Autumn 2010

Ci collective insight

insights into SA investing from leading professionals

THE VALUE CHAIN IN INVESTMENT DECISION-MAKING

Who should be doing what on behalf of trustees?

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Contents

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Spotlighting the 'value chain'

MUITHERI WAHOME
Investment Solutions

THE FIRST ISSUE of this new decade has a number of excellent articles for the trustee and will be a worthy addition to any library. This issue is entitled "The value chain in investment decision-making. Effectively, who should really be doing what on behalf of trustees?"

As the industry searches for alternatives to the traditional pension fund management and consulting model, the debate on the changing roles of the key players and how the pension fund solution will be delivered, managed and controlled into the future continues to intensify. We have contributions from asset consultants, implemented consultants, multi-managers and legal and independent experts, each of whom represents a different voice in the discussion. This issue also has two international contributions, which is pleasing and certainly highlights the growing stature of *Collective Insight*.

The lead article, by Andrew Davison and Rob McMahon of acsis – "Retirement funds' evolution" – provides a succinct account of the development of investment decision-making, strategy and service providers in South Africa. The transition from defined benefit funds to defined contribution funds saw a shift of investment risk to members and subsequent focus on investment strategies. Partly as a result of that, over the past two decades there's emerged an ever-growing list of investment specialists. The blurring of the lines of responsibility continues to intensify the battlefield, with significant implications for the future. It's a must read!

The next article brings a legal perspective and addresses governance issues in a piece by Jonathan Mort entitled 'The value chain'. It highlights fiduciary responsibility as set out in PF 130 and underscores the need for trustees to set clear objectives, as those shape and influence all other decision levels in the investment risk management process – including the costs of implementation. Mort acknowledges trustees need expert advice to achieve that and periodically may need to seek other views to enhance debate.

The third article is by Advantage CIO Anne Cabot-Alletzhauser and is entitled "Is it really adding value?" The author ponders how the ever-expanding value chain will deliver the solution to clients given the prevailing rivalry between the players. In a nutshell, trustees need to understand the total cost of the solution and deal with the conflicts of interest so there's less churn of asset managers.

The fourth article – "It's a chain, not a rope" by Rob Rusconi and Rhonda Stewart – represents the voice of the independent expert. It reiterates trustees must aim to achieve good organisational governance to promote effective decision-making. However, that will almost always be a colossal task, owing to the existing knowledge or information gap between trustees and their service providers and the inescapable conflicts of interest. This article offers some useful recommendations and highlights the role the independent experts can play in the process.

> Not unlike a jazz ensemble, it's important different players work together

The next two articles tackle asset manager due diligence. The fifth article – "More than a beauty parade" by Roland Grabe, of Brockhouse Cooper – quotes from David Finstad's paper on the basic elements of successful manager selection. The sixth piece is entitled "The new 'trust but verify'" by Ron Surz, of PPCA, based in the United States. It suggests consultants need to consider what an asset manager does and how he/she does it when conducting a due diligence. Past performance and analytics that rely on often flawed benchmarks are usually a waste of time. Indeed, developments in computer technology now make it possible to delve deep when analysing an asset manager – there's no excuse.

The final note is an article entitled "Long on intentions, short on deliverables" and is based on the results of an offshore study by Amin Rajan, of CREATE-Research in Britain. It draws attention to the global pension landscape and the cycle of shortcomings that has created ruptures in the investment value chain. The author identifies useful ways to tackle weaknesses. Bottom line, asset managers and pension consultants need to embrace their clients, orient their professions towards fresh ideas and insights and create products and solutions that are fit for purpose and offer value for money.

Not unlike a jazz ensemble, it's important different players work together if the delivery of the total solution is to happen with the desired efficacy. ■

IN THE NEXT ISSUE…

THE TOPIC for our next issue is "The cost of peace of mind." We want to examine the trade-offs investors face when they select investment products that provide guarantees or protections from downside risk. Potential subjects authors could address include:

- The true cost of guaranteed or smooth bonus products.
- How absolute are absolute return products?
- What exactly do hedge funds hedge?
- The many variations of life stage products and their implications for terminal wealth.
- What exactly are the range of options investors can consider and how do their trade-offs or pay-offs vary?

Please remember: this is a research publication and, as such, please no market commentary or marketing materials.

Please contact advisory committee convenor Anne Cabot-Alletzhauser at (011) 575-4333 with your topic ideas so we can minimise duplication. Articles (approximately 1 200 words, plus illustrations) need to be submitted to matsholom@collectiveinsight.co.za. ■

Retirement funds' evolution

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DESPITE an increasing prevalence of professional trustees, retirement fund trustees are now often part-timers who aren't remunerated. They're generally elected by their peers or nominated by their employers and therefore don't necessarily have specialist trustee or investment skills. To further exacerbate that, the retirement fund sector has become more complex over the years, with new legislation being promulgated and new – often more complex – investment alternatives being introduced.

The publication of PF Circular 130 in 2007 by the Financial Services Board (FSB) highlighted the need for better governance of retirement funds. Since its introduction, many trustees have endeavoured to understand their roles and responsibilities better. All of these circumstances have led to an evolution in the way retirement funds are managed and operated. More specifically, there have been significant changes in the areas of investment strategies, investment service providers and investment decision making by trustees over the past few years.

The evolution of retirement fund investments is inextricably linked to the evolution of two different types of service provider: namely, asset managers and consultants. Initially, large public and private retirement funds had dedicated staff who managed both the operations of the fund as well as the investment of its assets. The status quo remained for many years due to the relatively restrictive requirements to hold prescribed assets from around the Forties until the establishment of the FSB in 1990. However, over that period smaller private funds were formed, where size didn't justify having dedicated investment professionals and even large funds realised the merits of outsourcing the investment of the assets to dedicated and skilled teams of investment professionals. The asset management industry – led by the life companies – was the main beneficiary of this initial outsourcing of investments.

That process gathered steam during the Eighties and Nineties as more asset managers opened their doors in response to the introduction of Regulation 28 of the Pension Funds Act, which meant funds were no longer required to hold a substantial portion of their assets in prescribed assets. To help trustees make sense of the plethora of asset managers available, and to help analyse liabilities and design the investment strategy, asset consultants sprang out of the employee benefits consulting industry. These asset consultants were initially the preserve of only the largest funds, with the trustees retaining the responsibility for making the final investment decisions. As a trustee respondent in a recent European survey of the retirement industry by Spence Johnson put it: "Consultants used to drive you to the edge of a cliff, watch you jump off then stroll back to their car."

Multi-managers then arose to address the difficulty of sorting luck from skill in the asset management industry. Multi-managers could package investment products that could be used by funds further down the size spectrum and pooling led to greater economies of scale and lower fees. The advent of multi-managers led to a move away from balanced portfolios towards specialist asset class portfolios. The debate still rages as to whether so-called single managers or multi-managers are best suited to making asset allocation – especially tactical asset allocation decisions – and recent years have seen some reversion to balanced portfolios.

The consulting side of the industry then evolved further, leading to the concept of implemented consulting. This approach was designed to introduce efficiencies, especially faster implementation of investment decisions and pooling, into the development and management of the investment strategy process. It was also designed to improve transparency and accountability for key investment decisions. The result – similar to the advent of multi-managers – was that smaller funds were able to access the type of consulting advice previously only available to large funds.

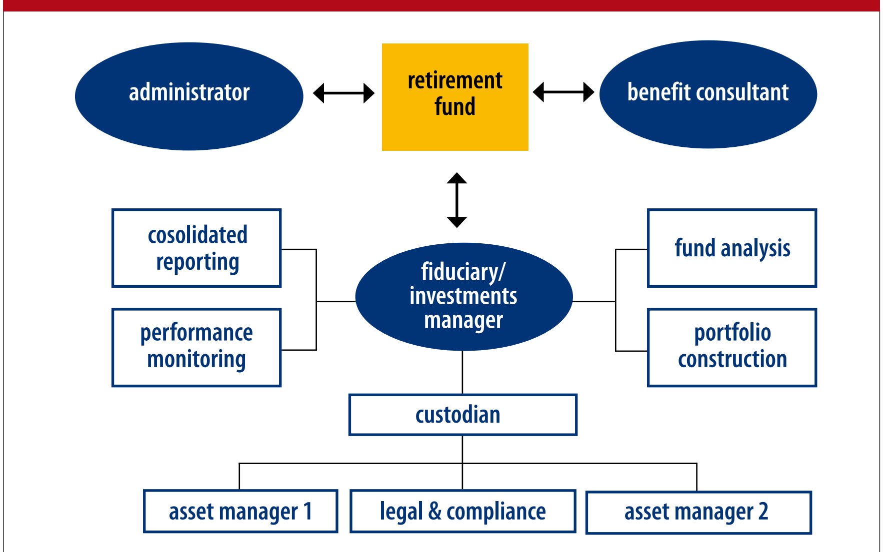
The competition intensified, and asset managers, specifically multi-managers, responded to the implemented consulted approach with a focus on fiduciary management. Although a convenient, simple and consistently applied definition of fiduciary management doesn't exist, it's very similar to implemented consulting in that it's also an outsourcing of the design, implementation and oversight of the investment aspects of a fund.

The fiduciary management concept is hard to define, because the solution differs from client to client. To add to the confusion, it goes by a variety of names depending on the market where it evolved: investment outsourcing in the United States, fiduciary management in the Netherlands and implemented consulting in Britain and other consultancy-led markets.

In this article we'll use implemented consulting and fiduciary management interchangeably. All of these slightly different business models have common themes of partnering with trustees and fiduciaries in an investment advisory capacity, with varying degrees of accountability to make and execute decisions on behalf of the retirement fund. The aim is to improve accountability for investment decisions, increase the speed of implementation of investment decisions and move the focus away from a product pushing mentality to a comprehensive, client-centric solution. The diagram below attempts to illustrate a typical implemented consulting or fiduciary management model.

As in nature, this evolutionary path won't produce only one perfect end result. Retirement funds have unique needs, membership and liability profiles and each fund's investment strategy needs to take its circumstances into account. Some trustees may feel they also have little control over crucial decisions, so fiduciary management isn't suitable for them. As fiduciary management is a solution rather than a product, such concerns can be overcome. However, it's likely some funds will adopt this approach while others may follow a different evolutionary path. For example, in the Netherlands – home to one of the world's most developed retirement systems where fiduciary management is widespread – there's already a move towards unbundling the services to provide more flexibility for

MANAGEMENT MODEL



Source: acsis

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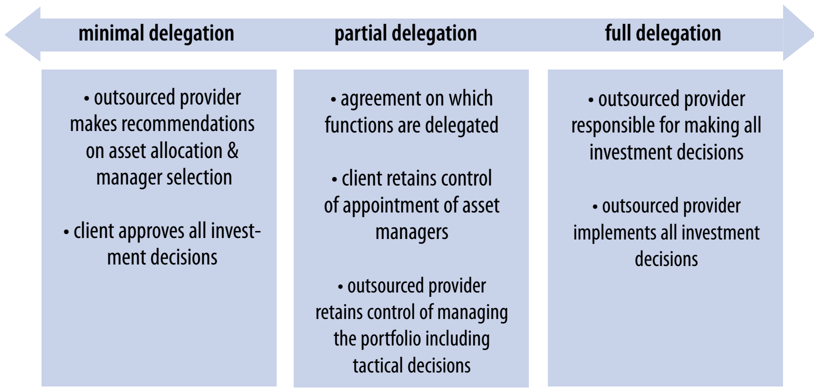
THREE DELEGATION POSSIBILITIES



Source: acsis

trustees to delegate some of the investment function and retain other elements where they have the skills. The graph above shows the range of delegation possibilities.

The focus on short-term investment performance is a serious shortcoming in the retirement fund industry. Fiduciary management has the potential to address that as accountability is centralised and the goals of the fund and its stakeholders are shifted to more appropriate 15- to 20-year time horizons. For this reason it may be useful for the industry's evolutionary process to slow down for a while to allow quality implemented consultants to deliver on their strategy. Of course, this assumes implemented consultants have the skills required and take advantage of the leeway provided on the measurement criteria and time horizons to deliver real benefits for members.

It's clear that, over time, investment strategies have evolved and will continue doing so. As risk has shifted to the member and the responsibilities of trustees increase, the review of investment strategy, valuation of scheme designs and the overall management of retirement funds will come under the spotlight. The traditional model of retirement fund management may come to an end with a move towards a new model that provides support to trustee boards and strengthens governance structures for the benefit of members.

The evolution of the retirement fund industry has led to a convergence of investment solution providers and it seems consultants and asset managers may now, more than ever, be in direct competition. This will necessitate adjustments on both sides. Asset managers will need to improve their consulting skills to enable them to analyse and better understand the needs of the retirement funds and their members. On the consulting side, investment skills will be required. That's likely to result in resources moving between the two parts of the industry and will inevitably lead to an intense debate about where the best skills lie for each aspect of the investment process.

Interestingly, while the trend in Europe has followed a slightly different evolutionary path from SA there have been similar developments resulting in an overlap between asset managers and consultants. Respondents to a fiduciary management survey by Spence Johnson predicted asset managers will in future win a bruising confrontation in European markets, particularly in the Netherlands and Britain.

In SA the fiduciary management industry is certainly not as well established and the predominance of defined contribution schemes introduces different challenges. Key advantages of this new service include a focus on client needs and the ability to take accountability for investment decision making. If this can be combined with a long-term outlook to match the liabilities of the fund or those of the average member and the implemented consulting provider can demonstrate that they have the required breadth of skills and can win the trust of the fund's board – thus buying them time to allow superior decisions to bear fruit – then retirement funds and their members are likely to enjoy a period of relative prosperity.

If not, then the merry-go-round will continue, with the associated drag on net returns. Either way, it seems clear the evolution of investment strategy and investment solution providers is reaching a crossroads that could have significant implications for the way retirement funds manage their assets in the future.

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The value chain

IT'S HUMAN NATURE to have an opinion on important issues, especially if they're contentious. And for lawyers (including pension fund lawyers, such as I am) you might even be tempted to say it's a necessary professional requirement not only to have such views but to express them as eloquently as possible. I profess no expertise in investment issues but I do have an interest in the governance of retirement funds and it's from that aspect that I write this.

At the outset, as the topic itself implicitly accepts, it's the board of trustees which is responsible for the appropriate investment of fund assets. In carrying out that responsibility the board is entitled to, and should (unless it has the requisite skills itself), obtain expert advice. All that's in accordance with PF 130.

PF 130 lists three governance purposes (paragraph 4) that are relevant to the topic, but I prefer those governance purposes to be expressed as follows:

- That the benefits promised by the fund are actually delivered.
- That these benefits are optimal within the constraints of appropriate risk.
- That the costs involved in the provision of the benefits and the administration of the fund are transparent and justifiable.
- That the process of delivering the benefits is credible and can be trusted by the fund stakeholders (being the members, employer, sponsor and regulator).

The investment objective is to ensure that, in accordance with at least two of the above purposes, the fund benefits aren't only delivered but also are as optimal as possible. This entails a focus not only on investment performance but also on what may impede that performance, such as excessive costs. The very phrase "value chain" – used in the heading of the topic – implies the value from correct investment decision-making exceeds its cost.

However, the costs involved in investment decision-making follow from the objective of the investment-decision making itself. Put differently, one must necessarily decide what the investment objective is before dealing with the costs associated with it, because the costs may be different according to each investment objective.

So the first task is to determine what the investment objective is. I shall refer briefly to defined benefit arrangements, but then move on at greater length to the defined contribution terrain, whether with or without member investment choice, and whether viewed through the prism of a standalone occupational fund, umbrella fund or a retail fund (preservation or RA).

In some respects defined benefit (DB) funds have an easier investment objective than DC funds: the object is simply to ensure a defined benefit can be provided on the retirement of a member. Although the pension increase promise is notoriously vague in the promise made to a new employee who becomes a member of the fund, the fact is that it's the employer who makes the promise of the benefit on the basis it's the fund that provides it. As it's the employer who makes the promise and usually bears the investment risk (where, as is usual, there's a balance of cost obligation), the board mustn't exploit the balance of cost guarantee and within the constraint of that fix an investment objective that will ensure, on a balance of probabilities, it will be met. In so doing the board will almost invariably have to take account of expert advice on the issue, not least from the fund actuary, who must be satisfied the investment approach is likely to achieve the required outcome.

In the DC arena, because the promise is simply to provide a benefit equal to the accumulated retirement savings with investment return after deduction of costs, it isn't possible for the board to know whether that benefit will be sufficient to provide adequately for a member's retirement unless a full financial analysis is conducted of each member that takes account of each member's assets, whether directly held or not, and his or her liabilities. That's clearly not feasible. However, what a board can and should do is to provide a member with what his or her expected retirement benefit will be, assuming a prospective net investment return over a specified time horizon, with the benefit adjusted to reflect its real value after account is taken of an assumed prospective inflation rate. Of course, that's a complex calculation.

At this point it should be noted that where you are engaged in a field of endeavour from which you derive your livelihood it's human nature to believe you can add value in that area. Indeed, were it not so, you'd be acting contrary to your conscience and it would be difficult to maintain your credibility for any length of time.

However, it's probably also true it's difficult for you to be able to assess yourself how much value you can add or, perhaps more accurately, the value you can add in relation to your cost. That's particularly so in an area where there are substantial amounts involved and where, it must be stated plainly, the investment costs and charges generally are high relative to the other costs of operating a fund.

In my view a relevant factor in a DC occupational fund is the profile of the average member. This is so because the member profile will be a major factor in determining the member's risk tolerance. To some extent the company must play a role, because it should have the best feel for the profile of its employees and should accept some responsibility as either sponsor or, in the umbrella fund environment, as the contracting participating employer. The employer may thus usefully seek advice on this.

How does this help with the topic? In the first place, it would be prudent for trustees not to accept too readily an investment adviser has all the investment solutions. It's the trustees alone who must decide the investment objective. The most expert advisers are also fallible and each adviser may, even subliminally, consider he or she has the best solution. So trustees should periodically seek different views from those provided by their investment adviser: not to show a lack of confidence but to enhance the debate both about the investment objectives and how to achieve them.

Second, in the occupational fund space the employer has an interest and a role to play in defining the investment objectives (and the governance of a fund), although it must always be the trustees who decide the objective and the governance arrangements.

Third, the costs of the investment arrangement must be borne in mind. Trustees should insist on full disclosure of all investment costs and fees – particularly that performance reports indicate both gross and net performance (before and after investment fees and costs have been deducted). It may be the costs are such as to make a board consider the appropriateness of a different investment product or approach where the costs are less. ■

Who should be doing what?

Is it really adding value?

THE PENSION FUND industry is due for a major wake-up call. Unlike other industries, where creating cost-efficiencies and streamlining service delivery are viewed as critical objectives, the financial services industry appears to thrive on introducing even greater layers of complexity, necessitating the inclusion of ever more intermediaries and layers of costs to an already expensive service delivery.

Something clearly has to give if trustees are going to derive more efficient and cost-effective delivery of what they need most: maximum value for their members' savings programmes.

In fairness, managing long-term retirement savings solutions is complex – simply because there are now so many levels of delivery for which trustees are accountable. But the key question is: How should trustees secure those multiple delivery levels?

What's now euphemistically referred to as the "value chain" arose in response to these ever-burgeoning requirements. In the beginning there were simply the EB consultants and asset managers that trustees interacted with. Then as the industry, the regulators and the trustees became more aware of their responsibilities and the industry evolved, pension funds recognised the following services could be important value enhancers:

- Asset consultants.
- Asset/liability modelling specialists.
- Transition management specialists.
- Solutions design specialists.
- Implementation specialists.
- Risk management and measurement specialists.
- Benchmark creation specialists.
- Derivative strategy specialists.
- Governance and compliance monitoring specialists.
- Proxy voting specialists.
- Performance measurement specialists.

Given the distinctly different skill sets required to deliver

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on that broad range of "value enhancers" it's no wonder services became compartmentalised. And while there are a number of service providers trying to consolidate the value chain into one comprehensive service offering, there's resistance, which we'll address in more detail below.

But let's not lose sight of another harsh reality: if the industry is adding on costs and complexity, trustees and other consumers of financial services have proven to either be ineffective at turning back the rising tide of costs and inefficiency that are the by-products of that complexity; or worse, they've been unaware of how such increases are impacting the long-term value creation for members.

Last year, one of the most significant papers relating to pension fund management practices was produced by Ron Bird and Jack Gray, of the Woolley Institute of Market Dysfunctionality. These two academics calculated that pension funds erode as much as 3% of value a year due to the following factors:

- A complex and inefficient "value chain" of service providers which focus on either insinuating themselves in or nudging each other out of the servicing equation. Despite a mountain of evidence showing that consultants and managers are invariably hired and fired at the wrong time simply because they confuse past performance with a promise of future skill, trustees are still easy touches for marketing campaigns holding out that future promise. And each time a service provider is nudged out by the promise of better returns, costs are incurred and returns invariably fail to materialise.
- Inefficient governance and cash flow management, due to the highly segmented nature of the industry and the fact that no one entity takes ultimate accountability for ensuring all the critical and complex components of managing the total fund exposures actually work in concert.
- Although one of the most sought-after elements of the value chain is performance measurement and monitoring, the increasingly short timeframe over which the industry is now producing performance analysis has inadvertently forced fund managers to become short-term traders. Not only is long-term wealth creation impaired by the high turnover cost, but the economy is also itself put at risk when listed companies manage to share price imperatives and not long-term sustainable business strategies.

Effectively, trustees need to weigh two distinctly different but very real concerns. On the one hand, the retirement fund industry hasn't covered itself in glory in terms of always acting in its clients' best interests. Controlling the whole "value chain" afforded opportunities for a small handful of service providers to mask decisions that may have serviced the business interests of the provider before the best interests of the fund.

The damage caused to the reputation of the entire industry was considerable. As such, Pension Fund Circular 130 now pointedly suggests trustees should identify the "best of breed" provider at each level of servicing in the hope that by segmenting the responsibility among independent providers these entities would provide a check/countercheck exchange that would help trustees mitigate against potential conflicts of interest.

But how realistic is this expectation? Most of these service providers are actually in direct competition with each other. To expect them to "police without prejudice" isn't just optimistic but there are grounds to believe the "check/countercheck" – or, put simply, the "nudging" model – may actually be at the root of much of the value destruction currently evidenced in South African pension funds.

Time to discard much of the extraneous elements that take the focus off sustainable value creation

The harsh reality is that while segmentation of servicing appears at a surface level to address the conflict of interest dilemma, it ignores the fact the trade-off for that peace of mind may be more costly than trustees ever imagined. Any number of industry studies (in addition to the Gray and Bird study) point out the cost benefits that come from the more simplified and efficient model of the "holistic" single service provider solution. That's the other option trustees may currently be dismissing far too quickly.

Changing the mindset of fiduciaries to deliver better value to their members

We believe there are substantive changes that could get the "value chain" back on track – and delivering value, as promised. However, they demand a radical shift in mindset and behaviour from both trustees and the consultants who guide their thinking.

Three "behaviour modifications" in the industry might stem much of the tide of value destruction to which Gray and Bird allude:

1. Trustees should weigh-out the full cost of changing service providers. Any potential new service provider to a fund must demonstrate a "least cost impact" solution, not just a "best house view" solution. The issue is that trustees shouldn't necessarily be seeking out cheaper solutions but rather they must attempt to quantify how much value destruction could be incurred with any change so they can properly weigh out their options. That cost goes significantly beyond fees alone.
2. Trustees should change their mindset that all-in service providers always pose potential conflicts of interest. Global research has repeatedly shown considerable value creation can be gained by streamlining the decision-making, governance and implementation processes that are all part of the "value chain". The industry needs more external independent process assessment specialists (some do exist) who can provide a level of comfort to trustees through a forensic audit that the one-stop implementation solution they have bought into is appropriate for their needs. At the same time, the contract with the all-in service provider needs to be unequivocal and hold it directly accountable to the trustees' requirements.
3. Finally, trustees need to dramatically rethink exactly what it is they should be monitoring and why.

The most important outcome trustees need to be held accountable for is the net replacement ratio each member earns: ie, the extent that a member's total accumulated savings will convert into an on-going income that must replace his final salary. The higher that ratio, the less impact there is to maintaining the member's lifestyle at the time of retirement.

But here's the catch. That net replacement ratio number is the product of a broad range of factors that may vary over time, far beyond the issue of fund manager performance. Here are just some of the factors that impact outcomes:

- Contribution rates (and their variation over time) by the member and the employer.
- Changes over time to the member's salary or to the overall fund membership.
- Changes over time to the quantum of additional benefits coverage and their variable costs over time.
- Administration and management costs at all levels: EB administrator, consultant or multi-manager, asset manager, etc.
- The nature and structure of the investment choice (ie, asset allocation, capital protections or risk management factors, performance targets).
- The performance of the different asset class markets over time.
- And last but not least, whether the active fund manager added or lost any value above and beyond those market movements.

As an industry we should be helping trustees to monitor how the whole "package" is impacting wealth creation or destruction. Or, more importantly, how changes to any of the above contributors could influence the outcomes for members.

Only then can trustees take the important decisions as to:

- Whether their members have the right range of options and are making meaningful decisions about those options.
- Where changes need to be made, if it's apparent the health of the members' savings simply isn't adequate.

We too quickly make the assumption that if members aren't retiring with adequate savings, the fund manager has somehow failed to deliver. No wonder the impulse is to constantly change managers.

There are many discussions and decisions trustees should be having and making but aren't – simply because, historically, the industry hasn't provided them with the right tools, the right framework for analysis and, crucially, an appropriate insight as to the right debate.

In summary, for the "value chain" to work effectively it needs to be drastically consolidated and refocused on the important issues that add or subtract value. And we need to discard much of the extraneous elements that take our focus off what really drives long-term sustainable value creation.

Get out there and exercise your right to demand what's best for your members! ■

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It's a chain, not a rope

THE WORLD isn't becoming simpler. Pension fund trustees face a remarkable set of challenges, seemingly growing all of the time. Efforts to address the complexity by adopting holistic solutions are tempting but may be counterproductive over the long run, we argue. That isn't helped by the blurring of lines between services as providers continue in their efforts to grow their share of a fractious marketplace by designing innovative yet increasingly complex offerings that are difficult to assess.

The value chain of institutional investing is complex enough as it is without such blurring. Trustees can do a great deal to reduce those tendencies – in the interests of their members and of the market as a whole. Our contention is that funds should seek to appoint the best service provider in each distinct category of service.

Best practice

Governance is the set of structures and practices that describes the way a fund and its constituent parts operate. Good governance, naturally, is about doing the best for the fund, its members and all of its beneficiaries. At its heart it's about doing right. However, heart may not be enough in the profit-making hurly-burly of the investment world. Trustees need to be shrewd, recognising the need to understand what motivates all stakeholders and then aligning those interests to ensure what the service providers may deem to be first prize for all, actually produces the best outcome for the fund and its members.

Effective governance requires board expertise to manage service providers, compare their performance, monitor all advice received and continually assess the appropriateness of those providers and their competitors for the fund. The trustees must take responsibility for that process. Multiple service providers appointed by a third party may not practice the same level of governance that the fund does, quite apart from the possibility of impure interactions between the parties; whereas a direct relationship allows trustees to insist their own standards of governance practice can be written into the contract and supported by eye-to-eye interaction and interpretation.

So trustees need to take responsibility for the selection and monitoring of service providers, choosing the best for each category of service and watching the combined effectiveness of the system to ensure the overall strength of the chain.

Knowledge gap

The information inequity – it might also be referred to as an expertise inequity, but that would wrongly suggest that service providers are generally experts and trustees not – provides an ideal climate for undue influence by service providers, especially in relation to high maintenance or complex structures that may lead to debateable interpretations of the inherent risks attached.

Trustees need to address that risk by becoming more closely involved with every part of the process of selection and monitoring. After all, they're accountable to their members for that and may be called to explain their decisions and the consequences of those decisions, including the revenue gained by service providers. While trustees may use specialists to assist them with that the responsibility for the outcome is theirs. They need to know who is providing services, exactly what those services are, what they're worth to the fund and its members, how the provider is being remunerated and how its relationships with others in the value chain may reduce the purity of its offering.

Moreover, they need to follow a decision-making process that's theirs by design and be able to articulate clearly why they have chosen that specific service provider over their competitors.

Spin-offs

Staying close to the decision-making and selection process has a number of other benefits. It allows for the segregation and calibration of responsibilities, making it easier to measure the performance of service providers and their contribution to the overall strategy, improving management of efficiencies of the value chain in the process.

It creates the ability to analyse the entire chain – and each link – for the value of their contribution and the corresponding cost. Strong knowledge of the chain and all its components permits the trustees to look out for gaps in the allocation of risks and responsibilities between the fund, its advisers and its implementers.

It gives to the trustees the right – and responsibility – to go directly to the originators of a product or service rather than via convenient, but perhaps deliberately complicated, structures that can inhibit the accountability and may carry opaque fee structures.

It reduces the potential for a large power gap to develop between the different service providers to the fund. It reduces the potential for information control by some so-called gatekeepers, who may be incentivised to improve the shine of their standing with the trustees by, for example, implying they were responsible for outperformance and then redirecting that responsibility when performance is less than stellar.

It prevents the development of a dependency relationship between the trustees and the providers of intellectual product, a dynamic prevalent and built on and sustained by knowledge differences. Our contention is that it's preferable to contract into an open source arm's-length association under which a specified service is provided and soundly remunerated and to bring independent trustee trainers into the chain.

It supports the separation of objective services, such as information provision, from subjective services: for example, interpretation and advice – both of which are required but which must be clearly delineated.

Finally, and perhaps most importantly, direct involvement in the selection of service providers enhances trustee understanding of the offering in question, its relevance to the fund, its relationship with the other services required by the fund and the industry as a whole. This reduces the knowledge gap, improves the extent to which trustees can develop the skills to assess and hold their service providers to account and ensures a much better chance of delivering performance that meets the needs of members.

Conflicts of interest in the value chain

"It's just not possible in this environment," we hear that all the time, "to select only independent providers." This attitude adds to the problem of the conflicts of interest that beset the industry because it adopts the wrong starting position, making it less likely for small independents to start up and succeed and more likely that impure relationships continue to thrive. That said, the industry is beset with unofficial conflicts of interest, where non-disclosure of quid pro quo – in most cases, unwritten and undisclosed – relationships continue behind the scenes.

Still, the problem with selecting "best of breed" for each link of the chain is that trustees may need to face the issue of conflicts of interest within the chain; at the very least they need to recognise the potential for such conflicts and address them head on.

We recommend trustees consider the following:

- As choices are seldom presented in a neutral manner, ask service providers to separate information, interpretation, decision support and advice. As trustees may – and should – be held accountable for decisions that help them identify the areas in which delegation is inappropriate.
- Certain decisions are governing decisions and mustn't be outsourced. Augment the board, if necessary, with independent experts who can challenge both service providers and the balance of trustees, improving the quality of the process and its results.
- Request full and written disclosure of shareholdings, arrangements, tied relationships, commissions, discounts and quid pro quo arrangements, with clear sanctions for nondisclosure.
- Be aware of the potential for tied relationships between service providers and the competitors of existing providers; ask tied parties to leave certain meetings where competitors to their related company are presenting their capabilities and ideas.
- Respect the intellectual property of providers by not sharing documents unnecessarily with other providers and by being conscious of the implications inherent in requesting a provider to analyse his competitors' results.

Service providers are increasingly offering the whole world to retirement funds. Trustees need to respond with care to those promises: if the service is broad, trustees may battle to know whether it's been delivered or not, let alone whether it was worth the fees paid for it. Strive rather for simplicity – breaking the chain into a series of links and ensuring each delivers what it promises at an appropriate price. ■

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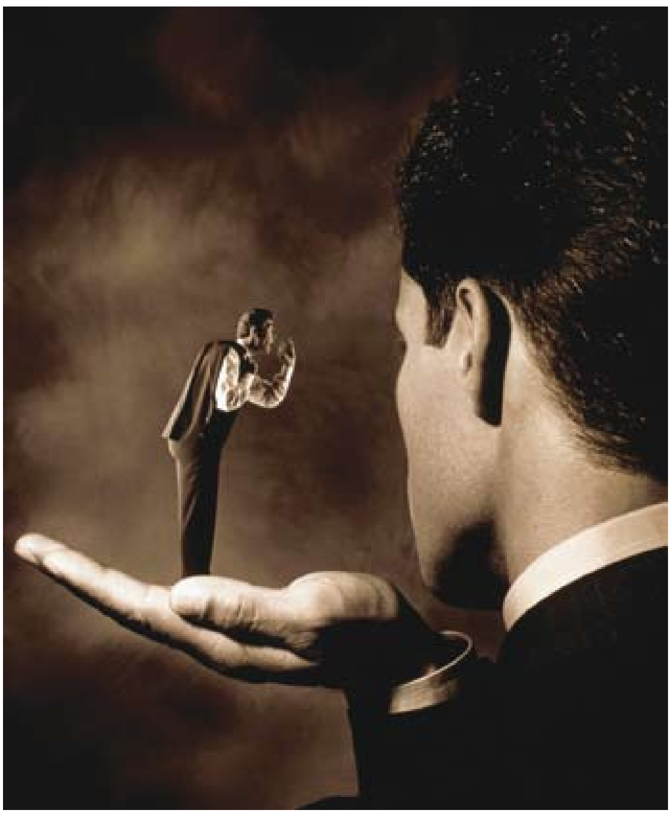
More than a beauty parade

RETIREMENT fund trustees need to be fully aware of the significant impact asset manager selection has on the performance of the funds under their administration. In both defined benefit and defined contribution funds, the investment, performance achieved will directly affect the value of the benefits ultimately received by fund members. If trustees believe the promise of active management, selecting those managers who will deliver outperformance in future years remains a huge challenge.

Performance surveys indicate manager selection based on past performance usually results in disappointment. Over one to three year periods it's not unusual to see the managers' rankings change dramatically. Therefore, a fund that selects managers based solely on past performance may not achieve its investment objectives.

Good advice comes at a price



Good advice will always come at a price, but the potential value creation is substantial. A modest outperformance of 1% a year over three years will add more than R1,5m to a fund of R50m. Clearly, manager selection is a vital component of the entire investment process.

David Finstad's paper entitled "Institutional or Entrepreneurial Management" (published in the *Canadian Investment Review,* Spring 2005), provides us with valuable guidance on the basic elements required for successful manager selection. His conclusions include the following:

- Staff ownership leads to better performance.
- The length of the track record isn't significant.
- The size of the company and the product isn't a key driver.
- Personnel turnover leads to poor performance.
- Value styles and low turnover strategies outperform.
- Years experience and size of teams aren't correlated to performance.
- A valuation-driven process has a better chance to outperform than a macro-economic view driven process.
- Concentrated portfolios outperform more often.

The above trends may not hold true over all time periods and in all countries, but there are some consistent themes that can be applied very successfully in a manager selection process. As pension funds may now invest 20% of fund assets offshore – and an additional 5% in the Africa region – it's equally important the same principles be applied in global manager selection. Manager search consultants can provide research to support manager selection from a pool of more than 1 000 asset managers worldwide.

There are a few key principles that will assist in creating a transparent and effective manager selection programme:

- Ensure access to detailed information on a large number of managers. The wider the initial search, the better the chance of selecting the most suitable providers
- Keep the process transparent and the criteria objective. Allowing conflicts of interest to restrict the choice of manager will have an opportunity cost. Only when all the relevant providers are evaluated can the selection be deemed objective.
- The trustees should keep their fiduciary responsibilities in mind by involving the board, or at least the investment subcommittee, in the decision-making process. Since trustees are personally liable they should remain actively involved.
- Trustees should ensure they have access to a comprehensive research report to facilitate an informed investment manager choice.
- Ensure alignment of the interests of all parties. If the service provider earns commissions from the selected products its advice may be conflicted. PF 130 requires all advice provided to a fund is done so independently. Conflicted parties are required to abstain from participation in the investment process, be it a conflicted trustee or a conflicted service provider. ■

The new 'trust but verify'

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PPCA Inc

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THE OLD "trust but verify" was all about the accuracy of performance results reported by money managers. We now have performance reporting standards promulgated by the CFA Institute, enlightened custodians and a raft of computer checks and balances. So you'd think the past was behind us – but it would appear not. Service providers – especially performance attribution vendors – sell real time, or at least daily, product because it's more "robust". The pitch is attribution is more accurate because the manager's calculated performance is more accurate. But do we really need to calculate manager performance over and over to achieve accuracy?

We're wasting our time, money and energy on the old "Trust but verify" but missing the fact that if the benchmark is wrong all of the analytics are wrong. Most attribution systems don't allow careful benchmark specification – unless the manager is an index hugger. Performance attribution tells us why the manager has succeeded or failed relative to a benchmark, so if the benchmark is wrong we're completely misled. We pay a lot of money for flawed information. Even worse, we make bad decisions. It's the old garbage-in, garbage-out.

By contrast, the new "trust but verify" is all about the spin. The most accurate performance results are presented in the most favourable light, even when the money manager has failed. Consultants need to take back control of the due diligence process by getting serious about the two key questions: What does this manager do? And does he/she do it well? Both questions have everything to do with accurate benchmarking and absolutely nothing to do with verifying reported manager performance. We can trust the accuracy of reported performance but not the story told about that performance. If the performance is cooked we'll discover that when we perform real due diligence: but we need to do it right.

Indexes and peer groups don't work in addressing the two key due diligence questions. In identifying what the manager does, most managers don't live in a style box – although most will agree to be benchmarked against whatever it takes to get the account.

As for the second question, performing well against a "representative" peer group tells us nothing. Peer groups are loaded with biases and sales people can always find a peer group that makes them look good, provided by a reputable source and with a name that sounds like what they do.

To properly answer the first due diligence question – What does this manager do? – we need tools that capture the people, process and philosophy (the three Ps) of the management firm. One of the tools we have available is style analysis – in particular, analysis that advocates custom blends of styles. The best style analysis uses the best style indexes and it's been shown the best style indexes are mutually exclusive (no stock is in more than one index) and exhaustive (the collection of indexes spans the entire market).

With a custom benchmark in hand we can address the second question – Does the manager perform well? That's best addressed with hypothesis testing. We test the hypothesis that the manager can and has outperformed relative to all of the possible implementations of his approach. Hypothesis tests compare the actual outcome to all of the possible outcomes. If the manager's performance is in the top decile of all the possibilities he's had significant success. Note that this approach is bias free and customised to the manager, unlike traditional peer groups.

Current computer technology makes it possible to simulate all, or a reasonably good sample of all, the paths the manager could have taken over time, creating portfolios from stocks in the custom benchmark. ■

We need tools that capture the people, process and philosophy

Long on intentions, but…

PRONOUNCED DIVERSITY in pension fund arrangements worldwide has concealed the true significance of the crisis brewing below the surface caused by successive seismic waves. Our recent research study based on a survey of 222 asset managers and pension plans (collectively accounting for €22 trillion of assets in 15 countries) provides a critical insight into the problems.

What do pension funds think of their consultants?

When asked to evaluate the contribution of pension consultants in meeting the unfolding challenges of this decade, pension funds in our survey convey a mixed but unfavourable picture (graph 1).

On the whole, in every one of the activities in the chart there are notable incidences of favourable ratings under the labels of "good" and "excellent". That's notably the case in areas such as asset liability modelling and performance monitoring.

But, at the other end there are also notable unfavourable ratings under the labels of "poor" or "limited" in vital activities, such as strategic asset allocation, manager selection and strategy implementation.

As plan sponsors have raised the bar on their trustees, trustees have raised their expectations to levels to which consultants haven't been accustomed.

The unfavourable ratings are indicative of the emergence of new urgencies as much as the prevalence of embedded weaknesses. But there are exceptions: consultants specialising over a narrow area have developed greater proximity to their clients. They're perceived as adding greater value than their larger peers, with expertise across the board. However, the key differentiator isn't size but the quality of the relationship with clients.

What do pension funds think of their asset managers?

When asked to rate the contribution of their asset managers in helping to meet the challenges of this decade, pension funds' assessment has again been decidedly mixed (graph 2). The favourable ratings are much more evident in activities such as stock selection, portfolio construction and risk management. But in the critical area of returns, 55% of the respondents rate them as "poor" or "limited". Unfavourable ratings become more pronounced in other areas, such as strategic or tactical asset allocation, access to new asset classes and investor activism. They become most pronounced when it comes to pre-retirement, post-retirement and capital protection products.

Those pension funds that have diversified did so because they either accepted the uncorrelated returns story from their managers as an article of faith or they were enticed by the much publicised advantage that's turned the Yale and Harvard endowment funds into world-class icons.

In hindsight, as the funding crisis unfolded over this decade, the response of asset managers was overly product-orientated: there wasn't enough understanding of the nature of either the crisis or the responses it required. Furthermore, returns in this decade have shown evidence of "fat tail" risks, casting doubts about the viability of the current generation of risk models used by managers. There have been more extreme events than are catered for by the backward-looking nature of the models in use.

Finally, as in the case of consultants, the reported dissatisfaction has to do with the fact that the expectation bar for asset managers has been raised to a level to which they aren't accustomed. It's also indicative of the disapproval of the ways in which many asset managers operate.

Tackling the systemic weaknesses

To chart the way forward our study pursued three specific questions: first, what factors would feature strongly in pension funds' choice of their asset

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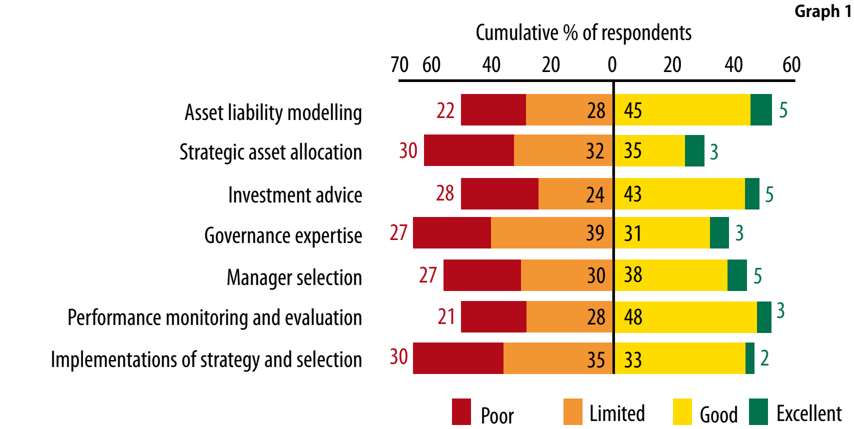
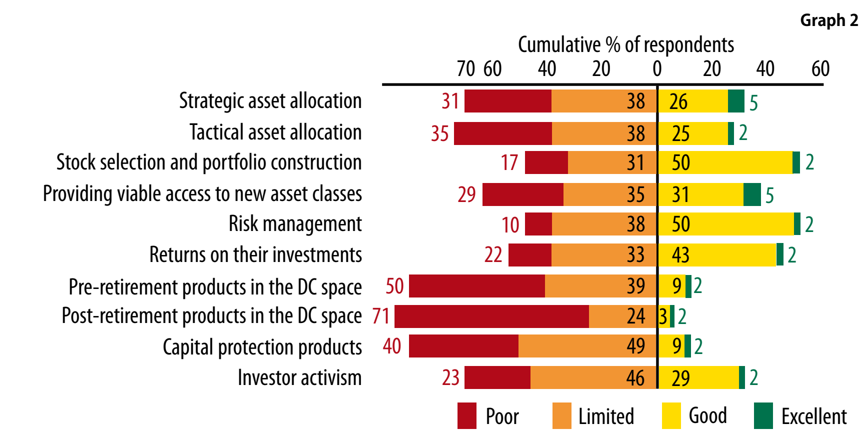
HOW DO YOU RATE THE CONTRIBUTION OF YOUR PENSION CONSULTANTS IN HELPING YOU TO MEET THE CHALLENGES THAT YOUR PENSION PLAN NOW FACES?

Graph 1



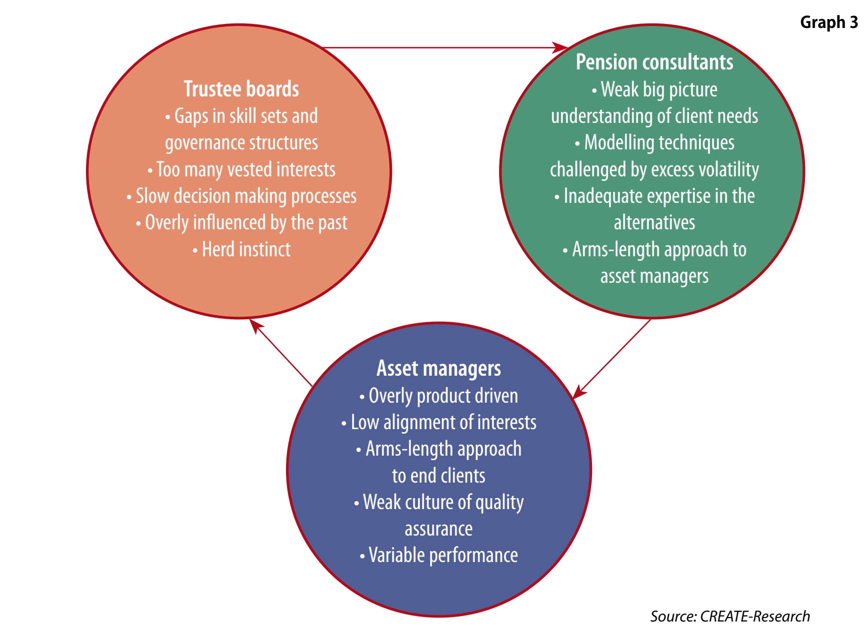
Source: CREATE-Research

HOW DO YOU RATE THE CONTRIBUTION OF YOUR ASSET MANAGERS IN HELPING YOU TO MEET CHALLENGES THAT YOUR PLAN NOW FACES?



Source: CREATE-Research

A CYCLE OF SHORTCOMINGS HAS CREATED RUPTURES IN THE INVESTMENT VALUE CHAIN



Source: CREATE-Research

managers in the next generation of mandates; second, what do asset managers need to do to add more value; and, third, what actions are needed by the three sets of players in the investment value chain.

To the first question, the answer was unanimous: good returns, backed by quality people with quality processes and alignment of interest to ensure their sustainability into the future.

On the second question there was also unanimity: asset managers and pension consultants need to embrace their clients. The current arm's-length approach isn't conducive to understanding clients' dreams and nightmares. New uncertainties require more joined-up thinking.

On the third question, the view was this aloofness is the cause and the symptom of a cycle of shortcomings that prevails in each link in the investment value chain (see graph 3). Internal shortcomings have caused external disconnects and mutual misunderstandings.

Accordingly, pension funds need to tackle the prevailing skills and governance gaps that have for too long promoted herd instinct and rear-view mirror decision-making.

On their part, consultants need to orientate their professionalism towards fresh ideas and insights that create an edge. They need to re-think their time-honoured approaches to asset allocation and manager selection – as nobody gets the benefit of the doubt any more.

Finally, asset managers must stop selling what they have and start selling what their clients need by creating products that are fit for purpose – not copy-cats – with a better value-for-money fee structure. Innovation should be about meeting clients' needs, not just revenue generation.

Above all, each party needs to interact directly with the others regularly to exchange ideas, review progress, make course corrections and monitor outcomes. Nobody has the monopoly on wisdom. Consultants' current gatekeeper role pigeonholes managers and retards creativity when it's most needed. Examples of best practices are there – but they're few and far between. The difference between the best and average is striking.

The immediate cause of the current funding crisis is, of course, the bear market. But previous recoveries have merely concealed the deep-seated problems in every part of the pension value chain and postponed the root and branch reforms that have been long overdue.

At the end of a traumatic decade the mounting crisis can't be resolved at the same level of thinking as that which gave rise to it. Without fresh thinking, pension funds will continue to stumble from one crisis to another in an era where old certainties no longer hold. ■