2 INTRODUCING A WHOLE NEW MODEL

Could a new model for asset management provide an answer?

It's time we made a clear-cut separation in asset management servicing between investing to win the top performance sweepstakes and investing to meet a member's replacement ratio requirement.

We would like to be provocative here. The government provides a tax incentive for an individual to save for their retirement using pension and provident funds, preservation funds and retirement annuities in compulsory investing. We believe that for the world of compulsory investing to be viable, the issues of performance chasing and performance fees (or high fees) **must** be taken off the table.

Perhaps it's time we made a clear-cut separation in asset management servicing between investing to win the top performance sweepstakes and investing to meet a member's replacement ratio requirement.

It could be done – and done in a way that could create a far more robust and diversified asset management industry in general.

Imagine an investment world where active managers would provide two types of asset management services:

- Mandates for compulsory savings vehicles
- Mandates for discretionary funds.

MANDATES FOR COMPULSORY SAVINGS VEHICLES

The first mandate would be for the exclusive use of compulsory investment funds. The fee here would be capped at a reasonably low level, possibly halfway between what is currently charged for active and passive strategies for all retirement fund clients. The investment strategy on offer would be whatever the manager felt was feasible at that fee.

But the irony here is that these mandates for compulsory retirement vehicles would be won or lost, not on performance, but on the manager's ability to follow a targeted, risk-budgeted mandate. This quality of delivery is essential in a blended manager strategy, because it gives the manager of the blend the confidence that their managers will remain diversified. Managers would lose mandates if they couldn't control their risk budgets.

When compared to purely passive strategies, this blended strategy of risk-controlled mandates, if robustly diversified, should provide incrementally better risk-adjusted returns over the long term than a purely passive strategy – and not necessarily because managers are hugely skilful. It's actually the combination of the diversified mandates at a lower risk than the index that produces the magic.

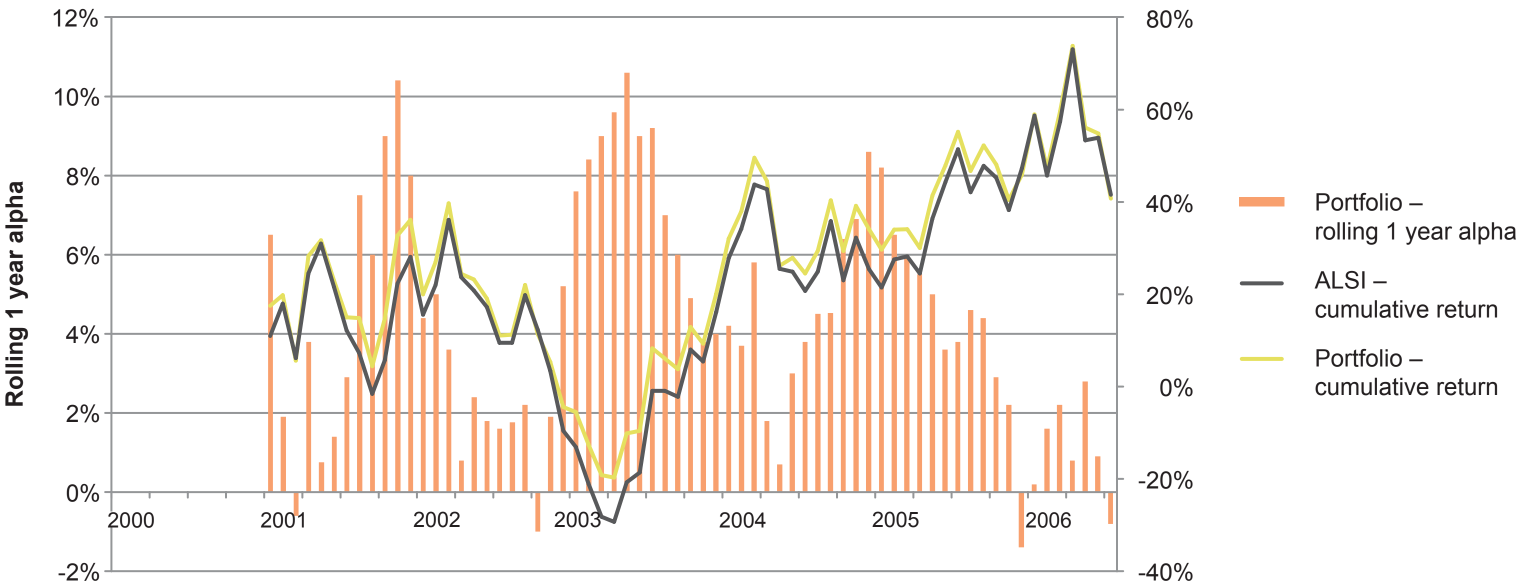
The graphs on the next page illustrate this point, employing a real blended manager solution. The first graph shows the variable, rolling one-year performance of the different active managers in the blend over time. In the bottom graph the orange bars represent the aggregate outperformance of the blend of managers.

In 2000, Allan Gray provided exactly this type of portfolio to multimanagers. It was a risk-controlled version of their Classic Equity portfolio, offered at a significantly lower fee. While Classic may have outperformed in certain market phases, this risk-controlled solution offered more robustness over time.

VALUE OF DIVERSIFICATION
UNCORRELATED PERFORMANCE OF THE UNDERLYING MANAGERS

Source: Advantage Asset Managers

VALUE OF DIVERSIFICATION
REFLECTING A ROLLING 1–YEAR ALPHA GENERATION OF THE BLEND



Source: Advantage Asset Managers

WHY TWO DIFFERENT MANDATES?

The other mandate active managers could offer would be exclusively for discretionary clients. This would be the same value proposition they are currently offering. But asset managers would be welcome to charge what they view as fair for their alpha generation potential.

Why preclude compulsory savings funds from using the latter mandate?

What retirement investments need is more certainty of outcomes if they are going to meet the liability funding requirements over a 40-year investment period. The reality is that research repeatedly highlights that short-termism, and chasing return, has introduced one of the most important sources of potential value erosion in the active management space. For example, a study by Ron Bird and Jack Gray on the Australian Superannuation Fund industry calculates that these two factors perpetuated as much as 3% of value erosion per year.

Right now the balance of power is on the side of asset management marketing machines that continually hold out a promise of more return. Retirement funds don't need more; they need consistency, certainty and simplicity – and of course, lower costs.

A proposal like this **creates opportunities** that are not only fair to all parties, but could **develop a far more diversified industry.**

THE VALUE-ADD TO THE WHOLE INDUSTRY

While momentum is gathering to promote passive over active strategies in this space, we believe a proposal like this creates opportunities that are not only fair to all parties but would also develop a far more diversified industry. Consider the implications that such a model of separate mandates would have for asset managers – to say nothing of investors themselves:

- Because the necessity for aggressive alpha generation would be taken off the table, active manager fee demands would readily fall.
- Because outperformance would no longer be the primary criteria, the asset management industry could easily accommodate newer, greener, less well-known asset management brands, as long as there were adequate risk controls.
- BEE managers could flourish in this environment and a few large players on both the active and passive side are far less likely to monopolise 'the pot'.
- Active management, which seems to provide a better risk-adjusted return to index funds as long as costs are kept low, could still be considered a viable option for long-term retirement funds.
- Great alpha generators could still flourish and charge whatever the market will bear – but for a different market than a retirement savings plan.
- It would also mean that current performance reporting would need to be completely revamped. The target would be the liability, or the income replacement required by the fund member, and not the peer group.