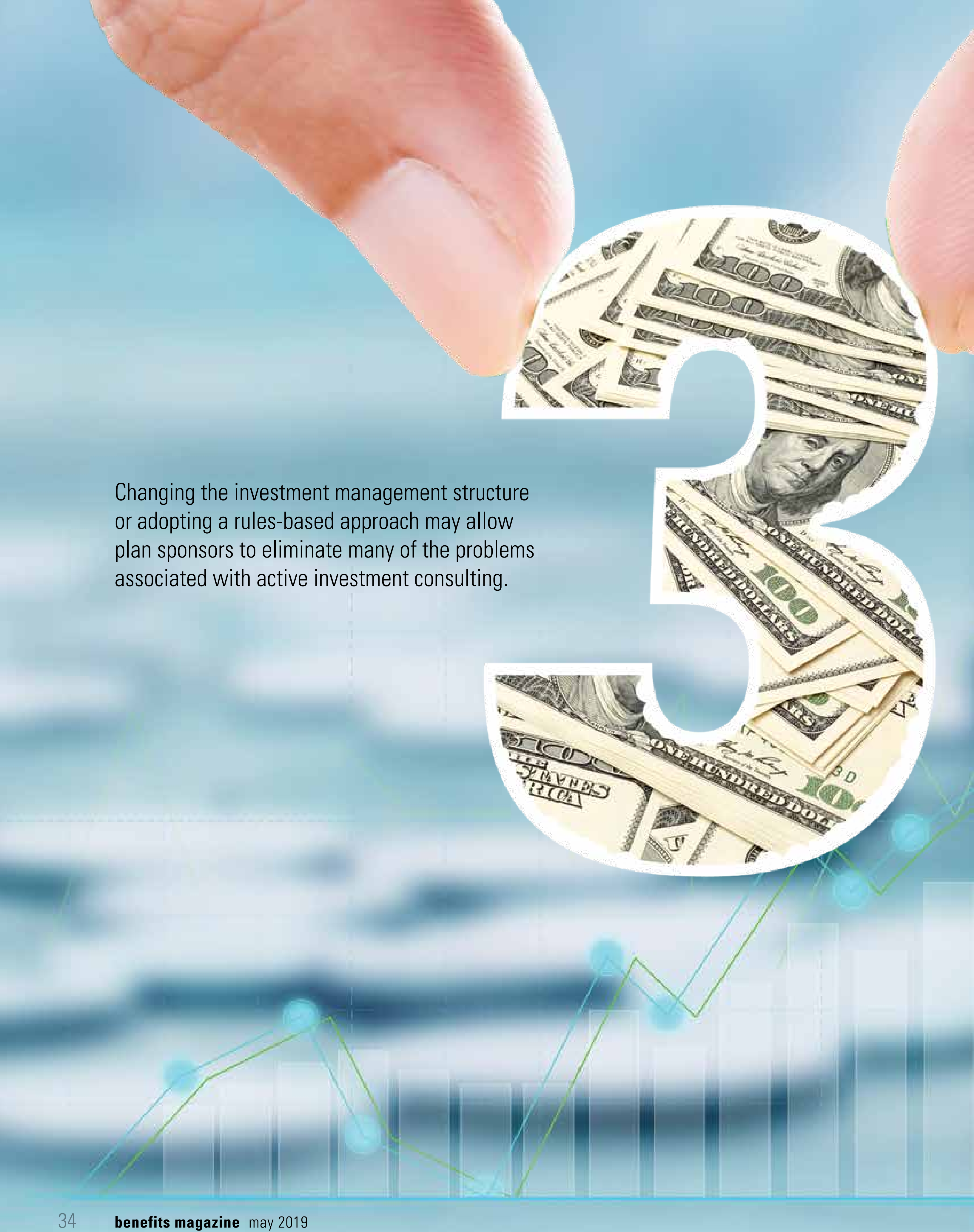
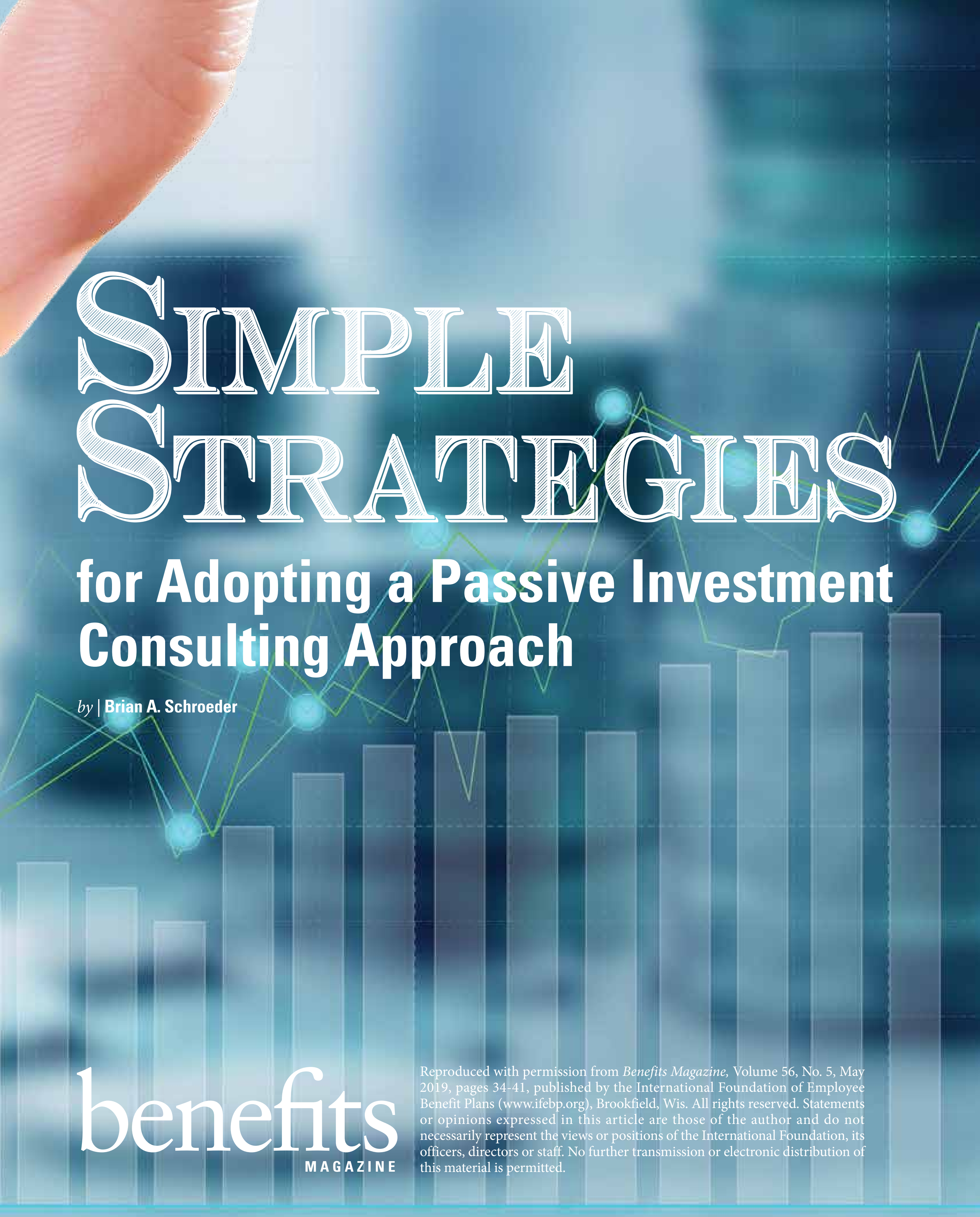


Changing the investment management structure or adopting a rules-based approach may allow plan sponsors to eliminate many of the problems associated with active investment consulting.



Simple Strategies

for Adopting a Passive Investment Consulting Approach

by | **Brian A. Schroeder**

benefits MAGAZINE

"A problem well-stated is a problem half solved" has long served innovators seeking a better way. This Charles Kettering quote inspires us to investigate the current state of managing institutional plan assets and then explore alternative improvements.

Warren Buffett believes "Money flows to the patient investor" and "Our favorite holding period is forever." These quotes, however, seem to be at odds with the investment practices of institutional plan sponsors.

Most plan sponsors hire a full-time investment consultant to lead their investment strategy. This structure, as it is implemented today, can lead to results that are less than optimal. This article will examine the reasons this is true and suggest three simple ways to eliminate the causes.

A Problem Well-Stated

Academic studies show that institutional plan sponsors usually lose value when changing asset allocation and investment managers. These changes are normally made at the board level following the advice of an investment consultant.

Beyond the fact that investing is little more than an educated guess about the future, behavioral finance concepts can explain why value is lost, including:

- Chasing "hot" managers and asset classes
- Firing "cold" managers and asset classes
- Delayed decision making
- Reactive decision making
- Emotional decision making
- Lack of patience
- Politics, nepotism and pay-to-play privileges
- The instinct to "do something"
- Conflicts of interest.

Trustees serving a pension plan, foundation, endowment, etc., have difficulty recognizing whether they are falling into these investment traps. There are three ways trustees are shielded from knowing the true results of their decisions.

- **Lack of transparency and sufficient information in investment consultant reports.** Trustees may not have enough information to make a valid comparison between old and new asset allocation strategies or the efficacy of portfolio rebalancing or tactical asset allocation changes. Reports also fail to display the impact of investment manager changes, which can only be recognized if the plan sponsor knows how the terminated manager would have performed.
- **Time.** It often takes more than ten years to know with statistical certainty whether an asset allocation or manager change added value. This long feedback loop is an obstacle since many changes may have taken place in the meantime to muddy the water. Further, the "fog of time" and personnel turnover—for both the board of trustees and professionals—destroy institutional memory.
- **Conflicts of interest.** Although both are normally fiduciaries, it's difficult for investment consultants and trustees to admit that their recommendations or decisions resulted in a loss of value. This creates a conflict of interest in performance reporting.

Active Investing

The terms *active* and *passive* normally refer to types of money management such as active stock management or passive bond management. But these terms readily apply to investment consultant duties.

Active management seeks to beat an index. Using fundamental analysis, factors, trading strategies, algorithms and other methods, active managers seek to beat the index. Risk can also help differentiate whether an active approach beats its relevant index.

Over time, adjusting for fees, trading costs and risk, active management cannot beat the market since active managers collectively are the market. They are therefore competing in a zero-sum game. Individual money managers can win only if another loses. However, those winning managers are far outnumbered by the losers because of fees and transaction costs.

Active investment consultants do not follow a rules-based approach. Rather, like active managers, they make recommendations based on client objectives, risk tolerances, cash flows and market conditions while incorporating their forecasts, research and analysis. With financial markets in constant flux, outlooks in flux, unpredictable manager performance and continual creation of new investment products, investment consultants can usually find a reason to recommend change.

Sometimes the catalyst for making changes to investment strategy is external to the process (e.g., lower interest rates, increased market volatility) and therefore reactive. Further, trustees also can be the catalyst for change by demanding "something be done" due to funding status, legal changes, emotions, changes to the board or any number of reasons.

If it seems there is always something to be done at every board or investment committee meeting, that should raise a red flag. Investment consultants have the conflict of interest to be constantly busy. Whether it is active manager monitoring, performance attribution, a new strategic or tactical asset allocation, or a manager search, an investment consultant has a constant need to justify its role. Trustees need to be vigilant since wheels turning do not always mean moving forward.

If asset allocation changes and money manager changes tend to destroy value, but the investment consultant needs to stay busy, the well-stated problem is clear.

takeaways

- The typical model of using a full-time investment consultant can lead to results that are less than optimal for institutional plan sponsors often because the plan sponsor changes asset allocation and investment managers too frequently.
- Employing a passive investment strategy (rules-based approach) using part-time investment consultants or using multiple multi-asset class (MAC) managers can be easy solutions to this challenge
- A rules-based investing approach incorporates rules that concern investment consultant decisions on strategic and tactical asset allocation, manager hiring and firing, and portfolio rebalancing.
- Using part-time investment consultants helps plan sponsors diversify investment advice.
- Using multiple MAC managers diversifies investment advice and can reduce fee-related costs.

Passive Investing

Passive money management, or *indexing,* simply tries to replicate a market index. The market index is a rules-based construct designed to represent a specific asset class. Passive money management is therefore a rules-based approach.

Recall the joke about a patient who goes into a doctor's office, twists his arm up behind his head and then says, "Doctor, it hurts when I do this." The doctor quips, "Then don't do that." If trustees could feel the pain of their poor investment decisions, they would certainly change their behavior.

The goal of passive investment consulting is to stop doing the things that hurt by applying simple, explicit and objective rules to the investment process. By either changing the investment structure or adopting a rules-based approach, plan sponsors can eliminate many of the painful problems associated with active investment consulting.

There are three simple ways to bring a passive approach to the investment process:

1. Adopt a rules-based approach.
2. Use part-time investment consultants.
3. Use multiple multi-asset class (MAC) managers.

1. Adopt a Rules-Based Approach

Institutional plan sponsors are considered long-term investors. This means they have a long investment horizon, a fixed objective, a predictable liability stream and seek to last forever. Yet despite this monolithic construct, investment decisions are often shortsighted and frequent.

A rules-based approach will rein in the desire to constantly tinker. Further, eliminating emotions, reactiveness and conflicts of interest will help in avoiding the behavioral finance traps most investors make but are shielded from knowing they are falling into.

Investment consultants execute the following four disciplines, regardless of whether an institutional plan sponsor then votes on the recommendation:

- Strategic asset allocation
- Tactical asset allocation
- Manager hiring and firing
- Rebalancing.

Plan sponsors that adopt a rules-based approach maintain the existing structure of using a full-time, nondiscretionary investment consultant. The rules are formally incorporated into the investment policy statement and then followed meticulously.

Strategic Asset Allocation

Strategic asset allocation is the first discipline that could benefit from a rules-based approach. *Strategic asset allocation* is the art of dividing assets between stocks, bonds, real estate, commodities, etc., to achieve a hoped-for risk/return profile.

The figure summarizes the randomness of asset class returns from year to year. Given this uncertainty, it is impossible to craft an asset allocation hoping to be a winner every year. There is no hard evidence that any person or firm can consistently use such a strategy to beat a strategic buy-and-hold asset allocation that focuses on long-term results.

In the 2009 article "Absence of Value: An Analysis of Investment Allocation Decisions by Institutional Plan Sponsors," the authors analyzed 80,000 yearly observations from 1984 to 2007 concerning rebalancing and reallocation decisions.[1] They concluded that "Institutional investors do not appear to create value from their investment decisions." It should be noted this study did not account for fees and transaction costs.

The author's work performing due diligence on investment consultants has revealed that investment consultants frequently change strategic asset allocation. Anecdotally, in reviewing past studies for clients, the investment consultant that destroyed the most value made the most asset allocation changes. By contrast, the one that created the most value made the fewest changes.

One solution is to bring a rules-based discipline to the asset allocation function. The active and arbitrary method can be cumbersome, delayed, time-consuming, costly, disruptive and ineffective. Therefore, enacting the findings of an asset allocation study should be an infrequent exercise.

Instead of performing an asset allocation change whenever the investment consultant recommends it, plan sponsors can limit the exercise to a specific frequency, perhaps every five years. On top of that, they should seek the opinion of another investment consultant as well as their investment managers. These professionals should then openly debate their recommen-

FIGURE

Annual Asset Class Returns

Randomness of returns makes it difficult to correctly allocate assets in the short term.

1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
66%	14%	8%	22%	56%	26%	34%	32%	39%	5%	79%	27%	16%	18%	39%	14%	15%	21%	37%	9%
27%	12%	6%	10%	47%	20%	21%	26%	16%	4%	58%	25%	8%	17%	35%	13%	1%	15%	25%	2%
21%	8%	5%	6%	40%	20%	14%	18%	11%	1%	40%	19%	5%	17%	32%	13%	1%	14%	22%	0%
21%	6%	4%	2%	39%	18%	13%	16%	11%	-10%	32%	16%	4%	16%	23%	6%	0%	12%	20%	-1%
18%	-3%	2%	-1%	29%	13%	5%	16%	7%	-26%	27%	15%	2%	16%	14%	5%	-1%	10%	19%	-2%
13%	-4%	-3%	-6%	29%	13%	5%	15%	6%	-34%	26%	15%	0%	14%	6%	2%	-2%	9%	11%	-4%
5%	-6%	-4%	-16%	19%	11%	3%	12%	5%	-37%	8%	8%	-2%	11%	0%	0%	-4%	3%	8%	-9%
2%	-9%	-6%	-16%	9%	11%	3%	8%	5%	-41%	6%	7%	-4%	4%	-2%	-2%	-5%	1%	6%	-11%
-1%	-14%	-12%	-20%	4%	4%	2%	5%	2%	-43%	0%	5%	-12%	4%	-3%	-3%	-6%	1%	4%	-14%
-9%	-31%	-21%	-22%	1%	1%	-9%	4%	-2%	-53%	-30%	0%	-18%	0%	-3%	-5%	-14%	0%	1%	-15%

Large U.S. Stocks | U.S. Fixed Income | Mid-Cap U.S. Stocks | Emerging Markets | U.S. Real Estate
Small Cap U.S. Stocks | U.S. High Yield | Foreign Stocks | Non-U.S. Fixed Income | Cash (90-day T-bill)

Returns are rounded to nearest percent.

Sources: Barclays, MSCI, NCREIF, BofA Merrill Lynch, Standard & Poor's.

dations. This powerful combination will restrain change and provide many and diverse opinions.

Tactical Asset Allocation

Tactical asset allocation is the discipline of making short- to intermediate-term changes to asset allocation. Given that markets are efficient, these tactical opportunities are few and far between. Like strategic asset allocation, a rules-based approach will help.

To ensure tactical asset allocation changes do not become veiled market timing, plan sponsors need a rules-based discipline. An example would be to limit tactical asset allocation changes to no more than one change every seven years and limit it to 5% of total plan assets.

Manager Hiring and Firing

Manager hiring and firing is the discipline that could benefit most from applying a rules-based approach. Investment managers have salespersons, creative marketing and advertising, new product offerings and tickets to sporting events. They host conferences, throw lavish parties, publish research papers, etc. And they sometimes even have a "hot streak" to tout that helps create the siren's song that gets clients to chase their past performance.

All active investment managers eventually lag their index, and sometimes these investment managers end up on the "watch list" and come under scrutiny for failing to create excess performance, or *alpha*.

A study of hires and fires by 3,700 plan sponsors over a ten-year period concluded, "if plan sponsors had stayed with fired investment managers, their excess returns would be larger than those actually delivered by the newly hired managers."[2]

In the author's work performing due diligence on investment consultants, none of the institutional plan sponsors, following the advice of their investment consultants, created value with investment manager hire-and-fire decisions. Most actually destroyed value on both hiring and firing decisions. Nearly every reason listed at the start of this article can be cited for explaining the phenomenon of poor manager selection by plan sponsors.

First and foremost, all plan sponsors must admit that no one can predict with any consistency the future relative performance of any active investment manager. Again, research and anecdotal evidence show that institutional plan sponsors lose money when making such decisions. Like the doctor's suggestion to the patient, plan sponsors must refrain from doing what hurts them.

The first rules-based approach is to use passive strategies or index funds. This will eliminate the possibility of falling into so many of the investment traps. Beyond no longer being tempted to chase performance and "buy high and sell low," fees will be dramatically reduced and the time savings of not having to monitor all those active managers will be immense.

Of course, not all asset classes can be indexed, and plan sponsors will still need active investment managers. In those cases, a rules-based approach primarily concerns manager termination. Again, no one knows how to pick which active managers will outperform. But plan sponsors can at least rely on the behavioral finance heuristic that hiring a "hot manager" usually turns into failure.

Once an investment manager is hired, a minimum tenure should be allowed. For example, a newly hired investment manager cannot be fired for eight years (for performance reasons). If the manager experiences a loss of talent, severe change in personnel, ownership change, fee change or another nonperformance issue, only then should the plan sponsor consider terminating the manager. This minimum tenure will allow the manager's ability to show over various market conditions and eliminate decisions reacting to short-term performance.

Rebalancing

The last active investment consultant discipline that could benefit from a rules-based approach is rebalancing. Rebalancing is often overlooked, but effective rebalancing helps manage risk and captures incremental returns by trimming appreciated assets and redeploying into other assets to maintain optimal portfolio characteristics.

Many investment consultants miss rebalancing opportunities and will often say it was because they expected the market to continue to create an even better opportunity. While that may be true, such thinking only comes into play at inflection points at the end of market cycles. Thus, the opportunities within cycles, such as corrections, are the ones missed. These opportunities, however, are much more frequent than inflection points between bull and bear markets.

A rules-based approach to rebalancing means following objective triggers based on time, asset weightings, frequency or a combination of factors. For example, the investment policy would state, "If any asset class deviates 10% above or below its target allocation, then all liquid asset classes are to be rebal-

What About Hiring an OCIO?

Some plan sponsors have begun using an outsourced chief investment officer (OCIO). An OCIO has discretionary authority to act on the four investment consultant disciplines detailed previously without needing a vote of approval from the board of trustees. This goal is to streamline the investment process and "leave it to the experts" in hopes of better results.

This article will not address the pros and cons of converting to an OCIO. Plan sponsors should understand that changing to an OCIO does not magically exempt the investment process from the investment traps, the findings of the academic studies or uncertainty in the financial markets. Nor are there definitive studies showing that an OCIO will produce better long-term results than a nondiscretionary investment consulting structure.

Plan sponsors that use an OCIO should consider incorporating rules-based restraints into their investment policy statements. Every change, transaction and strategy modification will incur costs. OCIOs are people too and remain subject to the same circumstances they were as nondiscretionary investment consultants.

anced to target. Such rebalancing shall be limited to no more than twice per fiscal year. Monthly and quarterly-valued assets are to be rebalanced no more than annually."

For rebalancing, as well as the other investment consultant functions, a rules-based approach brings discipline and accountability while removing arbitrariness, emotions and conflicts of interest. Plan sponsors can work with their investment consultant to discover the objective rules, time limits and triggers that work best for their investment plan's circumstances.

2. Use Part-Time Investment Consultants

The majority of plan sponsors have settled on following the advice of a lone, full-time investment consultant. This structure completely lacks thought diversification. Whether it is financial, medical or legal, it is prudent to get a second or third opinion.

Adopting a passive or rules-based approach presents an opportunity to both lower costs and add diversification to the key decisions driving investment success. Instead of getting one opinion from the same source, plan sponsors can diversify by seeking other opinions. Diversification can protect plan sponsors from bad investment consultant advice.

Plan sponsors can terminate their full-time investment consultant and use several part-time investment consultants to save time and money and diversify strategic thinking. They can hire multiple investment consultants to perform project work per their passive rules contained in the investment policy statement. They may consider hiring a performance reporter that works separately from the investment consultants strictly for annual analysis. "People would be better stock market investors if they only published the prices once a year," says Warren Buffett.

3. Use Multiple Multi-Asset Class (MAC) Managers

Making too many investment decisions at the board and investment consultant level is the well-stated problem. The solution is to reduce frequency, remove emotions, restrain reactiveness and eliminate conflicts of interest by adopting a rules-based approach.

The last method for bringing passivity is to use multiple MAC managers. Unlike a specialty manager that is restricted to a specific asset class, MAC managers can invest across the spectrum, following broad guidelines to meet objectives. The table illustrates hypothetical guidelines for MAC managers to follow. No target allocations mean the MAC managers have discretion to execute their different strategies, creating thought diversification executed in real time.

TABLE

Hypothetical Guidelines for Multi-Asset Class (MAC) Managers

MAC managers should have broad flexibility to implement their different strategies.

	Minimum Allocation	Maximum Allocation
Equities		
Domestic Equities *(Small and Mid-Cap Not to Exceed 20%)*	10%	55%
International Equities *(Emerging Market Not to Exceed 15%)*	10%	35%
Fixed Income		
U.S. Investment Grade	10%	60%
Below Investment Grade	0%	15%
Non-U.S. Investment Grade	0%	10%
U.S. Convertible	0%	5%
Liquid Alternatives		
U.S. and Global Real Estate	0%	10%
Commodities	0%	5%
Hedge Funds of Funds	0%	5%

This structure delegates and diversifies the investment consultant duties to the MAC managers. Further, because a plan sponsor would hire only three to five MAC managers, the fee savings are great when compared with the fees paid for dozens of investment managers that plans typically have. Depending on the size of the mandates, surveys estimate the fee savings could be as much as 50%.

Both strategic and tactical asset allocation decisions would be performed by the MAC managers. The MAC managers could hire internal or external submanagers and choose which of those asset classes will be actively or passively managed. Finally, rebalancing would be delegated to the MAC managers, bringing needed diversification to that function.

Because there are fewer managers following the same guidelines, performance monitoring is simple compared with the investment consultant/manager model. The plan sponsor will no longer have to monitor the investment consultant. Like using part-time consultants, hiring a performance monitor should be considered but is not necessary when using multiple MAC managers.

For more detailed information about using multiple MAC managers, see the article “Multi-Balanced Model: The Missing Link of Investment Approaches?” in the July 2014 issue of *Benefits Magazine*.

Disadvantages of a Rules-Based Approach

Although studies and anecdotal evidence indicate that a passive investment consulting approach can lower costs, save time and improve returns, there is one potential drawback. Restraints could possibly hinder a consultant’s ability to create value.

If this claim is made, plans should document the consultant’s past record of successfully changing asset allocation, hiring alpha-generating managers, firing alpha-destroying managers and effective rebalancing. The rules-based policy should then be adjusted to reflect the consultant’s proven strengths, keeping in mind that past performance does not guarantee future results.

Finally, enacting a passive investment consulting approach means the board of trustees must be steadfast regardless of any short-term market gyrations. During times like the “irrational exuberance” of the late 1990s, the burst of the dot.com bubble or the financial crisis of 2008-2009, trustees must resist the inevitable temptations to react emotionally. It is precisely during such times that investors fall into costly behavioral finance traps. Mental and emotional discipline win when panic and greed lose.

Should We Adopt a Rules-Based Approach?

Many plan sponsors have no idea whether they are too active, getting bad investment consultant advice or falling into the behavioral finance traps. They are shielded from the truth and numbed to the pain by performance reporting that helps maintain the status quo.

Adopting any of the above strategies may cure many of the ills that institutional plan sponsors are unknowingly suffering. Academic studies and anecdotal evidence point to the fact that frequent change is a problem. Successful investing is about patience and avoiding mistakes.

Applying a passive approach to the investment consulting function is easy and can create substantial cost savings, save valuable meeting time and potentially improve long-term results.

bio

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Endnotes

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