a benchmark and to non-pilot program fixed income asset managers. It also describes the program structure, observations and lessons learned.

### **BACKGROUND**

PBGC uses institutional investment management firms to invest its assets, subject to PBGC's oversight and consistent with the investment policy statement approved by PBGC's Board of Directors (Board). PBGC does not determine the specific investments to be made, but instead relies on PBGC's investment managers' discretion in executing investments appropriate for their contractually assigned investment mandates. PBGC does ensure that each investment manager adheres to PBGC's prescribed investment guidelines associated with each investment mandate and measures each investment manager's performance in comparison with agreed-upon investment benchmarks.

In August 2014, the Board asked PBGC's Advisory Committee to provide recommendations to address the lack of inclusion of smaller asset managers and to expand diversity in its portfolio by increasing the number of investment ideas, approaches and management teams. The Board then directed PBGC to develop a pilot program to address these goals. PBGC staff, with the assistance of the Advisory Committee, assessed industry best practices in this area and developed recommendations on how such a smaller asset manager program might be established.

PBGC announced the Smaller Asset Managers Pilot Program (SAMPP) in May 2015. The program sought to reduce competition barriers faced by such firms while maintaining rigorous investment risk and control standards. PBGC selected US Core Fixed Income as the asset class for the pilot because research showed that there was a higher probability of finding smaller managers that could add value relative to the benchmark return compared to other asset classes. Additionally, the majority of PBGC's assets are invested in fixed income and the proportion of assets in fixed income was expected to increase over time.

In developing parameters for the program, eligible firms were required to have a minimum of \$250 million in assets under management (AUM), a five-year performance history, and undergo the same competitive evaluation as other PBGC money managers. The procurement was open to all managers that met the minimum AUM requirement. Additionally, PBGC limited allocations to no more than twenty percent of a firm's AUM, which is in keeping with industry standards. Ultimately, in June 2016, PBGC selected five firms for the pilot program that would be expected to outperform the portfolio benchmark (BBG Barclays Aggregate Bond Index) over a full market cycle of highs and lows at an acceptable level of risk. Each of the selected firms was allocated \$175 million, with performance management beginning on August 1, 2016.

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Four out of the five firms have owners with the following diversity characteristics:

- one firm was minority-owned (LM Capital Group);
- two firms were women-owned (Longfellow Investment Management and New Century Advisors);  
and
- one firm was minority woman-owned (Pugh Capital Management).

PBGC adopted a plan to analyze the implementation and operation of the pilot program after one year and to analyze the performance of the firms after five years, which is the industry standard. Five years is considered to be an appropriate period of time to determine whether a manager is successful because historically, on average, market cycles last approximately five to seven years. To fully evaluate a manager's performance track record, it must demonstrate its capabilities in the variety of market environments that encompass a market cycle.

Investment managers have unique areas of expertise with strategies that often result in managers performing differently in varying market conditions. For this reason, a full market cycle is necessary to allow each manager the opportunity to demonstrate their skill in varied market environments.

## **ANALYSIS AFTER FIVE YEARS AND INCEPTION- TO- DATE**

The following analysis of the SAMPP includes structure, due diligence, performance, and resource factors.

### **PROGRAM STRUCTURE:**

PBGC designed the program for hiring of smaller asset managers in an asset class where active management has historically added value. This is reflected in the relative performance of its Core US Bond Composite returns.

The successful hiring of small asset managers was a result of the asset class, the program parameters, and the procurement process.

- **Asset Class:** Core US fixed income was chosen because inefficiencies exist in the asset class that allow for the success of active management. In contrast, the U.S. public equity sector of the market is highly efficient, making value-added performance from active management harder to achieve, by either large or small firms. This is reflected in the current position of the PBGC domestic equity portfolio, which is entirely passively managed via use of index funds. Additionally, the risk (volatility) of equities is greater than the risk of Core US fixed income. An active international fixed income allocation applied to a smaller manager framework is not feasible, because those asset classes require a large infrastructure to cover the breadth and complexity of those markets. There are other segments of the market, such as private equity and private real estate, for which the PBGC investment policy statement does not allow an active allocation. PBGC's private market assets consist entirely of assets inherited from terminated pension plans.
- **Program Parameters:** In designing the SAMPP to accommodate smaller managers, the PBGC lowered both insurance requirements and the minimum AUM required to bid on this PBGC investment contract.

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- Procurement Process: The cooperation of multiple PBGC departments was needed to make the search process efficient. The Corporate Investments Department (CID), the Procurement Department (PD), and the Office of General Counsel worked together to meet and successfully implement the pilot program. The effective collaboration was evident in a successful pre-bidder's conference at which PBGC staff described federal procurement rules for prospective managers.

#### **DUE DILIGENCE:**

- Deliverables: The same due diligence framework that is applied to PBGC's larger fixed income managers is utilized for the SAMPP managers. Managers have monthly, quarterly and annual deliverables. However, because of resource constraints at these firms, CID staff has had to work with some of the firms to bring their reporting practices up to the same standards as the larger firms. Examples where enhancements were necessary included tracking error and attribution reporting, which provide CID staff information on both the extent to and the reasons why a manager's performance deviates from its benchmark. Currently, the managers are all providing the required information.
- Meetings: In addition to the periodic deliverables, CID typically conducts two due diligence meetings each year at six-month intervals, one on-site at the manager's office and the second at PBGC's office. Each of the SAMPP managers participates in the semiannual due diligence meetings and all are able to provide all required information.
- During the initial five years of the program, three of the five SAMPP managers have had guideline violations. The types of violations have varied and included items related to the new-account set-up process, required notifications and guideline interpretation issues. In all cases, CID staff handled appropriately and without harm to PBGC. CID staff reported these guideline violations to the PBGC Advisory Committee and Board through its normal process. As appropriate, in the one instance when a guideline violation had a negative monetary impact on the portfolio, the manager compensated PBGC for the small loss.
- Regarding manager reporting, one area that initially needed clarification was the communication of organizational changes that occur between reporting dates. CID needs to be informed about significant organizational changes as soon as possible. Examples of such changes include staff departures/additions and client losses. At this point, all SAMPP managers understand CID's expectations and inform CID of such changes as they occur.

#### **PERFORMANCE:**

As of July 31, 2021 (five years after initial allocations), each of the five smaller managers generated net-of-fee returns exceeding the established benchmark. In the aggregate, the program generated a five-year return of 3.53% as compared to a 3.13% return for the benchmark. While the SAMPP Composite somewhat underperformed the investment program's larger US Core managers over the five-year period, it is important to note that strategies perform differently over the course of an economic cycle.

The table below reflects the initial five-year net-of-fee performance for the SAMPP Composite, the benchmark, and the PBGC Core US Bond Composite:

| <b>Investment Performance (Five Year)</b> |                   |                                  |
|---|-------------------|----------------------------------|
|   | <b>Five Year*</b> | <b>Difference from Benchmark</b> |
| <b>SAMPP Composite</b>                    | <b>3.53%</b>      | <b>0.40</b>                      |
| <i>BBG BARC Aggregate Bond Index</i>      | 3.13%             |                                  |
|   |                   |                                  |
| <b>PBGC Core US Bond Composite</b>        | <b>3.74%</b>      | <b>0.61</b>                      |

\* Net of fees as of 7/31/21

## **OBSERVATIONS/ LESSONS LEARNED**

Observations and lessons learned from the program to date include:

- Identifying the right asset class was important to a successful and efficient search process, and maybe to the performance of the managers. As described in the analysis, Core US fixed income was chosen because inefficiencies exist in the asset class that allow for the success of active management.
- The pre-bidder's conference was well received and proved helpful in describing the federal procurement rules for managers who were unfamiliar with the process.
- Tailoring the Request For Proposal (RFP) to more accurately address the potential strategies of smaller, niche asset managers made the evaluation process more efficient.
- The smaller managers initially had issues with meeting PBGC reporting requirements, because smaller managers typically have fewer resources. PBGC staff was able to collaborate with smaller manager staff to bring their reporting in line with requirements.
- Smaller managers generally have a higher asset concentration per client, which increases the firm's operational risk to investors. CID strives to develop an understanding of current clients of the firm (when disclosure is not prohibited), which allows PBGC to better assess areas of potential risk. One smaller manager had a few sizeable accounts leave the firm, which CID discussed with the manager. CID continues to monitor the asset levels of the manager since it has been identified as an area of risk.

## **NEXT STEPS**

The Smaller Asset Managers Pilot Program has been successful in achieving its objectives and each of the five managers in the program has exceeded the PBGC's core bond benchmark.

Earlier this year, the PBGC Board approved establishing the Smaller Asset Managers Program (SAMP) as an ongoing program.

Accordingly, PBGC will soon announce its plan to recompete its SAMP contracts and expand the program, beginning with a virtual conference for interested firms to learn more about the program and federal procurement process.