

# Death of common sense

In his final article on a new report, Amin Rajan concludes that without a sea change in the existing practices, pension funds will continue to stumble from one crisis to another

“It is best to avoid predictions, especially about the future,” said the founding father of modern physics, Niels Bohr. The current crisis has exposed a black hole that is deeper, darker and scarier than first imagined. Any prediction about what kind of fund industry will emerge eventually can only be a matter of armchair conjecture at this point.

The plain truth is that financial innovation has been exposed for what it was: the latest con trick to fleece the clients.

In hindsight, it beggars belief that the sub-prime casino lasted for as long as it did – making dubious loans to people with dubious credit rating, re-packaging them by dubious means, and getting a seal of approval from dubious rating agencies whose risk models were as secure as sand castles.

It is truly shocking that Alan Greenspan and his financial wizards at the Federal Reserve couldn't see this crisis coming. Nor did they have any inkling that a sub-prime crisis in the US could soon tip into a global disaster by the new mark-to-market rules.

Credit default swaps are another financial roadside bomb waiting to blow up. It is a bomb that is invisible, unregulated, and largely untraceable. CDS are akin to taking out an insurance policy on a friend's car and collecting the cash if he wrecks it. This kind of speculation has pushed the outstanding CDS value to nearly \$55trn (€42.7trn), against the total corporate debt that is one tenth of this sum

No wonder today's investors fall into two camps – shocked, and dismayed. The market rout that occurred in the week beginning 6 October 2008 has wiped out up to two decades' capital gains. Even those with strong funding levels – the Dutch and Danish pension funds – have seen their assets shrink below the statutory watermark. The corrective actions are easier said than done, since the collateral damage has hit all asset classes, including cash. The era of benign neglect is over, as is the age of innocence.

In retrospect, the 2000-03 equity crash was a defining moment in global fund management. As millions lost billions, the old ways of investing fell into dispute. People discovered that relative returns couldn't buy groceries in a bear market. Nor could the hype of equity risk premium or benchmark hugging stop a severe shortfall in defined benefit pension plans worldwide.

So they switched from relative to absolute returns, in what promised to be an era of low nominal returns. This decisive shift coincided with the most benign conditions in credit markets in living memory, until the sub-prime debacle in summer 2007. These conditions served to perpetuate the myth that absolute returns were not only desirable but also deliverable, thanks to the arrival of the 'new masters of the universe' who had suddenly re-discovered the

skills that lay fallow in the bygone era, when chasing alpha was akin to looking for a needle in a hay stack.

In the brave new world of absolute returns, this new breed of managers overly relied on the use of leverage, shorting and derivatives in their freshly minted 'go anywhere' type strategies, with many verging on financial alchemy. Since then, they have painfully discovered that every device to improve their returns – including hedging tools – is a zero game: winners win only because losers lose.

“In my relations with others, I listen to their words, but I look to their actions.” It seems as if this timeless piece of wisdom from Confucius is finally being taken on board by clients after the current turmoil, according to a new study\* published by IPE and CREATE-Research.

For now, it is worth emphasising that the biggest problem that the fund industry has is that it is the victim of its own propaganda. It is riddled with fads. At best, these say a lot about nothing. At worst, they conceal long-standing problems and provide an excuse for inaction.

The industry has always relied on market recoveries to bail itself out. Fund managers' rhetoric of alpha is far removed from reality. And they are surprised when clients challenge their 'black box' approach or adjust their performance numbers to allow for the 'mean reversion' effect. This attitude is a recipe for disaster now, when most people have absolutely no faith in the entire financial system.

Trust has been the single most important casualty in the current crisis. To regain it, fund managers will have to use an unusual degree of common sense to deliver four imperatives:

➤ **Innovation:** like car companies, asset managers must only push out products that are fit for purpose. All products need to be tested by time and events, not by simulation models powered by pious mathematical hot air. Innovation should focus on five specific features of products: returns, risks, liquidity, transparency and volatility:

➤ **Alignment of interests:** in the current investment food chain, managers do better than their clients. There is scope for better balance. In Europe, fees have gone up by 50% in the past four years at a time when 70% of funds delivered mediocre returns before the current crisis. Diversification into alternatives occurred when the best of returns were history.

➤ **Client proximity:** in the institutional as well as retail spaces, fund managers have been substantially dis-intermediated to the extent that they have little genuine understanding of their clients' goals and challenges. Yet, many continue to peddle products dressed as customised solutions. Fund managers need to get closer to their clients.

➤ **Hype:** clients want simple credible product propositions that are consistent with the art of possible, not a list of desirables. Fund managers can no longer thrive on the lingo of fads, greed and fear.

It is hard to predict what kind of a fund industry would emerge from the current crisis, so pervasive has been the carnage. However, I've seen the end of the world many times in my life. Like other crises, this one will pass. But its pain will long endure. Two things are most likely. First, when it comes, the next recovery will be marked by flight to quality, simplicity and safety:

➤ **Quality,** in terms of lower risk per unit of returns

➤ **Simplicity,** in terms of the transparency and liquidity of the strategies in use

➤ **Safety,** in terms of their capital protection features.

Second, this mother of all crises we are now

## Responses required by pension funds, consultants and managers

	FROM	TO
<b>Trustee boards:</b>	Vested interests	Broad-based expertise
<b>Executive capabilities:</b>	Limited expertise	Breadth of specialist skills
<b>Investment approach:</b>	Follow the head	Follow the instincts
<b>Relationship with asset managers:</b>	Distant service providers	Strategic partners
<b>Relationship with consultants:</b>	Reputation protectors	Thinking partners
<b>Role:</b>	Necessary gatekeepers	Trusted independent advisers
<b>Core competency:</b>	Models relying on past	Foresight based on experience
<b>Diversification approaches:</b>	Simplistic rationale	High conviction logic
<b>Clients' challenges:</b>	Broad broad awareness	Granular familiarity
<b>Manager selection:</b>	Past performance	Future potential
<b>Value proposition:</b>	Tenuous promises	Hard deliverables
<b>Innovation:</b>	Copycat products	Improved products
<b>Investment returns:</b>	Periodic	Sustainable
<b>Fees:</b>	Unbalanced interests	Aligned interests
<b>Relationship with pension funds:</b>	Distant contacts	Fiduciary role

Source: CREATE-Research 2008

experiencing will unleash a fresh wave of business Darwinism. The industry will also commoditise substantially – the sheer scale of losses will force widespread loss aversion. When the next recovery comes, it will be very subdued, if the past is any guide. Risk-takers have taken their profits and gone. The originators of risk are not in the business of holding it. That job falls on investors who have to be prepared for the long haul.

In this environment, many fund managers will not survive – theirs is a fixed-cost business that cannot be leveraged in a prolonged bear market. They will be forced to put up ‘for sale’ signs. However, it will be at least two years before we witness an outbreak of mass sanity.

However, as the first article in this series pointed out, when the recovery comes, the pensions crisis will ease but not disappear. Previous recoveries have merely concealed the deep-seated problems in every part of the pension value chain and postponed the root and branch reforms that have been long overdue on the part of pension funds, their consultants and their managers.

### Attacking the sacred cows

In an era where old certainties no longer hold, the systemic weaknesses highlighted in our first article (IPE, November 2008) risk turning Europe’s pension dream into a nightmare. To prevent that scenario, each set of players needs to make step changes in their existing approaches (see figure below left).

Shifts required by pension funds focus on two areas. The first covers board composition, decision-making and investment expertise. Currently, vested interests are over-represented and outside experts under-represented. It is time for a better balance to ensure that key decisions are driven by strong investment beliefs rather than herd instincts. The full-time executives need to have a breadth of skills that allows them to operate in real time, instead of calendar time.

The second area of action covers relationships with their two sets of service providers: they must use pension consultants as thinking partners, not hand holders; they must use asset managers as strategic partners, not distant vendors.

Shifts required by pension consultants also focus on two areas. The first is their core competency: it should centre on forward looking personal insights, not models that are backward looking. Their recommendations on manager selection and asset diversification need to be driven by high conviction logic, rather than past performance and vendor hype. The second area of focus is relationship with pension funds: consultants need to be trusted independent advisers, rather than gatekeepers who create deep blue sea between fund managers and their end-clients.

Finally, shifts required by fund managers focus on two areas. The first relates to returns: they need to ensure that innovation delivers better returns with better alignment of interest, not the same old products re-packaged in the lingo of absolute returns. The second area is about relationship with end-clients: asset managers need to go from product providers to trusted fiduciaries.

### The alpha behind alpha

Unless consultants and managers take on an ever greater fiduciary role, they will lose their relevance in a pension landscape where clients will perform become loss averse. Alignment

## A case study in strategic partnership

“Ours remains very much a partnership model, despite significant evolution over time.

The original business model integrated investment portfolios and administration for our two principal end clients – the BT and Post Office pension funds. However, over time, our business was constrained and not evolving in line with the wider asset management market. This is because we did not have sufficient definition and separation of roles (client vs asset manager), business objectives and priorities necessary to properly meet core client needs as well as grow third party AUM. Nor did we have the critical mass to compete cost-effectively with the emerging scale players in passive investments, which accounted for a significant part of our historical AUM. Alongside this, we needed to provide a first class service to address the responsibilities of trustees which were becoming more diverse and onerous.

Hence, at the end of 2007, two separate businesses were created within the single Hermes environment. There’s now a

dedicated team of fund managers who serve BTPS, and separately there is the asset management business which continues to manage specific strategies for BTPS, while developing the third party business. The focus has been on specialist teams and products with dedicated incentive structures. Non-core products, such as passives, have been divested.

The relationship between the two business areas remains collaborative, yet with client interests remaining paramount. Hermes has a holistic approach to governance. Its DNA is doing the right thing, being open and honest, being fully transparent and taking a long term view. This has nurtured a feeling of trust under which each side knows the constraints around which mandates are delivered. When issues arise, we use them as learning tools. We always flag the problems at the earliest, so that pre-emptive actions can be taken in time with full knowledge.

BTPS necessarily has a top-down view of investments but, through transparent collabora-

tion, it also has access to a more bottom-up view. Hermes is its main alpha provider although more third party managers are being introduced to increase diversification and provide a more visible external reference point against which to measure internal teams. Last year has been challenging for all managers in this space. But our transparent relationship has enabled us to address specific concerns and avoid one-dimensional views, without engaging in information overload.

BTPS is increasingly likely to use consultants for advice in some areas of manager selection. For its part, Hermes is developing third party business in a bid to deepen its talent pool. Neither party is cutting the umbilical cord and throwing the baby out in the street. But each party recognises the need to be more focused on its core areas and the need for the pension fund management team to develop deeper understanding of liabilities at a time when risks associated with asset-liability matching have become ever more dynamic.

of interests has to be the cornerstone of any buyer-seller relationships. The alignment will require the growth of strategic partnerships.

This concept is not novel, at least for some fund managers. For them, it is based on the ethos that “our clients’ business is our business”. The underlying approach uses the metaphor of a three-legged stool. The seat of the stool sets out the short, medium and long-term goals that pension clients are pursuing alongside the investment strategies which are being used to deliver them.

Thereafter, the first leg of the stool focuses on investment transparency at the manager-end. Their investment strategies are based on a well-honed disciplined process that is backed by an elaborate system which delivers simple, accurate and timely information. It also involves regular reviews with clients; highlighting deviations from the benchmarks, offering explanations, and agreeing corrective actions. As a part of investment transparency, managers seek best execution and offer full disclosure of its costs.

The second leg rests on client interests. The fund managers in question have a special internal client interest panel, whose main task is to provide a regular oversight of all client-related activities to ensure that client interests are put first. The panel ensures that sales and investment professionals understand clients’ expressed needs and risk tolerances, and are providing appropriate solutions. The panel also organises regular forums where senior executives from both sides meet to review investments and monitor outcomes. The panel is also used as a sounding board for generating new investment ideas and co-investments. Thus managers get so close to their partners that they are able to understand, articulate and

understand their clients’ needs in ways that even clients themselves cannot do.

The third leg rests on the nuts and bolts of day-to-day business governance. The main pre-occupation here is to avoid conflicts of interest, artificial distortion of prices, and artificial distortion of trading volumes. In addition, fee comparisons are frequently undertaken to benchmark against industry standards. There is also full disclosure of staff compensation. With most of their large clients, such managers have a low base fee and share of profits once the hurdle rate of return is achieved. For some of their new products, they do joint seeding. All along, managers aim to generate new insights that open up new opportunities for their partners.

This approach enables them to have fewer clients but deeper relationships. As a spin-off, partnerships have been a source of symbiotic branding, as big names have been involved in them. Much of this is common sense. But common sense has not been common practice.

### Final thought

If there is one overriding theme emerging from our report, it is this: the systemic inefficiencies are so rife in the pension value chain that there is nothing specific that clients want to change; they want to change everything!

Of course, asset managers cannot act on all the reported shortcomings of DC pensions. But they must do one thing do to ensure the long-term viability of DC plans: namely, design products that improve the trade off between capital protection and growth whilst shielding the gains from periodic market melt downs.

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