Managing Successfully within the Institutional Troika

Harry S. Marmer, CFA
Senior Vice President, Institutional Investment Services
Franklin Templeton Investments
Toronto

Each player involved in the institutional troika—the institutional investor, consultant, and money manager—has an important role to play in facilitating the successful operation of the institutional investment management system. These players have a unique but complementary role in managing this system, which revolves around leading-edge advice, successful implementation, and analysis of valuable information. These three activities represent the three key building blocks of effective institutional investment management. To quantify the success of the system, investors should set success hurdles and assess how well the system is operating relative to these hurdles.

The key players in the institutional investment management industry are institutional investors, consultants, and money managers. These three players form the troika of the institutional investment management system and must work together to create an investment system that will achieve the objectives and goals of the investor. Each of the players in the troika contributes to at least one of the three building blocks for successfully managing institutional assets: (1) leading-edge advice; (2) successful implementation; and (3) valuable information gleaned from monitoring the entire investment decision-making process. The evolving relationships within the troika are creating a new playing field, which appears to be working well. My presentation will describe the current challenges facing the players in the troika and how they have responded. I will also discuss how institutional investors can integrate each of the player’s roles in the return and risk management process.

Leading-Edge Advice
Traditionally, consulting services provided to institutional investors have included giving guidance on governance structure, performing asset/liability modeling and analysis, setting investment beliefs, developing investment goals and policies, searching for and selecting managers, and monitoring how well the institutional system is operating relative to the stated goals and objectives of the institutional investor.

Challenges. Recently, the traditional consulting paradigm has been challenged by a number of factors, one of which is professional turnover. The consultant industry has been a “breeding ground” for providing money managers with experienced investment professionals, thus depleting the talent in the consultant pool. The proliferation of databases and software is another complicating factor. A decade ago, an institutional investor wanting to carry out a manager search would have hired a consultant and paid $15,000 to $20,000 for the consultant’s manager search advice and report. Today, investment manager databases are available for purchase providing both the quantitative and qualitative information that in the past could have been obtained only from a consultant. In addition, software for sophisticated asset mix and style analysis is readily available for investors to purchase. The commoditization of some of the basic consulting services has been a major business challenge for the consulting industry.

Nontraditional sources of competition have also arisen. Brokerage firms now provide consulting services for “free,” as long as the manager who is hired by the investor considers trading with the broker. This is an extremely challenging business model because a traditional fee-charging consultant now has to compete with a firm willing to provide services with no direct costs. In addition, small consulting firms offer many of the same services as large firms, often at a much lower price.
Money managers have been another source of competition to consultants by providing what Bruce Clarke describes as “noninvestment alpha.”

Clients are looking for more than just alpha from their investment firms. Managers are increasingly being asked to help develop policies and to provide advice on asset mix, investment strategies, and style analysis, not to mention ongoing research that would benefit the fund. These services used to be primarily the domain of consultants.

Another challenge for consultants has been the growth of defined-contribution (DC) plans. Traditional consulting services, such as asset/liability analysis, are not required for DC plans, and manager monitoring is often left in the hands of the individual investor. With defined-benefit plans, a consultant can at least be used to establish parameters for managing the funds; with DC plans, the employees decide on their own how they want to manage their money.

Responses. The consulting industry has responded quite effectively and in a variety of ways to meet these competitive challenges. The most conspicuous reaction has been consolidation. In Canada, a great deal of consolidation has already occurred, and in the United States, although the market is still somewhat fractured, more consolidation is expected. Some firms have changed their business models—and the consultant paradigm—by entering the manager-of-managers, or fund-of-funds, business. Other firms have chosen to sell their consulting businesses, and some have opted to do nothing; these firms believe they have a successful program and do not believe they need to change the way they operate.

Leveraging Consultants’ Value. Clients have several areas in which they can further leverage the value provided by the consultant. In the early 1990s, risk was defined as the standard deviation of returns, but today, risk is defined from a total fund perspective (i.e., linking the assets and liabilities from a total balance sheet viewpoint). Consultants can add significant value by “personalizing” the risk faced by plan sponsors and helping them define risk that is specific to their fund’s circumstances and needs. For example, for a publicly listed company, volatility of EPS may be the most significant concern; more specifically, the concern may be how much of an EPS “hit” it can sustain in undertaking a particular asset mix. For a subsidiary or privately held company, the focus may be on cash flow or contributions to the plan. And for a fund suffering from financial weakness, the greatest concern could revolve around its solvency ratios and its ability to meet regulatory requirements.

Successful Implementation

Once the institutional investor has designed the investment policies and goals statement, the next step is to successfully implement it through the hiring of money managers. Successful implementation for an active manager involves producing unique information and applying it in an efficient and effective manner to maximize expected returns adjusted for risk.

Challenges. The job of an active investment manager is twofold: to produce alpha, which also entails managing risk, and to keep clients happy (i.e., provide client service excellence). The underlying premise of active management is that a manager’s unique insights can be consistently applied to beat the market. These unique insights—or intellectual capital (both hard and soft)—and the number of times that these insights can be applied (i.e., the number of bets a manager takes) determine a manager’s alpha-generating capability and associated risks. In other words, active managers’ quest for superior risk-adjusted alpha requires them to produce and apply their intellectual capital as frequently as possible.

Responses. To meet these challenges, money managers have acquired intellectual capital through mergers and acquisitions. For example, an investment firm with a large-cap value process can acquire a mid- or small-cap value shop to diversify intellectual

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1See Bruce Clarke’s presentation in this proceedings.
capital, broaden the opportunity set, and increase the number of bets the manager can take. The development of the third-generation firm, which Christopher Acito discusses, stems partly from the need for more intellectual capital.\(^2\) A multispecialist shop can provide more investment solutions for clients than one that specializes in a single investment strategy.

One of the benefits for investment managers who strive to do more for their clients is that they should be subject to less price pressure. As large firms grow, talented entrepreneurial managers will leave to start their own businesses, which will lead to more boutique firms. The barbelling of the industry will continue as mega firms that try to do everything for all clients compete with the small niche boutiques; some will succeed, others will not. This evolution of the industry is best represented by Schumpeter’s concept of “creative destruction.”\(^3\)

Investment managers today use quantitative tools to assess and/or manage their portfolio bets. From a client perspective, managers should be able to clearly articulate their expected alpha and risk target relative to the benchmark. Benchmarks are the only way for investors to assess how well a manager is implementing their investment philosophy and process. Clients can then evaluate a manager in terms of expected risk level versus actual experience to determine whether the manager is successfully implementing their investment policy and if their investment policy is being followed. For managers, these targets can act as quarterly quality “control” targets and can serve as indicators of structural market shifts.

Finally, trading skill has a major role to play in preserving alpha. Trading skill is typically measured by trading costs, and typically, trading cost assessments focus on commissions, but commissions are merely the tip of the iceberg. Trading costs also include opportunity costs and the costs associated with market impact and delay. Commissions are the least costly component at roughly 6 cents a share, compared with the cost of market impact, 9 cents; opportunity, 12 cents; and delay, 24 cents.\(^4\) AIMR has recently raised the bar in this area with the publication of the AIMR Trade Management Guidelines.\(^5\)

Given the heightened knowledge and awareness of total trading costs, managers will need to understand these costs and reduce them wherever possible. The importance of an efficient and effective trading desk will only increase in the future.

**Leveraging Managers’ Value.** Despite the continued pressure on managers to produce superior risk-adjusted alpha, several areas exist in which clients can leverage more from their managers. This leverage revolves around providing “investment counseling,” a term coined by Charles Ellis.\(^6\) In the 1960s, investment management had an advisory component. For example, a trust company would help design the investment policy statement and objectives and then implement them in a balanced framework.

Today, the emphasis is on specialist investment manufacturing and alpha. As mentioned earlier, recognition of the importance of noninvestment alpha is rising, especially as institutional investors consolidate managers. Institutional investors will again be turning to their managers for broad policy advice and guidance and more. The most sophisticated funds have gone further by “partnering” with their managers and sharing intellectual capital. This broadening of services encompasses a wide array of activities, ranging from the simple calculation of performance attribution to obtaining industry or economic insights from the manager’s analysts.

As the willingness to share intellectual capital increases, sponsors will consolidate manager relationships to produce the best combination of alpha and noninvestment alpha. The days of having 100-plus specialist managers are over.

Mega-management firms are following a clearly defined path in their ability to provide more investment solutions and counseling. Boutique firms with their defined specialty are following a clearly defined path as well. Midsize investment firms, however, continue to be seriously challenged because they lack the scale, positioning, and branding opportunities necessary to meet the needs of the institutional investor of tomorrow. It will be interesting to see how the market takes them.

**Valuable Information**

The third player in the troika is the institutional investor, who needs valuable information to determine how well the institutional investment system is working. The consultant’s leading-edge advice is used to set investment policies and guidelines. Successful implementation of those policies and guidelines

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\(^2\)See Christopher Acito’s presentation in these proceedings.

\(^3\)Joseph Schumpeter, *Capitalism, Socialism and Democracy* (New York: Harper & Row, 1942). Joseph Schumpeter coined the term “creative destruction” to denote a process of industrial mutation that revolutionizes the economic structure from within, incessantly destroying the old one and creating a new one.


entails selecting and monitoring the money managers who then must implement these policies and guidelines. At this point, the institutional investor has the responsibility of determining how well the system is working. Both qualitative and quantitative analysis, as well as ongoing capital market and manager research, are required for this building block to be used effectively and to determine how successfully the investment process has been implemented.

**Qualitative and Quantitative Information.**

After working for two consulting firms and having had the opportunity to engage consultants from around the world, it is fair to conclude that there is a general consensus (sometimes referred to as the four P’s) on how best to evaluate managers: people and organizational strength, philosophy and process, portfolio analysis and assessment, and performance and risk evaluation. The first two elements are qualitative, or fundamental, and the latter two are quantitative.

A quantitative assessment of a portfolio helps pinpoint the characteristics that confirm the implementation of the manager’s investment philosophy and process. For example, in assessing a value manager, the following factors might best represent the manager’s approach: price-to-earnings ratio (P/E), price-to-cash flow ratio (P/CF), and dividend yield. For example, a global manager should have a lower P/E and P/CF and a higher dividend yield than the MSCI World Index—all of which would support the manager’s stated investment philosophy. For a “quick and dirty” look at the manager’s style, a return-pattern analysis could also be applied. Despite the issues associated with this type of analysis, it is a fast and efficient means to quickly determine if the manager’s exhibited style clearly confirms expectations or if more analysis is needed.7

As discussed earlier, with the increasing availability of powerful software and broad databases, the quantitative assessment of managers is rapidly becoming commoditized. Expect institutional investors to be having lunch at their managers’ offices more frequently and asking tougher questions, trying to detect any “organizational uncertainty.” Please note the use of the word “uncertainty,” not “risk.” Unlike risk, uncertainty cannot be quantified. Assessing organizational uncertainty is a “touchy feely” exercise that focuses on how well the firm’s investment philosophy and process have been institutionalized and what organizational issues appear to be outstanding. The following is a set of qualitative features to consider in assessing organizational uncertainty:

- leadership strength and experience,
- suitability of compensation program,
- capability of attracting intellectual capital,
- innovativeness and adaptability,
- continuity of professionals,
- succession program,
- integrity and objectivity,
- team versus star approach,
- intangibles, such as character, attitude, and desire to excel,
- strategic direction of the company,
- strengths and weaknesses of the organizational structure, and
- capability of delivering client service excellence.

These factors are important because the underlying premise in hiring managers who have produced alpha is that they will be able to repeat their outperformance in the future.

**Ongoing Capital Market and Management Research.**

Ongoing capital market and manager research is another valuable information source. An example of recent research is shown in Figure 1, which depicts the distribution of the correlations of excess returns for Canadian equity managers for the five years ending 31 December 2001. The outcome is encouraging for Canadian investors in that nearly 55 percent of the managers in the study have a correlation of 0.5 or less. A significant amount of opportunity exists to combine managers so as to reduce risk without a corresponding reduction in return; thus, ongoing research can contribute valuable information—in this case, opportunities to combine different investment philosophies to manage risk so as to improve the management of the troika for the betterment of the whole.

**Leveraging Institutional Investors’ Value.**

The market offers two free lunches that every institutional investor should consider, namely, asset class and investment style diversification (as discussed earlier), which, in turn, can reduce the overall risk of a portfolio and asset class, respectively, without a commensurate loss of return. Both quantitative and qualitative information can improve the “signal-to-noise ratio” and create higher-quality information flow and accountability. In summary, top plan sponsors in the industry will continue to be models of success in this regard, such as the Ontario Teachers’
Pension Plan (OTPP) and the California Public Employees’ Retirement System (CalPERS).8

**Integrating the Return and Risk Management Process**

Assessing institutional investment success is a holistic process that considers expected returns, risks, and costs. Quantifying success begins with setting active investment success hurdles (assuming the active management of funds). An active investment success hurdle is the normal, or expected, value added for an asset class adjusted for risk, net of fees. The definition of normal will vary, of course, but an acknowledged belief system or view of the world can help determine an investor’s general expectations of success.

To help define expected valued-added targets, historical experience is usually the starting point. In any analysis that relies on past data, however, danger lurks. Five qualifiers must be acknowledged when evaluating historical data: survivorship bias, data mining and lack of independence (because of overlapping data), time-varying returns and risk, before-fee analysis, and sample-size limitations. The challenge presented by sample-size limitations was best summarized by Nobel laureate Paul Samuelson when he said, “We only have one history of capitalism.”9 Looking at history can be fatal in building expectations for the future, but doing so is nevertheless a necessary step in attempting to derive a reasonable basis for future success hurdles.

The panels in Figure 2 show quarterly (beginning in the first quarter of 1991 and ending with the first quarter of 2002) rolling five-year value-added results before fees for four equity asset classes: U.S., Canadian, International, and Global. (See Table 1 for additional data.) I define investment management success as being in the top third of each of the distributions.

Using these value-added distributions, an investor can derive expected value-added success hurdles and risk levels before fees for active investment management, as shown in Table 2. My assumptions in deriving these hurdles are as follows. In equilibrium, a long-term normal, or expected, alpha exists that is consistent with the level of residual risk the market is willing to reward. And, on average, active management is a zero-sum game. The information ratio, or the ratio of excess return to risk, is the summary indicator of skill.

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8The 2002 Annual Report for the Ontario Teachers’ Pension Plan is an excellent example of OTPP being a role model for the industry. This report can be accessed at www.otpp.com/web/website.nsf/web/2002AnnualReport.

9For more on these issues, see the introduction to Harry S. Marmer, Perspectives on Institutional Investment Management (Toronto, Ontario: Rogers Publishing, 2002).
Table 3 shows the real-time value-added results from external active equity management in the U.S. plan sponsor market. Performance results are highly dependent on how well active management has performed, as depicted in Table 4. Based on these yearly data, the simple average value added, net of management fees, is 40 bps, which is a nontrivial amount in a trillion-dollar system. Institutional investors,
Managing Today’s Investment Firm

Money managers, and consultants seem to be doing a good job based on this data, but if the data for 1991 and 2001 are deleted, the average net value added becomes negative, substantiating the saying that “statistics do not lie, but know your statistician.” In other words, sustainable periods of time can occur when the institutional investment system does not seem to be achieving success.

Conclusion

The institutional investment management system—as driven by the interrelationships of institutional investors, money managers, and consultants—will continue to evolve to meet the challenges presented by a dynamic evolving industry. The quest to raise the bar of success for each player in the troika is quite real. Success can be elusive at times, but having an investment belief system and plan, successfully implementing them, and using valuable information to assess the system is a clear strategy for success.

Table 3. Value Added from External Active Equity for the U.S. Plan Sponsor Universe, 1991–2001

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of Sponsors</th>
<th>Gross Value Added</th>
<th>Management Fees</th>
<th>Net Value Added</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>54</td>
<td>2.1%</td>
<td>46 bps</td>
<td>1.6%</td>
</tr>
<tr>
<td>1992</td>
<td>76</td>
<td>1.1</td>
<td>46</td>
<td>0.7</td>
</tr>
<tr>
<td>1993</td>
<td>120</td>
<td>2.6</td>
<td>46</td>
<td>2.2</td>
</tr>
<tr>
<td>1994</td>
<td>155</td>
<td>–0.5</td>
<td>49</td>
<td>–1.0</td>
</tr>
<tr>
<td>1995</td>
<td>192</td>
<td>–1.0</td>
<td>43</td>
<td>–1.5</td>
</tr>
<tr>
<td>1996</td>
<td>185</td>
<td>1.2</td>
<td>40</td>
<td>0.8</td>
</tr>
<tr>
<td>1997</td>
<td>167</td>
<td>0.0</td>
<td>37</td>
<td>–0.4</td>
</tr>
<tr>
<td>1998</td>
<td>172</td>
<td>–1.7</td>
<td>35</td>
<td>–2.0</td>
</tr>
<tr>
<td>1999</td>
<td>177</td>
<td>1.1</td>
<td>35</td>
<td>0.8</td>
</tr>
<tr>
<td>2000</td>
<td>161</td>
<td>2.7</td>
<td>35</td>
<td>2.4</td>
</tr>
<tr>
<td>2001</td>
<td>169</td>
<td>1.0</td>
<td>37</td>
<td>0.6</td>
</tr>
<tr>
<td>Simple average</td>
<td>—</td>
<td>0.8</td>
<td>41</td>
<td>0.4</td>
</tr>
</tbody>
</table>

Source: Based on data from Cost Effectiveness Measurement, Inc.

Table 4. Active Management Success in the United States

<table>
<thead>
<tr>
<th>Year</th>
<th>U.S. Equity Managers Beating Russell 1000</th>
<th>Average Excess Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>38%</td>
<td>–187 bps</td>
</tr>
<tr>
<td>1992</td>
<td>50</td>
<td>–32</td>
</tr>
<tr>
<td>1993</td>
<td>50</td>
<td>80</td>
</tr>
<tr>
<td>1994</td>
<td>37</td>
<td>–66</td>
</tr>
<tr>
<td>1995</td>
<td>16</td>
<td>–492</td>
</tr>
<tr>
<td>1996</td>
<td>40</td>
<td>–129</td>
</tr>
<tr>
<td>1997</td>
<td>27</td>
<td>–424</td>
</tr>
<tr>
<td>1998</td>
<td>20</td>
<td>–784</td>
</tr>
<tr>
<td>1999</td>
<td>43</td>
<td>–261</td>
</tr>
<tr>
<td>2000</td>
<td>64</td>
<td>572</td>
</tr>
<tr>
<td>2001</td>
<td>62</td>
<td>263</td>
</tr>
</tbody>
</table>

Source: Based on data from Mercer Investment Consulting.
Question and Answer Session

Harry S. Marmer, CFA

Question: Some consultants have become managers of managers and others are working for plan sponsors while collecting fees from managers. For example, in Japan, you can pay a consultant to introduce you to clients. Are you worried about the conflicts of interest that appear to be multiplying within the industry?

Marmer: Absolutely, I worry about the integrity of the industry, especially given all of the recent headlines about corporate scandals. But every industry has to deal with conflicts of interest. A consultant who is a manager of managers has conflicts of interest only if these conflicts are not declared up front.

Similarly, consultants who conduct manager searches and accept compensation from managers to be included in such search activities have to declare this fact to clients. Without a doubt, conflicts of interest have to be disclosed; AIMR’s Code of Ethics and Standards of Practice is explicit on this issue.1

Question: Why are midsize firms in trouble?

Marmer: From the Canadian perspective, the typical midsize firm had a growth spurt and enjoyed a period of success but is now directionless and struggling. Part of the problem is that midsize firms tend to be tightly controlled partnerships and thus have trouble attracting new talent, or new intellectual capital, into the business to drive alpha and become more innovative. In fact, many midsize firms have stagnated because they are not clear about their alpha capabilities. They have had median results at best because they have gravitated toward strategies to protect their assets.

Question: Should a firm with a high-net-worth client base try to move into the institutional and retail businesses?

Marmer: That is a tough strategic question. The answer depends on the mission of the firm, but my knee-jerk reaction is to say no. If a firm has been successful at private wealth management, why should it bother with building a strategy to attract and service institutional clients? If it has the right infrastructure, product line, and service, why cloud the vision by entering a completely different business?

Question: At a firm such as Franklin Templeton Investments, which has retail and institutional businesses, do the portfolio managers run money for both retail and institutional products or are they separated?

Marmer: Our institutional and retail products are run by the same managers so that all customers benefit from the same investment process and philosophy. An argument can be made for separation of the two, and to some degree we do that, with one chief investment officer for institutional and one for retail. It has been suggested that the retail market needs a completely separate manufacturing process, but average retail investors would argue that they should have the same research applied to their portfolios that is applied to those of institutional investors! One of the toughest challenges is keeping the portfolio managers back at the shop. We hire “investment specialists” who understand the investment process to interface with our clients so that the portfolio managers can stay at the shop at least 75 percent of the time.

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1AIMR’s Code of Ethics and Standards of Practice can be accessed at www.aimr.org/pdf/standards/english_code.pdf.