

Who “Owns” Your Institutional Investment Portfolio Returns?

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Following the three-year bear market of 2000-2002 and the crash of 2008, many sponsors of institutional investment plans were left wondering what went wrong, who is responsible for our relative performance, and how can we do better in the future? This essay shows plan sponsors where to look for answers to these important questions.

In order to be considered a prudent fiduciary, plan sponsors of institutional investment plans must faithfully perform many duties. Pertaining to investments, an extraordinary amount of time and resources are used to perform monitoring, due diligence, and research, then taking action on those findings. Often, the primary focus of these inquiries is on the various investment managers that manage small pieces of the total portfolio. While investment manager monitoring is important, the effort should actually be focused on the investment consultant or Chief Investment Officer (CIO).

When asked why he robbed banks, Willie Sutton purportedly said, “That’s where the money is.” This holds true for why the focus should be on the investment consultant or CIO, and it is especially true when managing a widely diversified, multi-manager portfolio. It is in this exact situation that the investment consultant or CIO primarily “owns” the investment process concerning duties and results.

This essay will explore where responsibility lies for an investment plan’s investment duties and results *as the number of investment managers employed increases*. It is my hypothesis that as more managers are employed, the responsibility for investment duties and results shifts away from investment managers and onto the investment consultant or CIO.

This hypothesis will be tested with regards to:

- Reporting
- Monitoring
- Total Alpha
- Asset Allocation
- Tactical Asset Allocation
- Rebalancing

Let us analyze each of these aspects to show why there is investment consultant and CIO “ownership” for these duties in a widely diversified, multi-manager investment portfolio.

Reporting

Reporting is critical for investment success. Accurate, reliable, and understandable investment reports not only provide important information, but should also help improve decisions and processes. In

recent decades, as investment plans have ballooned with an increasing number of investment managers, the importance and amount of investment reporting data has no doubt increased.

To explore the reporting function and other duties throughout this essay, let us examine the changes made by a hypothetical investment plan. It is a pension plan that is governed by ERISA and has 12 trustees representing different interests and backgrounds. Let us look at how this hypothetical investment plan evolves from a single manager to a multi-manager investment strategy and how this evolution affects total plan management and responsibilities.

Imagine this plan has one balanced manager and one investment consultant. The investment consultant's report is essentially a duplicate report or check on the balanced manager. Typically, the investment consultant report also provides some analytics and universe rankings.

Now imagine this plan sponsor awards 50% of its assets to a second balanced manager following the same investment guidelines. With two balanced managers, investment reporting is still simple. In fact, the argument can be made that it is also cheaper as you will no longer need the investment consultant report since there is now a check with the additional investment manager report. Further, it is easy to figure total performance- simply add up the returns and divide by two!

Now imagine this plan sponsor decides to change strategy. Instead of having two balanced managers, under the advice and direction of the investment consultant or CIO, the plan sponsor hires multiple specialty managers that each manages a specific asset class against a specific benchmark. These managers are not allowed to invest outside their mandate or time the market. Asset allocation and rebalancing are now handled by the investment consultant or CIO, and we will discuss that later.

In this example, let us say this plan now has 10 specialty managers across the investment spectrum. Each manager has 10% of plan assets and there is no overlap between asset classes.

This hypothetical plan sponsor meets quarterly to review performance. The plan sponsor now receives a myriad of reports. They receive one from the administrator in the form of financials, one from the auditor, one from the custodian, one from the investment consultant, and 10 from the investment managers. Obviously, there has to be a better way to filter the data in these 14 reports to make the information more useful. Fortunately, the investment consultant report summarizes the investment data, and therefore investment manager reports become redundant and are excluded from routine quarterly review. This is how the investment consultant comes to "own" the reporting function.

Monitoring

Monitoring is simply analyzing the various investment reports to learn information that may warrant action. Implied in monitoring is making changes based on new information contained in the investment consultant report. Analyzing absolute returns, relative returns, manager risk, universe rankings, portfolio risk, and asset allocation are examples. In practice, however, monitoring has come to be dominated by investment manager monitoring: how does a manager compare to their benchmark over a certain period of time and why? It is very understandable and easy to perform, which might explain why it is so prominent in monitoring.

Put another way, monitoring has become primarily about monitoring manager alpha. In our discussion, alpha is the performance difference between an active investment manager and its benchmark. If a manager beats its benchmark over a certain period, the manager is said to have "positive alpha" for that period. Conversely, being below the benchmark is called "negative alpha."

Given that the investment consultant or CIO is the de facto expert in the room and responsible for investment reporting, they naturally become the objective and professional monitor making change recommendations. Further, if they have discretionary authority, implementing changes in strategy in response to the monitoring function means that the monitoring is 100% "owned" by them. If not, then the plan sponsor certainly shares some of the burden of monitoring. But again, what the plan sponsor actually sees is controlled by the investment consultant or CIO through their reports.

Total Alpha

Simply put, in the aggregate, the plan's total alpha is the sum of the investment managers' alpha, weighted by percentage of assets. It can be read in an investment consultant report and is normally one of the first measures listed. It is the difference between total plan performance and its "policy index" or "plan benchmark." Re-balancing and cash flows can affect this difference as well.

Although, each investment manager is solely responsible for its alpha, the investment consultant *actually has the greatest potential impact on a plan's total alpha*. How can this be? The investment consultant or CIO does not pick any stocks, bonds or other investments in the managers' portfolios.

This is a new idea to explore and will require us to first talk about diversification and the alpha cycle. Specifically, we will see how active manager diversification and the alpha cycle combine to make the investment consultant more responsible for total alpha than commonly thought.

In order to explore this hypothesis of investment consultant responsibility for total plan alpha, let us first review diversification. Diversification is about eliminating unique risks. Not putting all of your eggs in one basket, having supplies spread about a convoy of ships, or having a diversified portfolio of stocks are examples of how diversification can reduce unique risks.

Since our general topic is investing, let us examine diversifying a stock portfolio. Imagine you have a portfolio that consists of just one stock. The return and risk of the portfolio is the same as the single stock. Adding additional stocks to the portfolio that do not have the same correlation lowers the standard deviation (risk) of the total portfolio. Additional stocks reduce the unique (unsystematic) risk of any individual stock in the portfolio until the risk approaches the systematic risk of the market.

Similar to stock portfolio diversification, each additional active manager will reduce the plan's standard deviation of alpha. Just as different stocks perform differently, so too do investment managers. Each additional manager lowers the plan's total alpha risk until it approaches the "market risk" for alpha.

Table 1 lists the alpha for the 10 active investment managers (A – J) over a 10-year period for our hypothetical plan. Each manager has 10% of the assets at the start of each year. The returns are

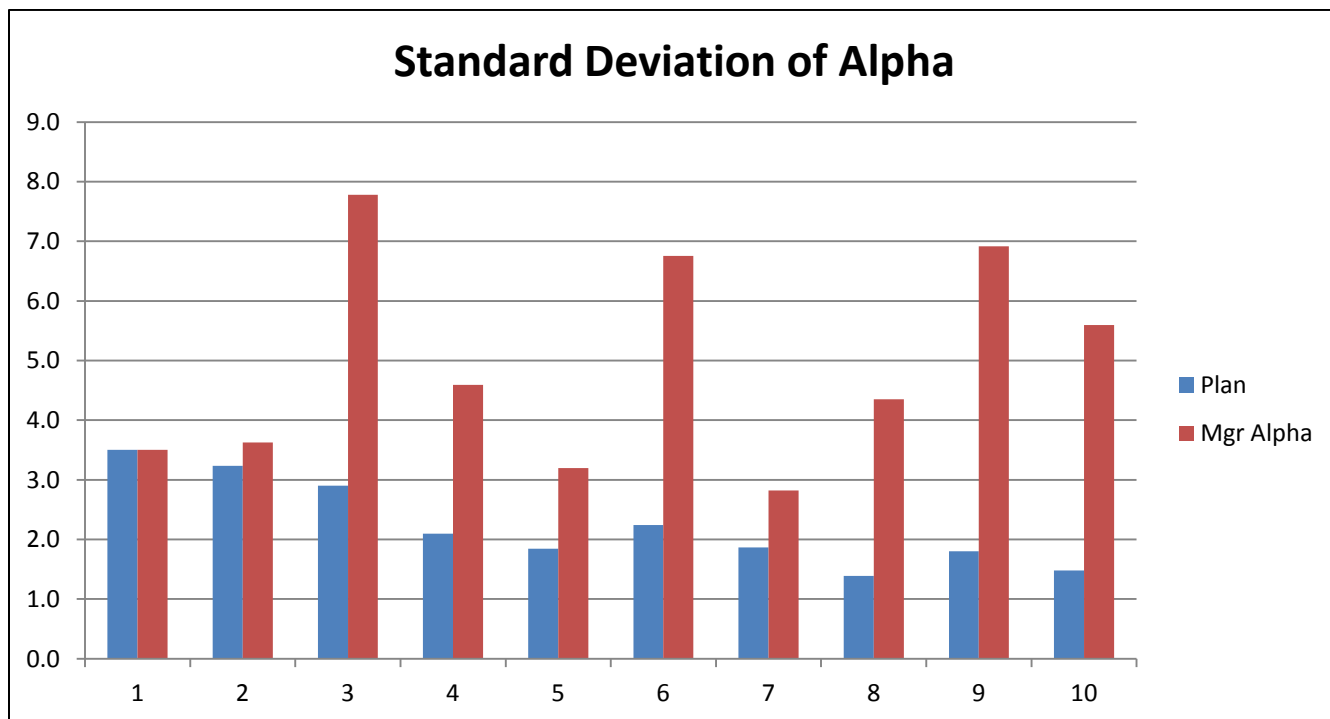
completely independent from each other. Notice that the total portfolio's standard deviation of alpha of 1.56 is lower than any one of the managers. That's diversification!

Table 1

Year / Mgr	A	B	C	D	E	F	G	H	I	J	Plan
1	4.0	4.0	2.0	2.0	-2.0	-5.0	0.0	4.0	-6.0	2.0	0.50
2	2.0	3.0	-7.0	1.0	-1.0	-3.0	1.0	3.0	-8.0	4.0	-0.50
3	4.0	3.0	-9.0	-6.0	-1.0	-8.0	3.0	-5.0	-5.0	6.0	-1.80
4	5.0	0.0	14.0	-3.0	4.0	8.0	-2.0	-8.0	12.0	8.0	3.80
5	-3.0	-2.0	12.0	-5.0	6.0	6.0	-4.0	0.0	8.0	-8.0	1.00
6	-5.0	-8.0	0.0	7.0	-3.0	5.0	4.0	2.0	7.0	-6.0	0.30
7	1.0	2.0	-2.0	4.0	-2.0	12.0	2.0	-5.0	4.0	-4.0	1.20
8	2.0	-1.0	-8.0	2.0	4.0	4.0	3.0	-2.0	0.0	-2.0	0.20
9	-3.0	-3.0	2.0	-6.0	3.0	-6.0	-3.0	4.0	-3.0	4.0	-1.10
<u>10</u>	<u>-2.0</u>	<u>-2.0</u>	<u>1.0</u>	<u>-4.0</u>	<u>-1.0</u>	<u>-2.0</u>	<u>-2.0</u>	<u>3.0</u>	<u>-5.0</u>	<u>6.0</u>	<u>-0.80</u>
Avg Alpha	0.5	-0.4	0.5	-0.8	0.7	1.1	0.2	-0.4	0.4	1.0	0.28
Std Dev	3.5	3.6	7.8	4.6	3.2	6.8	2.8	4.4	6.9	5.6	1.56

Figure 1 uses the data in Table 1 to show how adding Manager B, then Manager C, and so on with an equal weighting, reduces the standard deviation of alpha for the total portfolio.

Figure 1



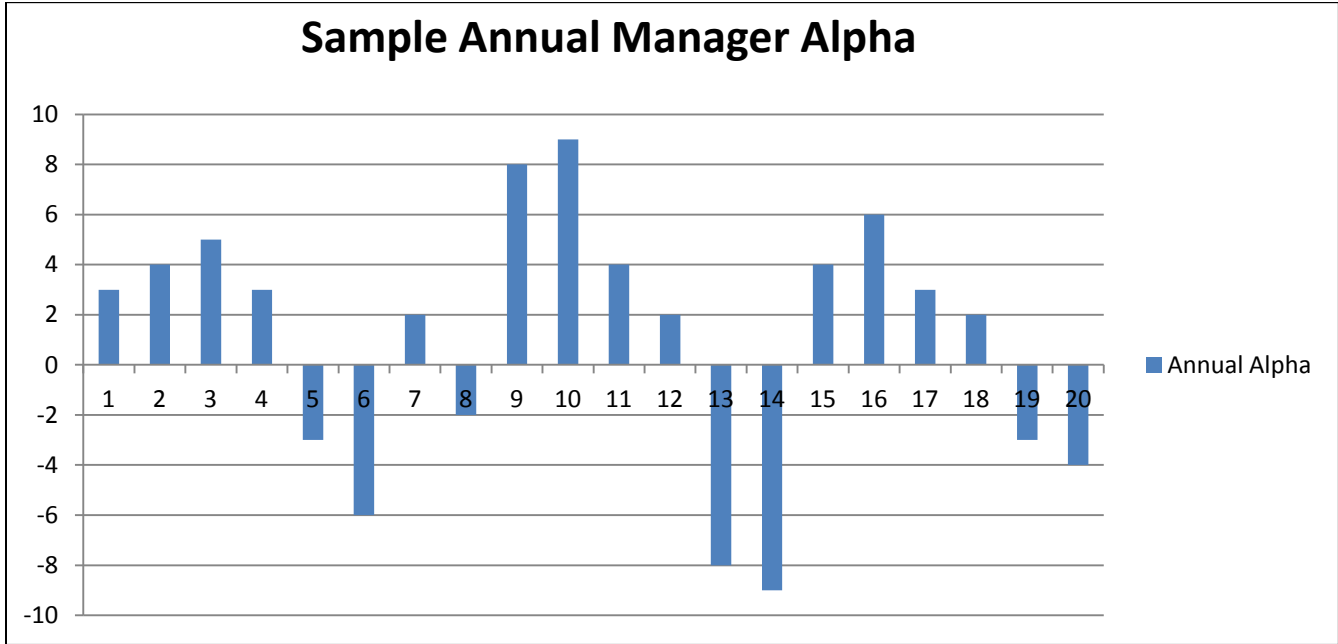
Similarly, as the standard deviation of alpha is reduced to that of the active manager market, so does the long-term expected total alpha. Exactly what that number is cannot be known. Many studies suggest that after fees, trading costs, and human error, active management, on the whole, performs worse than the indexes over time. Assuming that all financial assets, or at least a sufficiently large portion, are professionally managed, active managers essentially become the market. If a portfolio has practically minimized its active manager risk, then it should also expect market-like alpha over the long-term, gross of fees.

Notwithstanding the above regarding long-term market for manager alpha, for purposes of this discussion, let us assume that the active managers for our hypothetical plan have produced positive alpha. Notice in Table 1 that the simple average alpha over 10 years is 28 basis points, or 0.28%.

Both the concept of a sufficiently large sample of active managers producing market-like returns, and the positive alpha for our hypothetical portfolio share a common assumption. That assumption is *the active managers are held for the long-term*. However, given how active manager returns behave, rarely is there lifetime tenure for managing assets. Often managers are hired and fired for a variety of reasons before they ever achieve a “long-term” track record with a plan sponsor.

Figure 2 below is the theoretical alpha cycle for an active manager that has achieved 100 basis points of alpha on an average annual basis over a 20 year period. Over the course of those 20 years, there are periods of positive alpha, followed by periods of negative alpha. Sometimes the periods can be long and/or deep. In this case, there are several periods where the 5-year average is below its benchmark.

Figure 2



Although managers may produce alpha in the long-term, as noted above, actually capturing that alpha can sometimes prove difficult for the plan sponsor. How, when and why a plan sponsor, following the advice of the investment consultant or CIO, terminates an investment manager and hires a replacement can have a huge impact on the overall alpha of an investment plan.

Looking again at Table 1, imagine the investment consultant recommends and the plan sponsor fires three of the investment managers after a period of under-performance and replaces them with new managers. Table 2 shows the managers that were fired, indicated by the red numbers. The blue numbers show the subsequent performance of the replacement managers.

Table 2

Year / Mgr	A	B	C	D	E	F	G	H	I	J	Plan
1	4.0	4.0	2.0	2.0	-2.0	-5.0	0.0	4.0	-6.0	2.0	0.50
2	2.0	3.0	-7.0	1.0	-1.0	-3.0	1.0	3.0	-8.0	4.0	-0.50
3	4.0	3.0	-9.0	-6.0	-1.0	-8.0	3.0	-5.0	-5.0	6.0	-1.80
4	5.0	0.0	14.0	-3.0	4.0	4.0	-2.0	-8.0	12.0	8.0	3.40
5	-3.0	-2.0	12.0	-5.0	6.0	7.0	-4.0	0.0	8.0	-8.0	1.10
6	-5.0	-8.0	0.0	7.0	-3.0	0.0	4.0	2.0	7.0	-6.0	-0.20
7	1.0	2.0	-2.0	4.0	-2.0	-2.0	2.0	-5.0	4.0	-4.0	-0.20
8	2.0	-1.0	-8.0	2.0	4.0	-4.0	3.0	-2.0	0.0	-2.0	-0.60
9	-3.0	-3.0	2.0	-6.0	3.0	-6.0	-3.0	2.0	-3.0	0.0	-1.70
10	-2.0	-2.0	1.0	-4.0	-1.0	2.0	-2.0	1.0	-5.0	-2.0	-1.40
Avg Alpha	0.5	-0.4	0.5	-0.8	0.7	-1.5	0.2	-0.8	0.4	-0.2	-0.14
Std Dev	3.5	3.6	7.8	4.6	3.2	4.7	2.8	4.0	6.9	5.2	1.55

Given just these three investment manager changes, the total alpha of the plan goes from +28 basis points per year to -14 basis points. This is entirely due to the manager changes made based on the recommendations of the investment consultant. The investment consultant’s alpha for the three changes was -42 basis points per year over the 10-year period. That is 150% of the portfolio-level decisions of all of the investment managers combined!

The numbers are illustrative of the immense potential impact of the hiring and firing decisions following the advice of an investment consultant or CIO. This is certainly true for investment plans that are widely diversified among many active managers than for plans that use a few balanced managers or seldom make such changes.

Of course, investment consultants or CIO’s can make manager selection decisions that increase alpha. However, many studies concerning the hiring and firing decisions by institutional plans suggest that such changes tend to reduce portfolio returns. But that is a topic for another time. The point here is that the investment consultant can have a greater impact on total plan alpha than the investment managers and therefore has the greatest potential to “own” the plan’s total alpha- certainly more so than any individual investment manager in a widely diversified investment plan.

Asset Allocation, Tactical Asset Allocation, Rebalancing

Asset allocation, tactical asset allocation, and re-balancing are all aspects that shift from investment manager(s) to the investment consultant or CIO as the number of managers increases. Although these aspects are paramount for investment success, we do not have to get too complicated to explain why the investment consultant or CIO “owns” these responsibilities for multi-manager investment plans.

Going back to the example of a single balanced manager, the investment manager simply manages according to the investment guidelines. Often in these situations the mandate is broad which gives discretion to the balanced manager. Other than determining the original asset allocation ranges within the mandate, 100% of the asset allocation rests with the single balanced manager. Should the plan then award 50% of the assets to a second balanced manager following the same mandate, each would have 50% of the asset allocation responsibility.

However, when an investment plan becomes widely diversified among specialty managers, 100% of the asset allocation duty shifts to the investment consultant or CIO. The only way it could not be 100% is if those investment managers were empowered to move money between managers (re-balance), alter the long-term strategic asset allocation, engage in market timing, or make tactical asset allocation moves outside their mandates. Unless those specialty managers are empowered to do so and actually do it, the investment consultant or CIO “owns” these three duties by setting the strategic asset allocation, making tactical asset allocation decisions, and determining when to rebalance the portfolio.

Conclusion

To summarize, regardless of the investment strategy, institutional plan sponsors have a duty to question and monitor their investment professionals, their investment process and their investment results. This can often be a daunting, time consuming and never ending process.

If the plan sponsor has chosen to follow a widely diversified, multi-manager strategy, paradoxically, despite the large number of investment managers, the investment consultant or CIO should be the primary focus of inquiry as they definitely own the investment duties and results.