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Social Security Investment Unit (SSIU) Performance Evaluation

Final Report

May 31, 2005

The author's views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.

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- Organizational issues
- Valuation for asset allocation decisions
- Governance
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- Department manager
- Trading limits
- Compliance office
- Investment committee
- Brain-storming meetings
- Commercial paper
- Longer-term government bonds
- Liquidity objective
- Commercial lending
- Real estate subsidiary
- Investment policy statement (ips)
- Decision-making responsibility and authority
- Transparency
- Regulation no. (111) of the year 2001
- Asset allocation
- Evaluating performance
- Actuarial specialist
- Benchmarks
- Repos
- Asset-backed securities
- Market maker
- New public shareholding
- Syndicated lending
- Liquidity

Abstract

The purpose of this report is to respond to the SSIC request for the AMIR Program to conduct an assessment of the SSIU's: performance, its compliance with the Investment Policy Statement (IPS), and its compliance with internal controls. In addressing these important issues, this report recommends certain changes to the SSIC's decision-making process that would result in more of a disciplined, team-oriented investment approach for the combined efforts of the SSIC and SSIU. Specifically, the report addresses the manner in which the SSIC supervises the SSIU and the how the SSIU operates. The underlying principle driving these recommendations is that of serving the best interests of plan beneficiaries.

The goal of this report is to provide the SSIC with ideas for building a professional investment environment in which independent investment ideas flow freely and professional managers responsible for making investment decisions are held accountable for those decisions. Such an environment is a requisite for successfully investing the public's money over long periods of time. If recommendations presented in this report were adopted, the result would be a world-class decision-making process in which investment professionals are free to exercise their best judgments unencumbered by organizational obstacles. Adoption of these recommendations would also lead to greater workforce participation rates and higher subscription revenues, both of which are objectives of the SSC's current public relations campaign to spread social security awareness.

The report is divided into three sections. The first section addresses organizational issues confronting the SSIC. Recommendations in this section focus on creating an environment supportive of an independent, professional investment unit. In order to create such an environment, the SSIC needs to more closely align authority with responsibility in its decision-making process. The second section of the report recommends certain changes to the SSIC's Investment Policy Statement (IPS) that directly impact how the SSIU operates. International best practice requires a disciplined, creative approach to investment decision-making and an important recommendation is that of holding weekly "brain-storming" sessions the purpose of which is to stimulate original thinking in the group of participants. The third section of the report addresses valuation of assets when making asset allocation decisions. These recommendations focus on using market values to the maximum extent possible. A particular problem arises in the case of real estate and private equity investments so for these two asset classes, the recommendation is to use appraised values and generally acceptable mathematical formulae, respectively, as opposed to book values.

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Executive Summary

The purpose of this report is to recommend changes in the organizational structure and operational procedures of the SSIC. If the recommendations presented here were adopted, the SSIC would gain international recognition as a world-class investment institution with the clear objective of serving the best interests of plan beneficiaries. The recommendations can be divided into three parts:

1. Organizational issues—this section recommends that the SSIC revise its decision-making process to create a more supportive environment in which the SSIU operates. The recommendation is for the SSIC to implement clear lines of responsibility between its supervisory responsibilities of the SSIU and how the SSIU operates. The main point of these recommendations is to give the Unit's CEO responsibility and, thus, accountability for all aspects of managing the SSIU and implementing the SSIC's IPS.

2. Investment Policy Statement (IPS)—these recommendations modify the existing IPS to conform more closely to international best practices. The main recommendation of this section is for identifying a minimum return objective equal to the expected long-term rate of inflation. Other recommendations include: (1) avoiding the practice of "market making," (2) establishing that the minimum holding period for an investment will be 6 months, (3) splitting the Unit's Fixed Income and Treasury Department into two separate departments: Fixed Income and Short-Term Debt Obligations, (4) renaming "Investment In Private Shareholding Companies" as "Venture Capital" and (5) gradually eliminating lending practices.

3. Valuation of Assets for asset allocation decisions—these recommendations focus on the need to rebalance the portfolio according to long-term target ranges for each asset class regardless of existing market conditions. Currently, the SSIC is not practicing this strategy, which has led to a significant over-exposure to equity risk. While past decisions that drove this situation have been fortunately timed, such a strategy going forward is inconsistent with a long-term, disciplined strategy that is appropriate for a state-run pension fund. In addition to being more disciplined in rebalancing the portfolio, this section also recommends valuing real estate using appraised values and private equity using industry-accepted mathematical formulae. These valuation techniques are more reliable than the current practice of using book value. For real estate, the use of book values creates hidden reserves in the portfolio that distort asset allocation decisions and could, ultimately, affect the actuary's recommendations on appropriate subscription rates.

Section I. Recommendations Concerning Organizational Issues

Introduction

The purpose of this section of the report is to address organizational issues affecting the Social Security Investment Commission (the "SSIC"). Since the SSIC is responsible for supervising the Social Security Investment Unit (the "SSIU"), organizational issues affecting the SSIC directly impact the SSIU. It is our intention here to make recommendations that clearly define levels of decision-making responsibility and authority for each organization.

Specifically, these recommendations align the SSIC's authority with its responsibility for supervising the SSIU, and align the SSIU's authority with its responsibility for implementing the SSIC's Investment Policy Statement (the "IPS"). Adoption of these recommendations would enhance accountability for both organizations.

Given the high level of professional competence in talented people presently working within each organization, revising the relationship between the SSIC and the SSIU will enhance the performance of both entities and lead to a world-class investment decision-making process. Sources of information used in this section include:

- "Regulation No. (111) of the Year 2001";
- Interviews with each Department Manager, the acting CEO, and the Investment Consultant of the SSIU;
- Interviews with the Chairman of the SSIC.

Recommendations presented here represent international best practices for:

1. Streamlining the current decision-making process;
2. Enhancing the flow of information between the SSIC and the SSIU;
3. Empowering the SSIU's professional staff to take greater advantage of their unique talents and training;
4. Encouraging the SSIU professional staff to be more proactive in interacting with Jordan's financial community;
5. Creating an organizational environment that focuses on good governance with a clear vision of the ultimate goal of serving the best interests of the Fund's beneficiaries.

These combined recommendations would provide the structure for building a professional investment environment in which independent investment ideas flow freely. Such an environment is a requisite for successfully investing the public's money and generating relatively stable returns over long periods of time In addition, adoption of these recommendations should lead to greater Jordanian workforce participation rates and higher subscription revenues, which are goals of the SSC's current public relations campaign to spread social security awareness.

Recommendations and Rationale

A. SSIC—Given the SSC's approval of the Commission's IPS, the SSIC shall:

1. Hire a Chief Executive Officer (the "CEO") who bears the responsibility for all activities of the SSIU including both administrative procedures and investment decisions;

2. Supervise the CEO to insure that he adheres to the Asset Allocation and trading limits outlined in the IPS;

3. Provide a sound methodology for evaluating performance of the CEO according to benchmarks identified in the IPS. I suggest that the SSIC retain an outside consultant (preferably from Jordan) to assist in this evaluation since the methodology and data verification needed for evaluation should be independent of the CEO and staff of the SSIU;

4. Designate a compliance office (with reporting responsibility to the Chairman of the SSIC) whose responsibility is to safeguard the flow of sensitive financial information in and out of the SSIC and the SSIU. The compliance office shall implement procedures designed to prohibit any form of conflict between management of the Fund and personal interests of members of both organizations. Additionally, the compliance office shall be responsible for inquiring into alleged violations of the internal rules and regulations of each organization;

5. Recommend changes in the IPS to the SSC based on advice from the SSC's actuarial specialist and the SSIU's CEO. I suggest that the SSIC invite the SSC's actuarial specialist to its quarterly meetings to provide an actuarial perspective when evaluating portfolio performance. The actuarial specialist would also serve as a valuable resource to the SSIC and SSIU for explaining the actuarial process and assumptions, which is a highly technical and specialized field of study;

B. SSIU—The SSIU is the operating arm of the SSIC comprised of investment professionals and managed by a CEO who serves at the pleasure of the SSIC.

1. Duties of the CEO shall be to:

   a. Implement the IPS under the supervision of the SSIC;

b. Seek advice from the Investment Committee on asset allocation decisions. The role of the Investment Committee is advisory with membership comprised of all Department Managers in the Unit;

c. Recruit and hire Department Managers. All final hiring decisions would require consent of the SSIC (recruitment and hiring of administrative employees would not require approval of the SSIC);

d. Supervise Department Managers by providing them with investment policies and benchmarks outlined in the IPS;

e. Report the portfolio’s investment performance to the SSIC on a timely basis;

f. Organize and conduct weekly brainstorming meetings the purpose of which is to stimulate the flow of new investment ideas. Invitees would include Department Managers and their respective staffs, members of the SSIC and SSC, and the SSC’s actuarial specialist.

2. Duties of Department Managers shall be to:

a. Select sectors and individual securities within the allocation provided by the CEO that are consistent with investment policies provided in the IPS;

b. Supervise their respective staffs;

c. Advise the CEO on asset allocation decisions via the Investment Committee;

d. Conduct activities as directed by the CEO

C. Other:

1. Create a business development position. Such a position would give the SSIU a mechanism for being more proactive in the financial community especially in the development of new financial instruments. The business development person would have the title of “Business Development Officer” and report to the CEO.

2. Separate the Fixed Income and Treasury into two departments: a Fixed Income Department and a Short-term Debt Instruments Department. Separation would allow a greater degree of focus for each department that should lead to the introduction of new debt instruments such as repos, commercial paper, asset-backed securities, and longer-term government bonds. The SSIU is in a good position to take the lead in this development.

D. Rationale:

1. The skill and experience of investment professionals in the SSIU provide an excellent resource to the Unit for making crucial investment decisions. These skills and experiences are underutilized at the present due to certain organizational obstacles. As a result, many professionals have either already left the Unit or are in the process of leaving.

2. The partnership structure outlined above would create a team-oriented philosophy that increases the opportunity for successfully investing the public's money. This structure emphasizes an investment approach based on clearly defined levels of decision-making and supervision that exist within a long-term investment philosophy of diversification across multiple asset classes, within each asset class, and within each sector.

3. The driving force behind any team effort is discipline and a commitment to professionalism. Members of the decision-making team (all members of the SSIC and the professional staff of the SSIU) are expected to enter into open discussion and lively debate in pursuit of investment strategies and ideas that make a difference in the lives of all people working and living in Jordan.

4. The primary drivers of the above recommendations are:

    a. Providing SSIC supervision of the SSIU that is consistent with Article 9 of "Regulation No. (111) of the Year 2001" as well as international best practice;

    b. Advancing SSIU autonomy within limits defined in the IPS;

    c. Aligning CEO and Department Manager authorities with their respective responsibilities for making investment decisions;

    d. Expecting departmental staff to provide crucial research and analysis in support of decisions of the CEO and Department Managers.

    e. Reiterating, as stated in the IPS, that the Fund should assume only as much risk as is needed to generate the expected return stated in the actuary's report.

    f. The clear understanding that as a public pension fund, the SSIC has a long-term investment horizon that requires a disciplined, well-documented, and easily understood decision-making process that avoids short-term, ad hoc decisions. Every investment decision should be made in an environment dedicated to a thoughtful analysis of each alternative by investment professionals trained in the intricate theories of security analysis and portfolio management.

g. A creative environment is only possible where investment ideas are openly and frankly discussed, which is the purpose of the Investment Committee. If properly utilized, this committee can be a highly effective tool for assisting the CEO in making crucial asset allocation decisions across multiple asset classes. The idea is to create a situation where each Manager competes with every other Manager for the allocation of scarce funds. The CEO is responsible for allocating funds within target ranges for each asset class as outlined in the IPS. Once done, each Manager has the responsibility for selecting specific sectors and individual securities within his class that optimizes the risk return tradeoff. This decision-making structure clearly defines lines of authority, levels of responsibility, and ultimately, accountability of each decision-maker. The CEO is accountable to the SSIC, each Manager is accountable to the CEO, and each member of the staff is responsible to his respective Manager

Conclusions

The rationale behind these recommendations is for the SSIC to supervise the SSIU by creating a support system that encourages professional, independent thinking and decision-making. Such a system aligns responsibility with authority by clearly defining the roles of each entity. The recommendations presented here are designed to capitalize on the talent of the professionals in the Unit and to retain that talent over time. By redirecting efforts more toward a team approach with the responsibilities of supervision and operations clearly identified, the SSIC would enhance the probability of the Unit's long-term investment success.

Notes:

1. An excellent description of a world-class professional investment management firm can be found for Wellington Management Company at http://www.wellington.com/.

2. I am grateful to Gene Record, Senior Vice-President (retired), Wellington Management Company (WMC), for his insights into the investment decision-making process.

3. A case study of an efficient decision-making process can be found at: http://webapps.acs.carleton.edu/campus/doc/faculty_resources/important_documents/21st_century_report/decision_making_communication_and_community/

4. A review of governance of public pension plans can be found at: http://www.lens-library.com/info/whar5.html

5. For a review of construction of an Investment Policy Statement, see “Public Pension Systems: Statement of Key Investment Risk and Common Practices to Address Those Risks” National Association of State Retirement Administration, July 2000. My thanks to Dr. Joseph Farhat for providing me a hard copy of this report.

6. For an evaluation of risks that a public pension fund faces, see “Risk Standards for Institutional Investment Managers and Institutional Investors,” Risk Standards Working Group (undated). My thanks to Dr. Joseph Farhat for providing me a hard copy of this report.

Section II: Recommendations to SSIC (Investment Policy Statement)

Current Policies[1]	Recommendations	Comments
Professional Ethical Standards (ref: II, 5)	Appoint a compliance officer who reports to the Chairman of the SSIC(see "Recommendations to the SSIC, Organizational Issues")	The compliance officer would have the responsibility for establishing control mechanisms designed to prohibit personal gain as a result of exposure to sensitive financial information while a member of the SSIC or employee of the SSIU.
The Importance of Research and Education (ref: II, 6)	Include "continuing education for investment professionals" as a condition for continual employment at the SSIU.	Section II, 6 mentions importance of education only in passing. Continuing education of SSIU investment professionals should be a high priority.
Return Objective (ref: III, 1)—3-4 percent above the average discount rate used in actuarial analysis.	Change to "a minimum return equal to the expected long-term rate of inflation"	The discount rate is a controversial and often misunderstood measure. The expected long-term rate of inflation is consistent with Article (4) B of Regulation (111) that specifies a goal of preserving the real value of investments. Additionally, the expected rate of inflation is easier to understand and measure.
"The Unit will play an empowering role in the Jordanian securities market…that provides the elements of liquidity and stability….achieving the objective of deepening the market" (ref: III, 2)	Remove all references in the IPS suggesting or implying that the Unit may act as a "market maker."	"Market making" for the purpose of stabilizing prices is not a role that the SSIU should assume. Such activity confuses the market and subjects the Unit to investor claims of being unfair in its selection of which stocks to "make a market". "Market making" is a short-term trading strategy that conflicts with the Fund's long-term investment objective. Market making should be a regulated activity under careful supervision by the proper authorities.

[1] See "Social Security Investment Commission: Investment Strategies and Policies Proposed for the Commission for Investment of Management of Social Security Corporation Funds" by SSIC (undated).

Liquidity objective (ref: III, 3)	Update reference to actuarial studies that show "…cash surplus for coming 25 years."	Actuarial studies are highly dependent on underlying assumptions and both the SSIC and SSIU need to understand the importance of such assumptions (see recommendation to include the SSC's actuarial specialist in SSIC quarterly meetings in another part of report).
Timeframe (ref: III, 4)—refers to a long-term strategy but does not specify a minimum holding period.	State that the minimum holding period for an investment is 6 months.	The purpose of this recommendation is to remove a decision-maker's tendency toward a short-term trading strategy. The CEO could override this 6-month requirement if a Manager presents the CEO convincing analytical documentation that fundamentals of the investment have shifted sufficiently to merit an immediate trade. The CEO would, in turn, have to justify his decision to the Chairmen of the SSIC prior to making the transaction and after-the-fact to the full Commission at the quarterly evaluation meeting.
Cash Investments (ref: IV, 1)	IPS addresses bank criteria for developing a list of approved banks, but is silent on cash management strategies. The CEO should consider making a recommendation to the SSIC to split the Unit's Fixed Income and Treasury Department into two separate departments: Fixed Income and Short-Term Debt Obligations (I make this same recommendation in "Recommendations to SSIC, Organizational Issues").	Creating a separate "Short-term Debt Obligations" department would allow the Unit to focus more attention on developing this sector of the market. The SSIU could play a pivotal role in introducing new debt instruments for the domestic market in light of certain restrictions placed on investing outside the Kingdom (see IPS, VII). New debt instruments are needed for the Unit to pursue in matching asset and liability durations for risk management purposes.
Investment in Existing and New Public Shareholding Companies in the Local Market (ref: IV, 3)	Include minimum percentages in addition to maximum percentages in order to establish target ranges for sector allocations.	Inclusion of minimum percentages for improving internal risk management controls.
Investment in Existing and New Public Shareholding Companies in the Local	Override approval for exceeding a maximum holding of more than 25	Recommend that the mechanism for including new investment ideas into the Unit's decision-making

Market (ref: IV, 3, F)—refers to "…approval of the SSC Board of Directors"	percent of a company's shares requires the CEO to gain approval of SSIC.	process is through the weekly "brainstorming" meetings discussed in the "Organization Issues" section of this report.
Investment in Existing and New Public Shareholding Companies in the Local Market (ref: IV, 3, G)—states, "Any imbalance in total or partial investment ratios resulting from price fluctuation in the trading market shall be referred to the Investment Management Commission for action."	Remove this subparagraph since the CEO would handle imbalances with daily supervision provided by the SSIC Chairman and quarterly supervision by the SSIC (see "Organizational Issues, II B 1, Duties of the CEO).	This recommendation is consistent with the idea of aligning responsibility and authority in the decision-making process. Under the current arrangement, Department Managers have the responsibility for correcting imbalances but not the authority.
Investment In Private Shareholding Companies (ref: IV, 4)—effectively, this section deals with venture capital.	Recommend calling this component of the portfolio "Venture Capital" within the equity department and identifying specific sectors in which the SSIU will specialize along with an exit strategy. Suggest reducing long-term allocation to 5% - 10%	Suggest removing references to bond prospectuses, infrastructure projects, and government involvement. Instead, focusing on specific sectors of the market to which dedicated staff analysts would specialize.
Lending Activity (ref: IV, 5)—this activity needs review.	Recommend that the SSIC gradually remove itself from all lending activity including syndicated lending, which is a role for private-sector banks. Recommend letting existing loans self liquidate over time.	Commercial lending is a function of private sector banking and not appropriate for the SSIC. Funding growth for the private sector is more appropriately conducted through either the VC fund (private shareholding companies) or debt placements (loan bonds).
Investment in Real Estate (ref: IV, 6)—this section gives no guidance on the current practice of transferring completed real estate projects to the SSIU"s wholly owned subsidiary with subsequent reporting under the equity asset class.	For asset allocation decisions, recommend carrying all real estate projects, whether completely developed or not, under the real estate asset class as opposed to transferring the project to the equity asset class.	At some point in the future, the SSIC should consider a revolving strategy of selling its real estate subsidiary to the private sector via an IPO, creating a new real estate subsidiary, and periodically repeating the process. Such a strategy would continually interject fresh money into the SSIC and provide liquidity to the real estate sector. This idea needs further development.
Investment Outside the Kingdom (ref: IV, 7)—this section justifies the current practice of investing a	The current practice is to use structured notes linked to performance of certain international	Although each is different, structured notes usually employ derivative securities in some way that can cause loss of part or the

relatively small amount of money outside the Kingdom.	indices. Recommend great caution when using this type of investment for understanding the risks involved.	entire principal. This type of investment appears inconsistent with the IPS (ref: II, 2-3). For a general discussion of the risks involved in structured notes, see: http://www.finpipe.com/structnote.htm
Overall (no reference in IPS)—valuation of assets for reporting requirements and valuation of assets for asset allocation decisions.	The SSIU should use market values or best estimates of market values when making asset allocation decisions (for discussion of this issue, see "Fund Valuation for Asset Allocation Decisions").	International best practice is to use market values derived either from public transactions, when available, or generally accepted valuation techniques based on discounted cash flow for asset allocation decisions (please see comments regarding real estate in this sector and in "SSIC – Actual Asset Allocation 2004-2005"). Generally accepted accounting practices, however, may require a different set of rules for reporting purposes.
Inclusion of additional asset classes in IPS (no reference in IPS).	This action requires modifying the IPS based on recommendations coming from the SSIC to the SSC.	The SSIC should consult with the CEO in formulating recommendation to the SSC. The CEO should, in turn, consult with his Department Managers. The intent of this process is to establish clear lines of communication between the SSIC and the SSIU that represent different levels of authority and responsibility in the decision-making process.
Use of total return concept as an expected rate of return for the portfolio (no reference).	The CEO should calculate the Fund's weighted average total return expected over the long term at least annually and defend this calculation to the SSIC.	The purpose of this calculation is to align the Fund's actual asset allocation decision with Fund's return requirement.

Section III. Recommendations Concerning Valuation of Assets for Asset Allocation Decisions

(Data as of 4/30/05 from Dr. Joseph Farhat, SSIC Investment Consultant, May 2005-- **Accounting value** is value shown on the balance sheet according to international accounting standards. **Market value** is either market value of the asset or the fair proxy of the market value of the asset. **Cash and Cash Equivalents** include Current accounts, Time Deposits, T-Bills, CDs, and Commercial Papers.)

Asset Class	**L-Term Target**	**Accounting Value**	**Market Value**	**Comments and Recommendations**
Cash & Cash Equivalents	**10%-20%**	**15.26%**	**13.66%**	Cash allocation is acceptable although the target range may be too high. Recommend not keeping any more cash than is necessary to meet pension payments and operational expenses, which should be fairly predictable. Recommend duration matching strategy.
Fixed Income	**20%-45%**	**14.82%**	**14.14%**	Fixed Income allocation is too low due largely to the recent increase in equity values. Looking backward it was a good decision to not increase the bond allocation since such a decision would have meant reducing the equity allocation. The problem is that this outcome was not known at the time. Thus, the portfolio has been over-exposed to equity risk for several quarters. This situation should not be allowed to recur in the future. Recommend periodically rebalancing to long-term target ranges for each asset regardless of current market conditions.
Government Bonds	10%-25%	12.02%	11.49%	Acceptable
Corporate Bonds	5%-10%	2.27%	2.18%	Too Low
International Bonds	5%-10%	0.53%	0.47%	Too low
Equity	**35%-60%**	**63.29%**	**66.26%**	Equity allocation is too high. Over allocation to equity (public) suggests a short-term trading strategy that conflicts with long term allocation target. Recommend quarterly rebalancing according to long-term target regardless of current market conditions.
Public	25%-40%	61.73%	64.87%	Over-allocation
Private	10%-20%	1.08%	0.96%	Because the market value of private equity is difficult to calculate, recommend consistently using valuation formulae that are more reliable than using book values (see IPS for recommendation to lower LT allocation to 5% - 10%).
International	0%-5%	0.48%	0.43%	Acceptable allocation
Lending	**10%-20%**	**2.06%**	**1.86%**	This allocation is acceptable. Still, the long-term target range needs to be reevaluated due to the SSIC's apparent gradual move away from its current lending practices.
Real Estate	**10%-20%**	**4.58%**	**4.08%**	Valuation for Real Estate presents a serious problem since these assets are illiquid. The SSIC should use appraised values that approximate market values as closely as possible. The greater the divergence between market and book values, the greater the amount of hidden reserves that, in turn, distorts asset allocation decisions. Recommend consistently accounting for real estate projects as real estate as opposed to moving to private equity once development is completed.
Total		**100%**	**100%**	