DOES PAYING A PREMIUM FOR FUND MANAGER SKILL PAY OFF?

Ironically, we often hear trustees argue that they have no problem paying a premium to fund managers if it means securing the top talent. But here is where we need to be completely clear about how this aspect of the value chain performs over time.

Consider the reality of most long-term investment strategies for defined contribution funds.

1 Identifying top-performing managers

Even if we could be fairly certain that we have selected a skilful manager, there is absolutely no assurance that the market will reward that manager's particular skill set going forward.

- Chopping and changing managers in an effort to maintain exposure to top performing managers has been shown as a primary source of value destruction in study after study of long-term fund performance[1].
- As such, very few funds employ a single manager because of this single manager risk.

2 The impact of manager diversification

The problem is, once multiple managers are employed, the impact of this diversification significantly reduces any short-term performance.

For example, individual managers may reflect tracking errors of up to 7% to their benchmarks, but the tracking error of the blended managers typically reduces to around 2%. This is not a bad thing – such a diversification strategy provides a significant improvement on the fund's risk to return ratio. But the total return of the blend will be muted.

1 Bird & Grey (2009)

3 The problem with performance fees

Even assuming that manager fees are based on realised performance and not past performance, a fund could end up paying a high performance fee for a particular unspectacular outcome at the aggregate level. Performance fees are hugely problematic with multiple managers.

4 The impact of time on manager performance

In reality, fund manager performance tends to go in swings and roundabouts over time. The longer the time frame, the more likely any exceptional manager performance simply evaporates due to the impact of diversification of managers and the flux and flow of manager returns.

Bottom line?

Over the long term, **performance outcomes** are driven more by the long-term **strategic asset allocation embedded in the investment strategy** than they are by individual manager contributions.

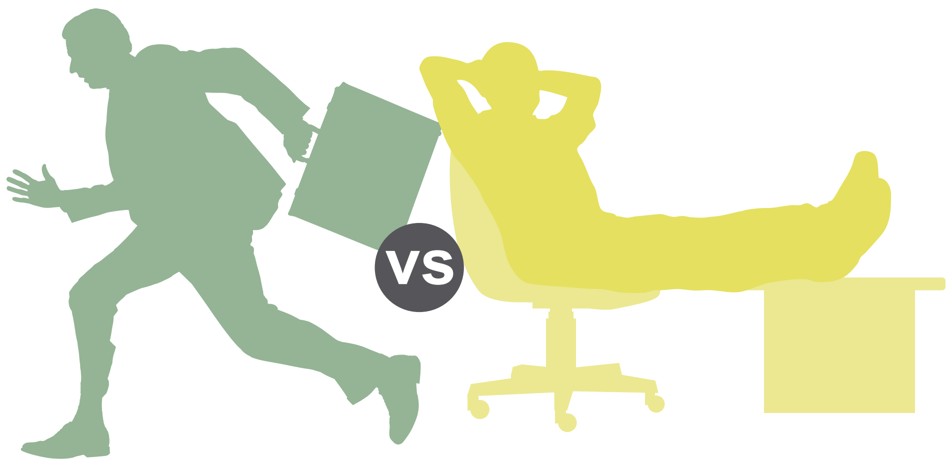
HOW MUCH OF A PROBLEM IS THIS?

As an example we consider the full value chain of costs in one particular umbrella fund to test the effect of an active against a lower-cost passive investment strategy to the final member outcomes. We use identical member profiles and pricing structures. We also assume that the cost of the active strategy would be 0.85% of assets under management per annum against 0.35% for our passive strategy.

By calculating the reduction in yield, a methodology that allows us to see the value erosion caused by the fee structure over a 40-year period, we can see that a switch to a passive solution would equate to an additional 5.63% points to the member's replacement ratio.

While every additional point in the final replacement ratio is important, keep this number in mind for later when we look at other sources of value erosion.

Note that this analysis says nothing about performance differentials between the two strategies. But assuming that both strategies employ the same long-term strategic asset allocation strategy, for the active strategy to even **match** the outcome of the passive strategy, it would have to generate a consistent alpha of 50 basis points year after year for 40 years to compensate for the additional costs. Trustees would need to give serious consideration to whether this is realistic.



Should this even be an **active** against **passive debate?**