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# Diversifying Investment Consultant Risk

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*At the time of this publication, institutional investors are reviewing their 2013 returns and should be pleased. Likely, they experienced double-digit returns above their historic norm. However, the sting of 2008 remains and plan sponsors, led by their investment consultants, should prudently continue to look for ways to diversify risk, reduce tail-risk, lower costs and improve returns.*

*Investment consultants, however, are likely not recommending diversifying one of the single largest sources of risk: poor investment consultant advice. Several comprehensive studies have analyzed manager selection and asset allocation decisions made by institutional investors and conclude by seriously questioning the benefits of these investment decisions.*

*This essay explores a "multi-balanced" investment strategy that diversifies the key investment consultant functions of asset allocation, manager selection and re-balancing. It clearly explains how this simple approach can be superior to the consultant-centric investment model in common use today.*

Last year three academics at the University of Oxford in England published the study *Picking Winners? Investment Consultants' Recommendations of Fund Managers*. Tim Jenkinson, Howard Jones and Jose Vicente Martinez studied the manager selection decisions of institutional investment plans in the United States. The study focused on the selection of domestic equity managers. In the paper's abstract, they concluded:

> ***"…we find no evidence that these recommendations add value to plan sponsors."***

The conclusion of this recent paper is reinforced by a similar study that was released in 2004, and later published in the *Journal of Finance* in 2008. *The Selection and Termination of Investment Management Firms by Plan Sponsors*, authored by Amit Goyal and Sunil Wahal, also analyzed the hiring and firing decisions of institutional plan sponsors. The paper's abstract reads:

> ***"We examine the selection and termination of investment management firms by 3,400 plan sponsors between 1994 and 2003. Plan sponsors hire investment managers after large positive excess returns but this return-chasing behavior does not deliver positive excess returns thereafter. Investment managers are terminated for a variety of reasons, including but not limited to underperformance. Excess returns after terminations are typically indistinguishable from zero but in some cases positive. In a sample of round-trip firing and hiring decisions, we find that if plan sponsors had stayed with fired investment managers, their excess returns would be no different from those delivered by newly hired managers. We uncover significant variation in pre- and post-hiring and firing returns that is related to plan sponsor characteristics."***

Manager selection is only one place where there is potential to add value. Asset allocation strategy is generally regarded as more impactful to investment success. Another study analyzed the asset allocation decisions of institutional plans and was published in the *Financial Analysts Journal* in 2009. *Absence of Value: An Analysis of Investment Allocation Decisions by Institutional Plan Sponsors* was authored by Scott D. Stewart, CFA, John J. Neumann, Christoper R. Knittel, and Jeffrey Heisler, CFA. In the paper's abstract, they concluded:

> ***"Much like individual investors who switch mutual funds at the wrong time, institutional investors do not appear to create value from their investment decisions."***

We can safely assume that the majority of the plans in the above studies used investment consultants to guide their manager selection and asset allocation decisions. It is apparent that there is real and substantial risk from following bad investment consultant advice. Given the above conclusions, every plan sponsor should consider the following questions:

> ***Are we getting good advice from our investment consultant?***
> ***How can we reduce or eliminate our investment consultant risk?***

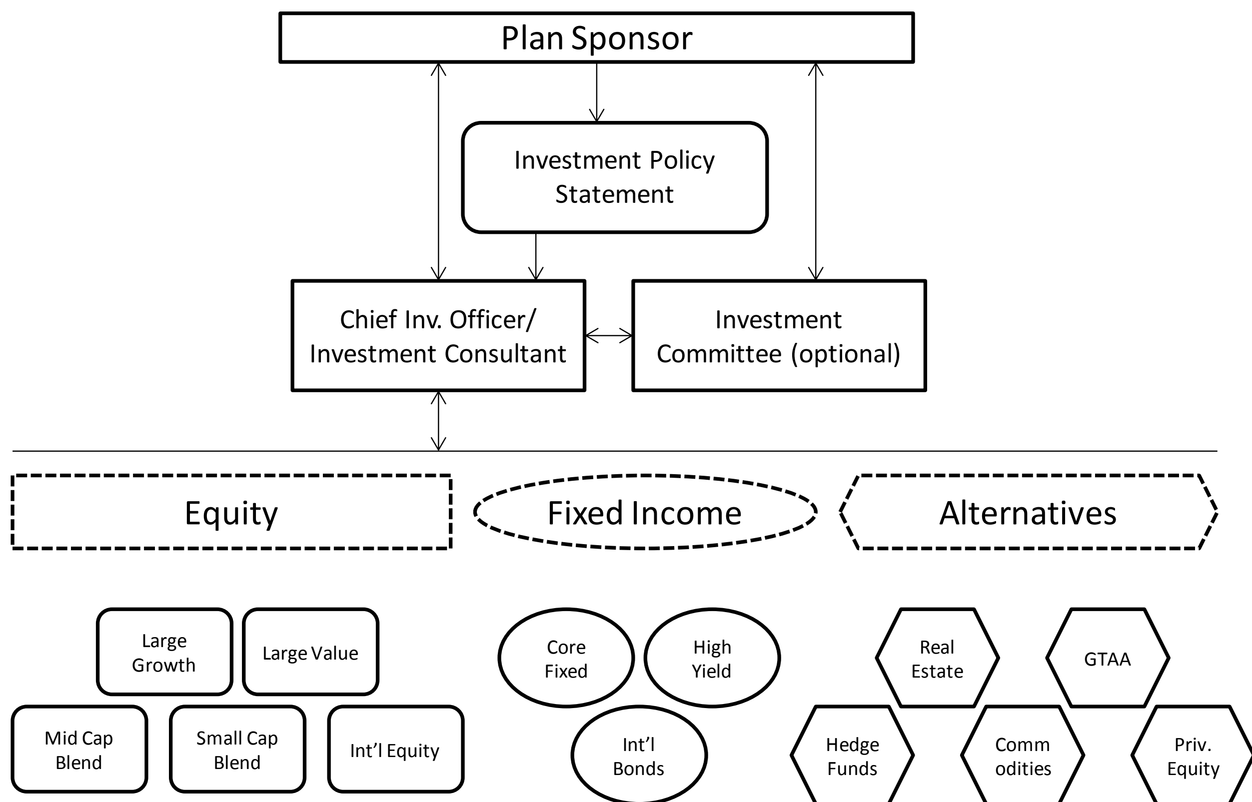
Addressing the first question, it is virtually impossible for a plan sponsor to evaluate advice from their investment consultant. I have written several papers that specifically address this gaping hole in performance reporting. The two best examples are *Who "Owns" Your Institutional Investment Portfolio Returns?* and *Decoding Investment Consultant Alpha*. The most troubling aspect is that a plan sponsor has to rely on investment consultant reports containing incomplete data and feedback loops.

Addressing the second question, like with so many other problems in investing, diversification is often the correct solution. Diversifying the risk of poor investment consultant advice could mean unbundling

investment consultant duties or having multiple investment consultants perform manager searches and asset allocation studies. This diversification from unbundling or redundancy ad infinitum may border on the absurd in terms of process, timeliness, functionality and greatly increase costs. Whether it is unbundling or redundancy, the plan sponsor remains in the current paradigm.

A more practical solution for addressing this second question will be the focus of the remainder of this essay. We shall explore an investment model that does not have to rely on a full-time investment consultant, but does indeed diversify the key consultant functions. Specifically, those functions are manager selection, asset allocation and re-balancing.

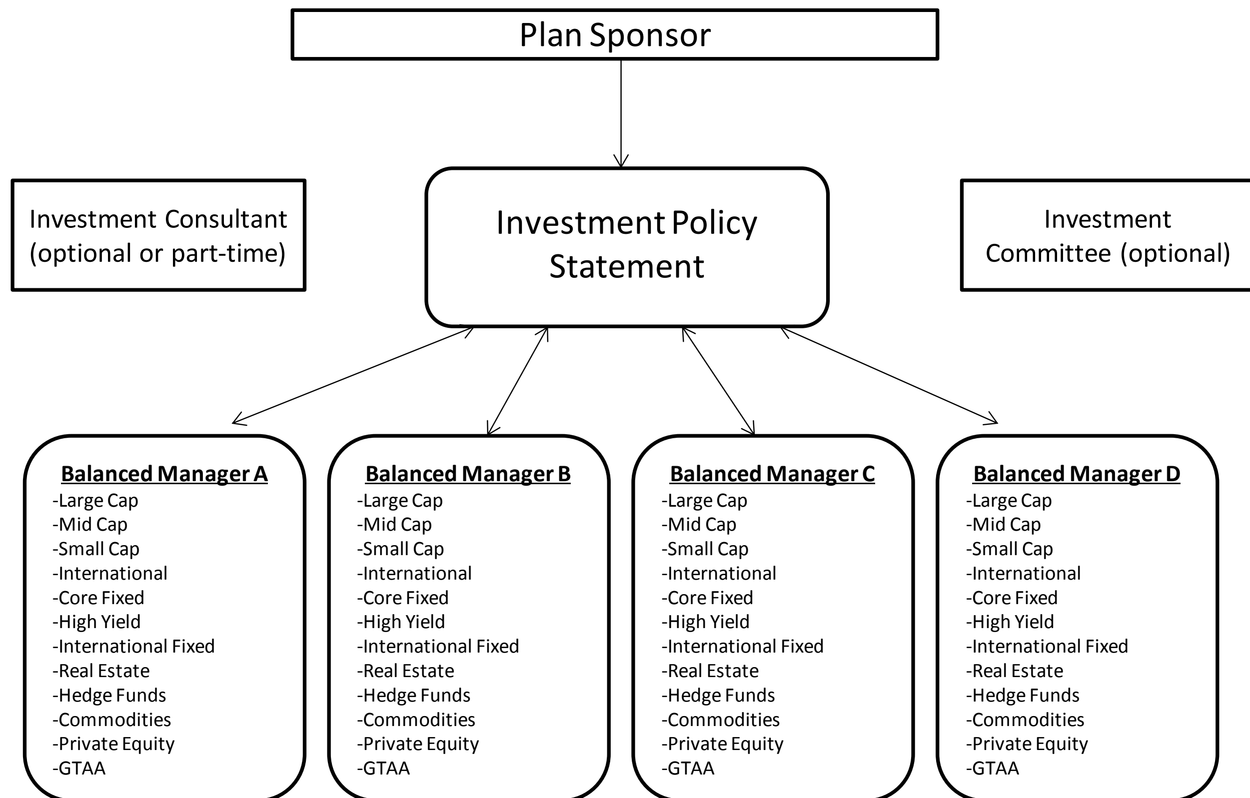
The current model for managing institutional plan assets can be depicted by the following illustration:




This consultant-centric model has the investment consultant squarely in the middle of the process. They are the driver of the asset allocation, manager selection, and re-balancing decisions. Granting discretionary authority to the investment consultant would actually exacerbate the lack of diversification as the plan sponsor and/or investment committee would no longer serve as a check.

This last point bears repeating. *Investment consultant risk is at its maximum when a lone investment consultant has complete discretionary authority*. There is absolutely no diversification of asset allocation decisions, re-balancing, performance reporting, manager hiring, and manager firing. Yet, despite the constant drumbeat of investment consultants preaching diversification, when it comes to diversifying their own duties, do they practice what they preach?

There is an alternative model that plan sponsors can easily adopt that will add diversification to their asset allocation, manager selection, and re-balancing functions. We shall call this the "multi-balanced model." This model can be illustrated by the following:




This simple and powerful approach to managing without having to rely on the opinions of a single, full-time investment consultant is worthy of exploring in light of the studies cited above.

There are many reasons why a multi-balanced model is superior to the traditional consultant-centric model directing multiple specialty managers. Those reasons are:

- Level 2 Diversification
- Real Time Dynamism
- Greater Asset Class Diversification
- Greater Manager Diversification
- Easier to Monitor
- Lower Manager Turnover
- Lower Costs
- Lower Fiduciary Liability
- Fewer Conflicts of Interest

We will now examine each of the above points and contrast with the consultant-centric model. Our goal is not to go into great detail regarding each point, but rather touch on the highlights, providing a succinct essay that stays focused on the big picture.

***Level 2 Diversification***

The first point that makes the multi-balanced model superior is that it incorporates Level 2 diversification. Level 2 decisions are those that concern asset allocation, manager selection and re-balancing. With the exception of re-balancing, these are the decisions evaluated in the studies noted above. Diversifying these decisions among multiple balanced managers protects investment plans from poor decisions of a single investment consultant. By definition, let me say again, a consultant-centric model has no Level 2 diversification; it simply relies on the opinion of a single investment consultant.

***Real Time Dynamism***

The second reason is that it incorporates real time dynamism. This means that decisions regarding asset allocation, manager selection and re-balancing can occur almost instantly. Each balanced manager is able to react to market conditions without having to run each decision "up the chain of command."

By having real time dynamism in the investment process, information can be incorporated into the overall portfolio more quickly. Each balanced manager can change sub-managers, asset allocation, and re-balance internally as opposed to between separate account managers. Visualize the delayed, cumbersome and time-consuming process it takes to move assets within a consultant-centric model. Even if the investment consultant has discretionary authority, this only bypasses the need for plan sponsor approval. The multi-balanced model is more nimble in executing all Level 2 decisions.

***Greater Asset Class Diversification***

The third reason is that there is greater diversification within an asset class. Following the consultant-centric model, very often an asset class is represented by a single manager. Some asset classes cannot be adequately represented by a single manager. For example, how many kinds of alternative asset classes are there? How many asset classes can be further sub-divided?

***Greater Manager Diversification***

The fourth reason the multi-balanced model is better is that there is greater manager diversification. Instead of the standard one manager per asset class, an investment plan will now have multiple managers in each asset class and thus more widely diversify its active manager risk.

***Easier to Monitor***

The fifth reason the multi-balanced model is more appealing concerns ease of monitoring. First, there are fewer managers. Second, all of the balanced managers manage to the same return objective and are measured against the same benchmark. Third, plan sponsors will not be faced with the questionable practice of benchmark linking. Benchmark linking masks the efficacy of asset allocation decisions.

***Lower Manager Turnover***

The sixth reason is that there is lower manager turnover. High manager turnover is often a symptom of poor manager selection. Further, there is a large and often unseen cost to changing managers. By having just a few balanced managers to monitor, more in-depth consideration can be given to the Level 2 decision of changing a manager.

***Lower Costs***
The seventh reason the multi-balanced model is better is that there should be lower costs and fees. Following a consultant-centric model with multiple specialty managers, any volume pricing power is lost by dividing mandates because management fee schedules are typically on a sliding scale.

Not all costs are monetary. There are substantial administrative and time costs to having a large number of specialty managers following a consultant-centric model. Just think how much time is spent reviewing contracts, billing, paperwork, and having long meetings due to monitoring the "watch list."

The expense of an investment consultant will also be greatly reduced, if not eliminated.

***Lower Fiduciary Liability***
The eighth reason the multi-balanced model is better is that fiduciary liability to the plan sponsor should be lower. This assertion, however, may not be as clear-cut as the others and is certainly debatable. The primary reason supporting the assertion is that the plan sponsor will not be in the position of having to approve so many Level 2 decisions. Fewer decisions should equate to a lower chance of breach.

Granting discretionary authority to an investment consultant will also remove the plan sponsor from having to approve as many Level 2 decisions. But, by granting discretionary authority to multiple balanced managers instead of a single investment consultant, an argument can be made they are acting more prudently by adding Level 2 diversification. Of course, each of these managers can be a fiduciary.

An argument against the assertion is that by not having a full-time investment consultant there is one less professional (and their insurance policy) to put between the bringer of a lawsuit and the plan sponsor. Should a plan sponsor wish to have this extra cloak of protection, an investment consultant could always be hired to implement and oversee the multi-balanced model.

Ultimately, a plan sponsor can never fully insulate themselves from fiduciary liability by being surrounded by an army of professionals. The key question is finding the right processes and decision models that are most consistent with the plan's goals, risk tolerances and stewardship policies.

***Fewer Conflicts of Interest***
The ninth reason the multi-balanced model can be superior is that it removes conflicts faced by the investment consultant. One glaring example is the conflict faced by an investment consultant concerning manager under-performance. There are several strong incentives for the investment consultant to fire a poorly performing manager. First, firing will remove the troublesome eyesore of poor past performance. Second, by not firing, the investment consultant is put into the position of defending poor past performance in hopes the manager's performance will improve. If performance doesn't improve, the investment consultant risks being more responsible for further losses. Third, the investment consultant may want to justify their existence and on-going fees by performing a manager search or other value-added service.

Another conflict the investment consultant faces is increasing complexity. More managers, more asset classes, and the need to "constantly adjust to ever-changing markets" make the investment consultant a virtual necessity. Anecdotally, a few years ago, an investment consultant requested a raise from a former client of mine. When the client asked the consultant why the raise was justified, the response was that there are now many more managers to monitor. The irony was not lost on the client that it was the consultant that recommended hiring all the new investment managers in the first place!

Another conflict investment consultants face is whether or not to use index funds. I have witnessed investment consultants claim with certainty to create value using active managers. However, they did not support their claims with any quantitative evidence. After all, if they claim not to be able to successfully capture future active manager alpha, then that could call into question other aspects of their abilities such as asset allocation. So today, we find many consultants are splitting the baby by indexing "efficient" asset classes and using active management for “less efficient” and alternative asset classes (which generally cannot be indexed.) However, the studies previously cited certainly call into doubt any investment consultant’s ability to successfully hire and fire active investment managers.

Considering the last two conflicts, it is hard to imagine a consultant managing an institutional plan using just a handful of passive ETF's following a disciplined asset allocation and re-balancing strategy. After all, how much of a premium could a consultant charge for such a simple and low-cost strategy that does not require having to continually monitor active managers?

The above reasons discuss the investment process. In theory, a more efficient, faster, more diversified and low-cost investment process should be positioned to achieve better results than the traditional consultant-centric model. Let's briefly explore how a multi-balanced portfolio might actually operate.

***How Might it Work?***

In practice, a multi-balanced strategy will use several balanced managers each managing according to the exact same investment guidelines. The investment guidelines will grant broad asset allocation and manager selection discretion. Once the balanced managers are funded, the plan sponsor will essentially only have to monitor the balanced managers, re-balance, and sometimes fire and replace.

The plan sponsor may still retain an investment consultant. In fact, an investment consultant leading a portfolio of specialty managers could be one of the balanced managers. Or, a plan sponsor may have an investment consultant serve as a performance monitor or oversee the multi-balanced strategy. Or, an investment consultant may serve as a performance monitor.

Historically, this multi-balanced strategy would have used only traditional asset classes. This would have allowed liquidity and easy re-balancing. However today, “alternative” investments may have a place in a diversified portfolio, but are often illiquid. Because of the conflict balanced managers would face in funding such illiquid investments, at a presumably higher fee and locked-in for a long period, it may be prudent to add an alternatives manager and strip alternatives from the balanced managers’ allowable investments. Or, each balanced manager could fund such illiquid investments with the approval of the plan sponsor on a case-by-case basis. Of course, this is only if alternatives are first deemed to have a place in the overall asset allocation.

This essay has introduced a powerful and simple alternative to the consultant-centric model. Until now, the biggest decisions a plan sponsor had to make were which investment consultant to hire and whether to grant discretionary authority. Either way, they remain in the same consultant-centric box.

A multi-balanced investment model is an outside-the-box strategy that has many advantages such that institutional plan sponsors now have a compelling alternative to consider.