New Manager Rating System

Addressee

This paper is addressed to the Officers and Pension Committee ("the Committee") of the East Sussex Pension Fund ("the Fund"). We are making changes to the system we use for rating investment managers and their strategies. This note provides an overview of these changes, including the motivation for making them and the implications for clients. The paper should not be released or otherwise disclosed to any third party except as required by law or regulatory obligation or without our prior written consent. We cannot be held liable for any loss incurred by a third party relying on this paper without such permission.

Background

As a reminder, one of our Research Team's key responsibilities is to review and monitor the universe of investment managers across many asset classes, from which we make recommendations to clients. The old rating system was comprised of five different ratings, which varied according to the level of conviction the Research Team had in the manager's ability to meet its stated objectives (see Appendix).

New ratings system

From Q1 2018 we have moved to a new ratings system, summarised in this table:

Rating	Comment
Preferred	One of our highest rated strategies in the asset class.
Positive	We have a positive opinion on the strategy and believe it has a high possibility of reaching its objectives. But we believe there are superior strategies available.
Suitable	We believe the strategy is suitable for pension scheme investors from a regulatory perspective, but we have no strong view on its forward-looking prospects.
Negative	We have a negative outlook for the strategy relative to peers.

Summary of key changes

To give a little more colour to these new ratings the key changes to the ratings system are described below, along with the rationale for each change.

a) Greater granularity on our degree of conviction

The new ratings system has three favourable ratings ('Preferred', 'Positive' and 'Suitable') compared to the two afforded under the old system ('5 – Preferred' and '4 – Retain'). This allows the Research Team greater granularity to express their views on a particular strategy. The highest rating will still be referred to as 'Preferred' but we expect that the proportion of strategies with such a rating will fall as we move to a higher conviction approach where the bar will be set higher for a strategy to be assigned a 'Preferred' rating. A 'Positive' rating will be assigned where we have high conviction in the strategy's prospects but there are some minor issues that is preventing a 'Preferred' rating when compared to the wider peer group. The 'Suitable' rating is described below.

b) Introduction of a 'Suitable' rating

One of the most significant developments under this new ratings system is the introduction of a 'Suitable' rating. Strategies that have been assigned this rating are those regarded as being suitable for client investment from a regulatory perspective, but where we do not have a strong view, either positively or negatively, on its forward-looking prospects. In such an instance, we will have higher rated strategies that we believe are stronger but do not have any reason to assign a lower rating.

In addition, the development of defined contribution ("DC") platforms over recent years has significantly increased the number of funds that self-select members can invest in. The inclusion of a 'Suitable' rating will allow a lighter touch due diligence process to be carried out on a fund more quickly and at a lower cost to clients than the full due diligence process.

c) Use of 'On Watch'

The old ratings system had a distinct '3 – On Watch' rating. The new system does not; instead, 'On Watch' will be deployed as an additional flag rather than a distinct rating. In practice, this means that were a significant event to happen to a 'Preferred' manager, we would highlight that this rating is currently 'On Watch' through our regular communication (such as quarterly monitoring reports) rather than having to downgrade the manager. This should prevent excessive (and unnecessary) changes in ratings relating to one-off events.

d) Removal of 'Sell' ratings

The two different sell ratings in the old ratings system are being condensed into one single rating, a 'Negative' rating', which indicates a negative outlook for the strategy's prospects. This change places greater emphasis on specific client circumstances. Under some circumstances it may still be appropriate for the client to remain invested in the strategy. The removal of the word 'sell' from the recommendation also affords greater flexibility to clients who are perhaps using the manager tactically and are willing to tolerate the risks of being invested in a strategy the Research Team has a negative outlook on. This makes a 'Negative' rated manager appropriate for some clients in exceptional circumstances.

Not Rated strategies

Funds that we do not actively research will be explicitly described as Not Rated. Such funds will usually be those that we have either screened out of our investment process or have carried out insufficient due diligence to form any opinion. This rating will be more applicable to funds that are available as self-select options, where the range of funds is quite wide. For not-rated strategies, we can undertake a bespoke lighter touch assessment where a client would like us to.

Migration from old ratings system

Preferred: Essentially equivalent to the old 5 rating. Most 5 rated strategies (but not necessarily all) have migrated to Preferred, but we expect the proportion of stategies with such a rating to decline in time as we focus our research resource on a more concentrated list of Preferred managers.

Positive: Essentially equivalent to the old 4 rating. Most 4 rated strategies have migrated to Positive, but many will migrate to Suitable (see below) in time.

Suitable: These strategies that we consider appropriate for client investment, but where we have a neutral view or no strong view on the capabilities of the manager to outperform. We will have typically carried out a lighter touch assessment and have identified no reason to assign a lower rating. We expect to use this rating frequently in DC schemes and for strategies used only by very small number of clients.

We may also use it for bespoke strategies that are offered by few asset managers where our goal is to identify managers capable of delivering the strategy rather than ranking managers from a wide universe.

Negative: This replaces both of the old Sell ratings, which will migrate to this new rating. Consistent with the old ratings, this reflects particular concerns about the manager or the process. In contrast to the old ratings system, we recognise explicitly that any decision to sell has to be made in the context of a client's overall investment arrangements.

Summary

Overall we believe the changes to the ratings system will allow us to apply higher conviction to our ratings, using a more granular approach. No action is required by clients. However should you have any questions regarding these changes then please do not hesitate to contact your client consultant.

Appendix

The old ratings system is summarised in the following table:

Rating	Recommendation	Comment
5	**Preferred**	Currently preferred high conviction strategy for the chosen asset class.
4	**Retain**	Minor concerns but remains a favoured strategy with a high probability of success.
3	**On Watch**	Retain but concerns are serious; meaningful risk of downgrade in coming months.
2	**Sell – Review Options**	Operationally sound but we have lost long-term confidence. Options and exit costs should be evaluated.
1	**Sell – Immediate**	Deterioration sufficiently serious for immediate, high priority exit.