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How Conflicted Is Your Investment Consultant?

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The professional that has the greatest impact on the performance of an institutional investment plan is the investment consultant. Like all service providers, their goal is to stay hired by doing a superior job at a competitive price. But investment consultants enjoy a special position of trust and responsibility that combine to create serious and unseen problems for the plan sponsor.

The unseen problems are conflicts of interest in every aspect of the consultant's duties. Readers will learn how these conflicts routinely advantage the investment consultant with greater job security, higher fees and lower accountability.

Pension plans of all stripes are suffering with unfunded liability and a bleak outlook. There is no doubt that conflicts of interest faced by their investment consultants have contributed to this global problem. Beyond illuminating these conflicts, this essay will offer practical solutions to solve the many problems due to investment consultant conflicts of interest.

On April 8, 2016, the Department of Labor published in the *Federal Register* its final Conflict of Interest Rules. In a nutshell, it defines who is a fiduciary as it pertains to investment professionals making recommendations to retirement plans under the Employee Retirement Income Security Act (ERISA). The rules also clarify certain conditions that must be adhered to regarding fees, written contracts, as well as exemptions for certain types of communication and professionals.

With conflicts of interest being the regulatory hot topic, it makes sense to dig a little deeper. Despite new regulations, investment professionals will continue to face conflicts of interest serving their clients. In my opinion, by far the most conflicted professional will remain the investment consultant.

When discussing conflicts of interest, there is often a distinction between "hard" or "direct" conflicts and "soft" or "indirect" conflicts. Exactly where the demarcation line falls is a matter of debate. But for the sake of argument, the conflicts we will explore shall be deemed soft conflicts. Soft conflicts are difficult to discern because they are often nuanced and cannot be explicitly documented nor quantified. But do not confuse soft conflict with soft impact. These soft conflicts may not become the proverbial death of a 1,000 cuts, but plan sponsors cannot deny the detrimental impact.

For over 20 years I have considered the role of the investment consultant; their responsibilities, their decisions, their processes, and for the last seven years, measuring for plan sponsors if their consultant is actually succeeding in adding value. My work, as well as many academic studies, suggest that the value-add by investment consultants is not just questionable, but often negative. I strongly suspect conflicts of interest are at the heart of the problem.

The conflicts of interest we will explore are:

- Performance Reporting
- Complexity
- Over-Confidence
- Model Preference
- Active vs. Passive
- More Managers & Turnover
- Defendable Decisions
- Do Something!
- Total Risk

I liken this essay to an impressionist painting or mosaic. Each one of these conflicts can be greatly expanded upon with examples and anecdotes. I am sure counter-points, exceptions and different interpretations can also be raised. Therefore, I suggest that the reader step back and visualize the full mosaic and recall your own experiences working with investment consultants.

Performance Reporting

Investment consultant reports are often 100+ pages of graphs, tables, figures, values, ratios and rankings. They report on total plan performance and the performance of the underlying investment managers. By design, however, it tells you nothing about the investment consultant's ability.

There are three primary ways the investment consultant creates/destroys value: asset allocation, manager selection and rebalancing. But investment consultants *do not self-report*. If relying solely on investment consultant reports, clients have no objective data to know if their investment consultant is adding value or costing them greatly. Zero disclosure about the most important decisions is certainly not acting in the client's best interest. Let's pull back the curtain to reveal how their reports are misleading.

Asset allocation is the primary determinant of risk and return. Therefore, the client's primary responsibility should be monitoring their investment consultant's asset allocation ability. Due to *Benchmark Linking*, the practice of having the Plan Policy Index or Plan Benchmark duplicate the changing strategic asset allocation, investor clients are left in the dark. The value-add within the asset allocation function is hidden because the basis for comparison is now a mimic.

Manager selection is the next area where investment consultants do not self-report because fired managers' post-termination returns are not tracked. It is simple to show this performance by monitoring the composite data for the terminated products. By analyzing your consultant's ability to successfully fire managers, plan sponsors can save precious time, effort and turnover expense. But why should investment consultants risk exposing potentially poor firing recommendations?

Rebalancing is the last primary duty of the investment consultant. Effective rebalancing manages risk and captures incremental returns. But I have yet to see in any investment consultant report a page demonstrating their value-add from rebalancing. As of this writing, the equity markets have been volatile with several 10+% swings in the last 12 months. How many investment consultants will report to their clients *that they did not* manage risk (sell high) or capture incremental returns (buy low) through timely rebalancing? Investment consultants have an obvious conflict when it comes to reporting on their rebalancing prowess. Are they really going to say, "There were several swings over 10% in the equity markets during the last 4 quarters, but we were asleep at the wheel?"

Given the great camouflage of investment consultant reports, plan sponsors cannot truly gauge if their consultant's advice is helping or if they are being led down the path of continual poor performance.

Complexity

It used to be that tax returns were routinely completed and filed by individual tax payers. Today it is quite different with CPA's, bookkeepers and software doing much of the work at considerable expense. How do you think the accounting industry (and the bureaucrats at the IRS) would spend their lobbying dollars if a flat tax was truly on the table in Congress? Complexity translates into job security.

Jenkinson, Jones & Martinez wrote in their paper *Picking Winners? Investment Consultants' Recommendations of Fund Managers*, "Consultants face a conflict of interest, as arguably they have a vested interest in complexity. Proposing an active US equity strategy, which involves more due diligence, complexity, monitoring, switching and therefore more consultancy work, drives up consulting revenues in comparison to simple cheap solutions."

If only it was just the manager selection conflict of complex over simple. What about all the different asset classes, various strategies and styles to be researched and considered? Then, once these complex investments are owned, it necessarily requires continuous expert monitoring.

The investment consulting industry is now pushing the OCIO Model (Outside Chief Investment Officer.) One of the main selling points is that investing has become too complex as trustees are no longer capable of competently approving/denying their investment consultant's recommendations. Going from a non-discretionary consultant to an OCIO also comes with a fee increase and *lessens the work load* for the investment consultant in having to educate the plan sponsor at board and/or committee meetings.

Less work, less time educating, less travel and higher pay is great for the investment consultant because investing has become “too complex.” Who made it so complex to begin with?

Imagine an investment consultant proposing to manage a portfolio using just a few passive ETFs. But what is the fee premium for simple?

Over-Confidence

It takes plenty of education, experience and confidence to proclaim oneself an expert. The investment consulting industry is rife with advanced degrees, certifications and licenses that suggest extraordinary knowledge, skills and competence. Often these credentials are difficult to achieve and therefore a professional with one or several must certainly be better than one without, right?

In 2006, James Montier’s study titled *Behaving Badly* revealed of the 300 fund managers surveyed, 74% believed their performance to be “above average.” The other 26% claimed their performance to be “average.” The impossibility of the math speaks for itself and I believe this easily translates to the investment consultant world. After all, consultants do not report their performance, not even to their clients! So claiming to be “above average” is easy because it cannot be proven false.

It takes confidence to tell someone what to do with their money. This is especially true when acting as a fiduciary directing other fiduciaries how to invest. However, many studies conclude that institutional investors (over 90% are estimated to use investment consultants) seldom add value with their asset allocation decisions. In the Financial Analysts Journal (2009, Volume 65, Number 6) article *Absence of Value: An Analysis of Investment Allocation Decisions by Institutional Plan Sponsors*, the authors conclude “institutional investors do not appear to create value from their investment decisions.”

In the famous research paper *The Selection and Termination of Investment Managers*, the authors Goyal and Wahal conclude, “Finally, using a matched sample of firing and hiring decisions, we find that if plan sponsors had stayed with the fired investment managers, their excess returns would be larger than those actually delivered by newly hired managers.”

My firm’s work for institutional investors confirm the above studies with just one investment consultant having added value and the rest costing their clients, often great sums. Further, none of the investment consultants evaluated added value with their manager selection. Yes, let me repeat that statement- every investment consultant studied destroyed value with their hiring and firing decisions.

Despite overwhelming evidence, investment consultants persist in claiming that their “proprietary models” and “rigorous research” led by “experienced professionals” bring “superior risk-adjusted returns” to their clients. Will the investment consulting industry ever humbly admit the great difficulty in successfully allocating assets or picking managers? Perhaps “false confidence” is more accurate.

Model Preference

In the early days of institutional investing, a bank or trust company usually managed a simple fixed income portfolio. The next evolutionary step was the inclusion of domestic equities to form a single balanced manager. Soon after the investment consultant emerged and added more investments to create a core-satellite model (a balanced core with smaller asset satellites.) Today, most institutional plans invoke wide diversification by asset class managed by specialty managers with every “style box” filled; not to mention complex, illiquid and expensive alternatives.

This model often entails dozens of managers each managing a small piece of the total plan. The overall strategy, however, is still led by the lone investment consultant. Why not one of the following models?

- A single multi-asset class manager with discretions to use passive and active strategies
- A core-satellite model that has a passive core with alpha seeking satellites
- Multiple multi-asset class managers all following the same, broad investment guidelines
- Multiple OCIO's each with total discretionary authority

The answer to this last question is a strong conflict of interest to put themselves squarely at the center of the investment process with monopolistic control. False confidence and the camouflage of their performance reports make this consultant-centric model attractive. Further, they remain the sole expert with no one to counter their advice, money manager obedience due to the gate keeping function, and control over what their clients see and hear.

Unfortunately for the client, this monopolistic model is the worst of all worlds. It is inefficient due to being cumbersome, costly, disjointed, delayed and loaded with conflicts. By thinly spreading assets across many specialty managers, economies of scale are lost and fees are high. By concentrating asset allocation, manager selection, performance monitoring and rebalancing within a lone investment consultant, there is *zero diversification of thought* concerning the most impactful strategic decisions.

Is it prudent having all of your big decision eggs in the lone consultant's basket?

Active vs. Passive

Have you ever heard of the *Consultants Congress*? It is a semi-annual convention (at least in 2016) held in luxurious locations. The primary purpose of the gathering appears to be introducing active managers to investment consultants. According to their promotional material it "Features 'One-on-One' Meetings with the Consultants, an important first step in building consultant relationships. Use this time to introduce your firm. Learn about the consultants (sic) priorities in the hiring of managers."

For $2,995 you can attend the Consultants Congress to gain access, hear them speak, rub elbows at luncheons, etc. If you become a sponsor, you can even become a speaker, get "assigned seating for dinners and golf foursome choices," and "gain access to leading consulting firms often considered the gatekeepers to investors." Pay to play persists with consultants pimping themselves out!

According to their website (www.investmentmanagementinstitute.com) the first three professionals they recommend who "should attend" are:

Marketing Professionals
Sales Professionals
Client Service Executives

At their March, 2016 meeting in San Francisco, the following seminars/workshops were offered:

The New Marketing Landscape
The Elements Of A Great Marketing Organization
Marketing Strategies Which (sic) Adding Value
Getting Into Searches
Differentiating An Investment Firm In A Competitive Market
How Emerging Money Manager (sic) Can Get Into Today's Searches
Marketing Active Management Over Passive
Winning The Finals: How The Selection Process Has Changed

If you read the session descriptions, this convention is primarily about how to sell active management to consultants. For the session titled *Marketing Active Management Over Passive*, the description reads:

> For years research statistics clearly demonstrate active management outperforms index funds for long-term investors. In fact, since the 2008 recession many active managers have knocked the cover off the ball through their exceptional analytical skills, risk management and decision-making. While investors, especially public funds haves (sic) often embraced passive strategies this is hardly a smart strategy when many state funds have not kept pace with their growing liabilities. One needs to look no further than endowments and foundations to see how active management is working. Hear from these distinguished industry leaders.

This makes perfect sense as the investment consultant community cannot afford to admit, despite the overwhelming evidence, they are unable to successfully hire and fire active managers. Remember, manager monitoring is a large part of the investment consultant's duties. How much time, effort and increased fees are needed to monitor active strategies compared to passive strategies?

More Managers & Turnover

Many years ago I worked for a great money manager. They focused on balanced investing with large cap stocks, investment grade bonds and core real estate. It was plain vanilla and led by highly ethical professionals for a low fee. For over 30 years this firm delivered a simple, reliable and economical solution with excellent long-term results. The only real vulnerability of this model was having poor relative performance during bad markets. Well, that combination eventually occurred after the dot.com bubble bursting and assets began flying out the door seeking greener pastures starting in 2004.

One of my favorite clients started diversifying away from our balanced approach and began filling all the different style boxes. The number of managers skyrocketed and the client was becoming "sophisticated" and "finally with the times." After all the new managers were hired, the investment consultant requested a substantial fee increase. A trustee questioned, "Why do you deserve this big increase?" The consultant responded, "There are now so many more managers to monitor."

More managers mean more money for the investment consultant; plain and simple. Once all the active managers are on board, things then get really interesting.

Inevitably, active managers will have periods of underperformance; sometimes long and deep. Matthew Rice of DiMeo Schneider published a study that looked in the rearview mirror of *top-quartile* mutual funds ending in a 10-year period. He found that 90% had a 3-year stretch of below-median performance and over 50% had a 5-year stretch of below-median performance. Wouldn't that be great having held onto all of your active managers that delivered top-quartile performance for the last 10 years?

When faced with an under-performing manager (that was picked by the investment consultant,) what happens next? The watch list process begins with the investment consultant notifying the manager they are now "on watch." The consultant sometimes visits the manager to perform intensive due diligence. The manager often then presents directly to the client to explain their performance and plead for more time. In my studies for institutional investors, I have found that once a manager is on the watch list, it is often difficult to get off… except by being fired.

The fate of the money manager is directly affected by a glaring conflict faced by the consultant. First, the consultant hired the manager and thus it reflects poorly on the consultant. Second, if the consultant preaches patience and defends the manager, any further under-performance is placed directly at the feet of the investment consultant. There is a strong incentive to terminate the manager.

Terminating the under-performing manager has many consultant benefits. The past performance eyesore is removed from future consultant reports. The consultant does not risk owning future under-performance. The investment consultant gets to do another search and exercise their gate keeping power. Since the fired manager's future performance is not tracked, there is no risk of discovering it being a poor decision should performance rebound. Recall the Goyal & Wahal study.

How often have you heard of an investment consultant, instead of firing, recommend giving a poor performing manager more money to "buy low" in the manager's alpha cycle?

Defendable Decisions
In speaking with countless plan sponsors I have learned that there is a little voice in their heads when making any decision. That voice is asking, "Can you defend this decision in court or justify it to a government investigator?" That little voice is problematic indeed- "Your house is on the line!"

An experienced ERISA attorney once told me that if one of his clients does not approve an investment consultant's recommendation, their next vote should be to fire the investment consultant. This makes sense as it means the client no longer trusts the investment consultant. So why should an investment consultant ever propose a difficult decision that may not be approved?

"Mr. Trustee, why did you hire Manager X that delivered such terrible performance?" asked the PBGC investigator. "We did an extensive search and hired Manager X because they were top-decile over the last 5 years and expected that performance to continue." That sounds much better than "Manager X was in the 50th percentile over the last 10 years and 90th percentile over the last 3 years. We thought they were due for a big rebound in performance."

Have you ever heard of an investment consultant recommending a 90th percentile manager? How about proposing an asset allocation that *lowers expected return*? How about instead of firing a poor performing manager, actually increase their mandate? How about firing a top-performing manager? These are all examples of hard-to-defend decisions that may turn out to be the best course of action but may never be considered due to this defendable decision conflict.

An important defendable decision concerns expected mean returns for the capital markets. Correlation and variance are historical measures. But expected mean return is predictive. It is the rare investment consultant that does not use *consensus capital market assumptions*. Similar to not defending a poor performing manager, why go out on a limb and use an expected return that can be shown to be wrong? There is safety in the herd. The tragedy of using consensus capital market assumptions is that asset allocation studies devolve into simply adjusting (usually higher) the risk/return profile without unique insights or "bets" from the investment consultant. But isn't that precisely why you are paying an investment consultant?

Do Something!
In the 20th Century, the great debate in economics concerned the business cycle and the role of government. On one side, John Maynard Keynes advocated government intervention to stimulate or

contract aggregate demand to smooth the boom-bust business cycle. On the other side, Friedrich A. Hayek argued that such intervention created further distortions or mal-incentives and only made things worse. In a nutshell, the argument was to *do something* versus letting the free market work itself out.

Having worked with institutional plans over the past 24 years, I got to witness firsthand how plan sponsors and their investment consultants reacted to irrational exuberance, the dot.com bubble, Enron-Worldcom, the 2008 credit crisis, the housing crisis, the Great Recession, etc. The common theme was the belief there was something they could or must do in response to what had *already happened*. "As responsible fiduciaries, we have got to take action" was a common refrain.

Much like the general fighting the last war, investment consultants trotted out their latest solution that was simply a cure to the problem still fresh in their clients' minds. To be fair, often these solutions were requested by the client who felt compelled to ask, "Shouldn't we be doing something?" Warren Buffett famously quipped, "Never ask your barber if you need a haircut."

How comforting is "We are going to stay the course and rebalance accordingly" to a frantic client in January of 2009? In terms of marketing, Hayek would have been a lousy investment consultant. A past client of mine switched investment consultant right in the midst of the 2008/2009 crisis. The new investment consultant, similar to Keynes, claimed to be able to lower equity risk without reducing future returns. Doesn't that sound appealing when you're down 30%? So the remedy was to reduce domestic equities (when they're cheap) and get into other asset classes. Like clockwork, the domestic equity market skyrocketed and the other asset classes, both on an absolute and relative basis, fared poorly.

Investment consultants are paid to navigate the ever-changing financial markets. They are expected to earn their fees by doing something. But wheels turning does not always mean you are moving forward.

Occasionally, a plan sponsor's need to do something means some professional be fired. To give the client their pound of flesh, a consultant will often throw under the bus whichever managers happen to be under-performing. This deflection is another benefit of using active managers over indexing.

Thinking back to the various academic studies and my own work, the more changes that are made the more likely value will be destroyed. Yet, investment consultants must continue to justify their fee by routinely doing something which is often just an after-the-fact reaction and not a proactive solution.

Total Risk

The most important decision for the investment consultant is setting a client's asset allocation to achieve a desired risk/return profile. The investor client's objective, time horizon, risk tolerance, liquidity needs, tax status and cash flow all combine to define a suitable asset allocation. This should also be determined for the exclusive benefit of the client. However, it appears the self-interest of the investment consultant has infected the process and I will show you how and why.

In the wake of the credit crisis of 2008/2009, investment consultants returned from the drawing board touting "new research" that highlighted risk budgeting, all-weather portfolios, risk-parity portfolios, tail-risk management and so on. This was to reassure their clients they now have the knowledge, expertise and are ready for the next "black swan" or "six sigma event." Armed with this new knowledge, many plan sponsors drank the Kool Aid.

Fast forward to 2016 with plan sponsors reviewing their reports, comparing their returns and considering their universe rankings. They query, "Why have we done so poorly?" The consultant's answer is what I call a counter-factual argument and it goes like this. "We positioned your portfolio to reduce downside risk. Over the last 6+ years, the markets have been quite positive and you still achieved your targeted rate of return *with downside protection*. Had the markets had a significant downturn, you would have fared much better than most. The markets today are over-valued and due for a correction. When it does happen, which it will, you will recover those lost gains and more by losing less."

The investment consultant's crystal ball cannot foretell if the opportunity cost of smaller gains *will be* compensated by an even smaller loss in the next meltdown. Of course they can estimate and compare how Allocation X and Allocation Y might perform. If it turns out *after the meltdown* that the lower amount lost compensates for the opportunity cost of smaller gains, then the investment consultant will trumpet the results. But if it is not, they will remain quiet by simply announcing how much less was lost *compared to other plans*. Monopoly control of performance reporting continues to pay dividends.

By choosing an asset allocation with "downside protection," the investment consultant enjoys the cloaking protection with this counter-factual argument. Let us now imagine the opposite. If an asset allocation is too aggressive and there is a significant decline in the financial markets, the investment consultant has nowhere to hide except, "Yes, we fared worse than others during this drop. But we fared so much better the previous years and we can therefore afford to take this bigger hit today. Our strategy should be to stay the course, rebalance accordingly, and continue to look long-term."

Yes, I have heard and read these consultant explanations. Having seen both of these scenarios multiple times over different market cycles, I can say without a doubt more investment consultants were fired for being too aggressive at the wrong time than for being too conservative at the wrong time. The opportunity cost of smaller returns is unseen while large losses are easily observed with the pain felt.

Cures For Consultant Conflicts

Charles Kettering famously said, “A problem well stated is a problem half-solved.” Now that the problems with investment consultant conflicts have been well stated, let us now explore some practical cures.

First, use of passive strategies will go a long way towards eliminating the problems surrounding the hiring and firing of active managers. Fewer managers are needed. Defendable decision-making will be reduced. Manager turnover and the associated costs will be reduced. Time spent on monitoring and performing searches will be saved. Management and consultant fees will be lower.

Second, the performance reporting conflict can be eliminated by separating this duty from the investment consultant. An independent performance monitor that tracks changes in asset allocation, post-termination performance of active managers and rebalancing execution will provide the needed transparency plan sponsors desperately need. It is a good idea to ensure that this performance monitor is forever prohibited from replacing the consultant being monitored.

The total plan risk conflict can be eliminated by getting another opinion. Just like a medical diagnosis, plan sponsors should hire outside consultants to also perform asset allocation studies. In addition, I am sure investment managers would be willing to join the conversation and provide asset allocation advice at no additional cost. This needed diversification of thought will ensure that the lone incumbent consultant does not recommend a sub-optimal asset allocation that ensures job security at the expense of performance.

Fourth, the most comprehensive cure to reduce investment consultant conflicts would be to abandon the consultant-centric model in widespread use today. This monopolistic model is costly, cumbersome and conflicted. Using multiple OCIOs or multiple multi-asset class managers will diversify investment consultant risk, reduce conflicts, lower fees and save time and effort. Further, the competitive nature and objective performance comparison between these multi-asset class managers or OCIOs will cleanse most remaining conflicts and provide greater transparency.

Conclusion

Institutional investors must be vigilant concerning all aspects of their investment process. Conflicts of interest faced by their investment consultant should be at the forefront of plan sponsors’ minds as these conflicts are real and certainly impact investment performance.

When confronted by risk, the “prudent man” should seek to diversify that risk. Now that the risk of conflicts of interest are known, plan sponsors should address the status quo. Otherwise, they will continue to get status quo results that have gotten so many plans into the position they are today.