



**“Eeny, Meeny, Miney, Mo?”
How to choose an Investment Manager**

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As a pension scheme trustee there are a number of questions you need to ask yourself. Who is minding your money? Why did you choose them? Are they doing a good job? Managing the assets of a pension scheme is just as important as managing the liabilities and it is the responsibility of the trustees of the scheme to ensure that the assets are managed in a responsible and appropriate manner.

Pension scheme trustees are concerned with controlling risk. But how is risk defined? Firstly, there is the risk that the assets of the scheme will be insufficient to meet its liabilities. Secondly, there is the possibility that the cost of maintaining the pension scheme will become too great and the sponsoring employer might decide to close the scheme (in the case of a defined benefit scheme), or that the benefits payable on retirement might be inadequate (in the case of a defined contribution scheme).

The trustees need to follow an investment strategy that seeks to maximize the returns achieved on the scheme’s assets while having regard to the fundamental need to meet the scheme’s liabilities as they arise. This requires a two-fold approach. Firstly, the trustees need to decide what asset classes the scheme should be invested in, having regard to the nature of the liabilities. Secondly, they need to appoint a professional investment manager to optimize the returns earned within these asset classes. This article focuses on the second aspect, and considers the question: *“What should trustees look for in an investment manager?”*

Investment Mandate

Before considering which investment manager to appoint, the trustees need to determine the scheme’s mandate. This will depend on a number of factors: the size of the fund, the funding position, the liability profile, the ability/willingness of the sponsoring employer to make good any shortfalls that arise. For defined benefit schemes, objectives for the overall fund should be expressed in terms which relate to the fund’s liabilities, rather than to performance relative to other pension funds or a market index. On the other hand, the trustees of a defined contribution scheme may be concerned with ensuring their fund does not underperform the peer group.

Types of Manager

Once the mandate has been determined, the trustees need to consider the different approaches to investment management. These can be broken into three broad categories: Passive, Active and Specialist. Passive managers invest the assets of the scheme in line with various market indices, with the aim of reproducing the index return. Passive managers should be considered where the trustees believe that no individual active



manager can consistently outperform the market, and that long-term returns therefore trend towards the index anyway.

Active managers do not invest in line with the index. They analyse the universe of available stocks and select those stocks that they believe will outperform the market as a whole, with the aim of producing a return somewhat ahead of the index return. Active managers would often be appointed to manage the full range of asset classes, and be given some discretion over the allocation of funds between these asset classes in an attempt to further enhance returns.

Specialist managers are really a subset of active managers. As the name suggests, they tend to focus on a narrower range of asset classes, and will often be appointed to manage just one or two portfolios rather than the entire fund. In addition, as they aim to produce returns that are significantly higher than the index, the portfolios of specialist managers will tend to hold considerably fewer stocks than those of active managers.

Choosing the right manager

If the decision has been made to appoint a passive manager, the selection process becomes very straightforward. You focus primarily on client servicing and fees as well as their record on index-tracking error. When selecting an active manager, other factors need to be considered including performance history, investment style and organizational structure. These factors are explored in more detail below.

The most obvious thing to look at when choosing an investment manager is performance history. When considering a manager's performance history, it is important to analyse the headline returns and consider numerous periods spanning various investment conditions to see if the manager is consistently above average or if periods of outperformance are followed by periods of underperformance. The performance of a manager in various economic environments will often depend on their investment style. However, performance history is not necessarily the best and is certainly not the only criterion which should be considered.

Investment managers are typically classified as having one of two styles of investment management – growth and value. Some managers will have a growth bias, which means they will generally favour stocks which have a high P/E ratio that are expected to produce above average earnings growth in the future. Managers with a value bias tend to favour stocks with a low P/E ratio that are expected to produce modest but stable earnings growth going forward. Many managers employ a blend of these styles. In general, growth managers tend to outperform value managers in times of economic expansion, such as the technology bubble of the late 1990's, whereas value managers are stronger in times of poor economic conditions, such as the first three years of this century. It is important that trustees are fully aware of the style adopted by any investment manager they appoint, and the implications of this for performance in varying economic conditions.



Another very important factor that the trustees need to consider is the organisational structure of the investment manager. Investment management is driven by people and process, and both should be carefully considered by the trustees. Firstly, look at the quality and stability of the investment team.

- Are the people who are going to manage the fund the same people that generated the strong historic performance?
- Is there a high turnover of staff, which might indicate that the personnel are not committed to producing the best possible performance on behalf of that manager's clients?

However, a stable, successful team is not enough. Secondly, it is important that there is a well-defined, consistent process employed. Lack of clarity regarding the investment process may indicate too much reliance on individuals within the investment team.

The ownership structure of the investment manager is also important. If this has changed or is likely to change in the future, this could have implications for the management of the scheme's assets.

In order to choose the right investment manager the trustees need to consider all of the above factors.

- They need to decide to what extent they are happy to accept volatility of short-term relative performance in search of potential long-term outperformance.
- They need to consider which investment style they have most confidence in, and which manager they believe has the team and process to deliver this.

It is important that the trustees are comfortable with any appointment that they make and have a clear understanding of how the fund will be managed. It is also important that they do not have unrealistic expectations.

More than one?

Another issue for trustees to consider is how many investment managers should be appointed to manage the scheme's assets. There are a number of circumstances where it might be appropriate to appoint more than one manager.

- The first is diversification. By appointing more than one manager with the same mandate the trustees are "hedging their bets". If this is the aim, the managers selected should have complementary rather than similar styles.
- The second is that for larger funds, it might be appropriate to appoint a different, possibly specialist, manager for each portfolio within the overall fund (e.g. one each for US equities, Eurozone equities, bonds etc.). For smaller schemes this is uneconomical, although it may be possible to invest in a pooled fund (known as a multi-manager fund) that has appointed number of specialist managers to manage its clients' monies.



- A third popular structure is to appoint a passive manager to manage the bulk of the scheme's assets and then one or more specialist managers to try and achieve significant outperformance on a small proportion of the fund; this is known as the core/satellite approach.

In conclusion

The management of pension scheme assets has been under the spotlight recently. The poor performance of equity markets has highlighted the need to adopt scheme specific investment strategies. The introduction of new accounting standards for companies has brought the issue of pension scheme deficits into sharp focus for many employers. Variations in the performance of investment managers have been more highly criticized than in the boom times. Going forward, pension scheme trustees will be more accountable and will need to be able to justify the decisions they make. When trustees elect to make investment decisions, they need to ensure that they get professional advice and have sufficient expertise to evaluate critically any advice they take. Choosing an investment manager will never again be as simple as eeny, meeny, miney, mo.