

Are We Ready for Excellence?

A plan sponsor reviews *Perspectives On Institutional Investment Management* by Harry Marmer

FIELD NOTES

BY TERRI TROY

When I started in the pension industry, two books were recommended to me as required reading: *Pension Fund Excellence: Creating Value for Stakeholders* by Keith Ambachtsheer and Don Ezra and *The Portable Pension Fiduciary: A Handbook for Better Pension Fund Management* by John Ilkiw. Harry Marmer's book *Perspectives On Institutional Investment Management* should also be added to this list. It is a valuable source of information and advice for those new to the pension industry, and it serves as a benchmark tool for people who have been associated with pension plans for a number of years.

Chapter I sets the stage with the following question: "Are We Ready to Manage for Excellence?"

In their well-known study, Ambachtsheer and Ezra concluded that, in aggregate, North American pension plans could be managed better to produce an additional 50 basis points (bp) per annum. This may not seem like much, but when 50 bp is multiplied by US\$5.3 trillion, the estimated size of the North American pension industry, potential savings could amount to US\$26.5 billion per annum. To put this in perspective at an individual plan sponsor level, savings of approximately \$5 million per annum exist for every \$1 billion in pension assets managed. This is a staggering amount.

Organizational dysfunction is the primary cause of excellence shortfall among pension plans. Specifically, organizational dysfunction refers to poor processes (structure, communication, inertia), inadequate resources, insufficient staff skills, etc. Does this sound familiar?

Marmer recommends that pension plans should be run like businesses and provides a blueprint for both large and small plans. He advises the person or committee responsible for pension investments to ask themselves the following key questions: Can managers beat the market? If yes, which markets? Over what time

frame? Under what conditions? Do managers add value after fees are taken into account? Pension plan fiduciaries need to formulate investment beliefs to provide the rationale for how they choose to invest pension assets.

IMPLEMENTATION CHALLENGES

In Section Two, entitled "Successful Implementation," Marmer provides tips for manager selection, manager structure, monitoring of managers and rebalancing the pension plans' asset mix. While performance is a key factor when hiring/monitoring a manager, the investor also needs to pay attention to investment process, people, and philosophy (investment style). To help guide the reader, a checklist is provided. A significant fact is highlighted here: "Last year, there were over 50 publicly reported people/organizational changes in the Canadian institutional investment management industry." The question is, what impact will these changes have on your portfolio? And how will you know before it is too late?

Furthermore, Marmer points out that "We need anywhere from 14 to 24 years to validate a manager's skill." I wonder if readers will scratch their heads and ask just how they are supposed to monitor these managers. For example, a key person leaves the firm. Does this mean you should change managers? Like many things in this business, it requires a judgment call. If you believe poor performance will be the result of a key person leaving the firm, you should change managers. But how will you know? Was past performance a result of luck or skill?

Investment style is important yet unpredictable. Marmer points out that 85 per cent of the return variance from stock selection is due to investment style. A manager may be under-performing in a certain period purely because that particular investment style is not in favour during that time. The following words of wisdom are provided:

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“Pension plans should be run like businesses.”

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“Avoid selling this year’s loser, which becomes next year’s winner, to buy last year’s winner, which becomes this year’s loser! Avoid the performance trap!”

Marmer also states that reducing style investment risk is one of the market’s few free lunches. For example, many pension committees will offset a value manager with a growth manager in the same asset class. A couple of questions deserve further exploration. Why not just stick to “core-like” managers to avoid hiring both a value and growth manager? Moreover, does the combination of value and growth managers provide more value added after fees than a “core-like” manager?

TRADING COSTS

I was delighted to see that Marmer included a section devoted to trading costs, a very topical subject in the pension investment industry. The selection of managers and ongoing monitoring of managers should not be done without considering trading costs. He hits the nail on the head when he writes, “Ask a typical manager about how efficient their trading is and the conversation will focus on commission costs. But commission costs are just the tip of the iceberg of trading costs.” Trading costs include not only commission costs, but also market impact, delay costs, and opportunity costs. In fact, commission costs are the least costly of the four components that make up total trading costs. Total trading costs are significant and cause a considerable drag on performance. In general, total trading costs range from 65 bp in a large cap value portfolio, 159 bp in a large cap growth portfolio, 160 bp in a small cap value portfolio, and 312 bp in a small cap growth portfolio. Indexed portfolios also have high trading costs of approximately 138 bp.

MANAGER ASSESSMENT

Finally, in Section Three, “Valuable Information,” Marmer provides a useful agenda to help a pension investment committee run an effective performance assessment meeting with an investment manager. Since Harry cites poor structure (processes, communication, inertia) as the leading cause of performance shortfall among pension plans, it

is very important to run effective committee meetings.

For example, a manager review meeting normally takes 45 minutes to one hour. Marmer recommends that both a qualitative and quantitative assessment of the manager be prepared prior to the meeting and reviewed by the investment committee at the meeting. He also advises that the manager discuss investment activity for the various time periods being reviewed. He recommends that the manager’s compliance audit be reviewed and, lastly, that a report card be completed by the investment committee.

Marmer points out that “one of the issues institutional investors face is that a typical pension committee meets only three or four times a year to oversee the pension investment business.” If pension investment committees are accountable for both investment policy and investment implementation (manager selection/monitoring), how can this be done effectively by meeting only three or four times a year?

Let’s revisit the recommendation made at the beginning of the book: “Pension plans should be run like businesses.” I am a firm believer that committees should be used to set policy, not to make managing/operating decisions. The selection/monitoring of managers is a managing function. As such, it should be the responsibility of an experienced team leader who is held accountable for decisions made. This person may decide to use external investing consulting experts to assist him or her in this regard. Whether the organization decides to continue with the committee route or to delegate this authority to a team leader, the approach recommended in this book for conducting a manager review meeting should be utilized to ensure that time is being well spent.

Marmer’s final words are, “What we do not recognize and understand, we cannot correct.” This book introduces the key issues that plan sponsors need to both understand and manage. Pension plan assets are there to support the pension plan obligations. Are the assets being managed in an effective way that will meet those obligations? ■

Perspectives on Institutional Investment Management is published by Rogers Media, Healthcare and Financial Publishing, 2002.