
SOUTH AFRICAN INSTITUTIONAL INVESTMENTS

WHOSE MONEY IS IT ANYWAY?

A DISCUSSION DOCUMENT

Rob Rusconi
January 2008

SUMMARY

South African workers depend heavily on the successful operation of their occupational retirement funds for their well-being in old age. Total assets in these funds have accumulated to some three-quarters of annual GDP and they form the largest set of institutional investors in the country.

This discussion document describes the operation of this part of the institutional investment market and identifies a number of areas in which, it would seem, the interests of service providers and the owners of capital are not in complete alignment.

Five themes find frequent expression throughout this paper:

- **Owners and agents.** Insufficient distinction appears to be made between the financial interests of the owners of assets – retirement funds and their members – and their agents, asset managers, investments consultants and a large number of supporting firms, all of whom are stewards of these assets.
- **Supporting the value chain.** The depth and complexity of the industry supported by retirement funds is probably not appreciated by the trustees of these funds. While market players provide an important service, a better alignment of interests would encourage them to do so more effectively.
- **The allure of the past.** Human beings are strongly inclined to seek meaning in a succession of events and often make the mistake of inferring causality where it might not exist. In the area of investment, this finds expression in an inappropriate attribution of good performance to skill, instead of recognising that at least some may be due to random factors. This in turn creates an unhealthy dependence on active asset management and on the information provided by sophisticated information intermediaries whose skills are difficult to assess objectively.
- **Conflicts of interest.** Providers of service to retirement funds have a variety of financial incentives that are not necessarily in the best interest of their customers. Conflicts of interest occur in a number of different ways, so commonly that it is not easy to find instances in which, with certainty, they do not exist.
- **Information inequity.** A large proportion of trustees are not experts in investment. They are representatives of the membership of a fund or its sponsoring employer and, to the best of their ability, seek to execute on their fiduciary responsibility to the fund and, by implication, to its members. Providers of service, on the other hand, are professionals in their fields and have the natural incentive to position themselves as well as possible, sometimes taking advantage of the information inequity in the process.

The market for institutional investments is enormously complex. This makes it easier for providers to price opaquely and to develop alternative sources of revenue, particularly with less skilled and experienced individuals serving as trustees. This also makes it difficult to provide a comprehensive analysis of the market. The discussion in this paper is therefore anecdotal in nature, asking questions in a number of areas rather than attempting to cover in detail the operation of the market.

After an initial description of the marketplace and its players and a synopsis of some of the legal principles underlying its operation, ten questions are asked. Some of these are relevant to the entire market, for example:

- Why is there such a strong emphasis on active asset management, as opposed to the index-linked alternative?
- Is the training provided to trustees independent and in the best interest of the trustees or does it tend to deepen their dependence on their service providers?
- Are fee models designed to align the interests of provider and customer?
- Is sufficient attention given to the fundamental principles underlying a socially responsibility investment approach?

A number of them are focused on particular parts of the market, for example:

- asset consultants,
- hedge funds, and
- multi-managers.

The remaining issues apply more to some parts of the market than others, but ask questions that are of relevance to trustee thinking generally.

- Do marketing activities enhance customer understanding or are they designed merely to attract a customer to a service, in aggregate moving retirement funds from one provider to another without adding significant value?
- Do performance surveys of asset managers provide a useful service and are they used responsibly?
- Are all asset managers executing all of their trades in the best interest of their customers?

The paper is aimed at retirement fund trustees. It does not name service providers, though in a small market identification by the expert is sometimes unavoidable. The express intention is not to identify business models that may be inappropriate, but to equip trustees to identify activity with which, if they understood all of its consequences, they might not be comfortable.

I hope that this work contributes to a more effective market and a better outcome for the millions of South Africans who are members of retirement funds.

AUTHOR COMMENTS

This section adds to the summary a few thoughts on intent and style, making it easier for the reader to make best use of the information set out in the paper.

Motivation

The purpose of the paper is to assist trustees. It is not intended to point fingers at providers. While much of its content addresses market conduct issues, these are not limited to the suppliers of service, but should provide food for thought to trustees as well.

Borrowing from the comments of two respected observers, it helps to categorise industry issues and to explain some of the economic rationale behind the activities of providers. But it should not be regarded as comprehensively achieving either of these goals, because it constitutes no more than the collected thoughts of an industry observer. If it motivates appropriate changes to thinking and strategy, it will have succeeded.

I am not agitating for government intervention in the market. I am philosophically committed to the operation of the free markets, but mindful of the warning of one of the greatest advocates for freedom of market operation, who was clearly aware of the potential for the informed few to gain advantage over the unaware many:

People of the same trade seldom meet together... but the conversation ends in a conspiracy against the public. (Adam Smith, The Wealth of Nations, pg 148, cited in O'Rourke, 2007:24)¹

Some may suggest that my intention is linked to another recently issued paper, written for the Department of Social Development and covering the rules under which providers might be accredited to supply services to a mandatory savings market (Rusconi, 2006). The documents are not linked.

- This paper is concerned with issues of market conduct, but does not suggest sweeping changes. It is motivated by the intention to equip trustees to be more effective in the execution of their responsibility and was started before the commissioning of the research into accreditation standards.
- The accreditation paper considers an environment in which saving for retirement is mandatory, partly into a central fund and partly into private sector arrangements. It assumes substantial changes to the current retirement market.

¹ The formal reference to Adam Smith is "An Inquiry into the Nature and Causes of the Wealth of Nations" (1937), edited by Edwin Cannan, **Modern Library**, New York.

While one of the implications of market conduct failure may be wide-ranging policy change, such a consideration is not within the scope of this paper.

Form

Some may wonder why I have chosen to include most of the content in the form of questions. This contrasts the study that Paul Myners undertook of the institutional investments market in the United Kingdom (Myners, 2001), in which he assesses the operation of each part of the supply chain.

There are three main reasons why I have not taken this approach:

- This is not a formal national study, complete with draft studies, written comment by market players and a comprehensive report to the government. Resources are limited to personal time and perspective. I feel that those resources are better allocated to asking a series of probing questions than to attempting to uncover the underlying causes of any market conduct concerns.
- The South African market has become enormously complex. Providers have sought both to establish differentiated products and to build vertically integrated operations to maximize efficiency and cross-sell. It is becoming more and more difficult to pigeon-hole products and services and to assess them separately. Each chapter aims to stimulate debate and encourage trustees to ask themselves and their providers similar questions, and indeed much more probing alternatives as well.²
- This is a discussion paper, intended to be the first step in a wide-ranging debate, possibly triggering more formal writing. A series of questions should encourage this dialogue more effectively than alternative forms of writing.

What about areas omitted from the questions? Ten topics is plenty and this paper is quite long already. I am aware of a few gaps, but I hope that they are covered in other parts of the discussion.³ Comments on omissions are most welcome.

Finally, each section is written in a way that is self-contained, forming an essay which need not necessarily be read as part of the longer discussion paper. This is designed to optimize the absorption of information, identification of error and feedback on the implications. The approach does result in a small amount of repetition.

² Some provider groups may feel hard done by because they have been identified specifically by a question. This is not necessarily negative. It suggests that such providers have a strong identity. Members of these groups who take seriously their commitment to their customers will enjoy the debate stimulated by these questions.

³ Absolute return mandates, for example, raise concerns that are at least partly addressed in the discussions on active management (section 1), hedge funds (section 5) and marketing (section 6).

Style

The paper is written to be accessible by trustees reasonably well versed in the language of retirement funds. This means that it is neither too complex nor inappropriately simplistic.⁴ I have used first-person language from time to time in an effort to improve readability.

References are cited formally where they are publicly available or permission has been received to use them. The identity of the quoted party is protected where it would not be appropriate to name them as a more general point is being made, for example, where I comment on advertising material.

To those who do not like footnotes, I apologise; there are lots of them. They are designed to add to understanding without damaging the flow of the text. They ought also to make the paper a little more interesting.

Acknowledgements

This paper would not have been possible without the input of dozens of industry players and observers with a great variety of perspectives. Some of them would prefer to remain anonymous and it is probably fairer to them not to list the others, but I am very grateful to all of them and trust that I have represented their views fairly. Where sections have depended on the assistance of particular individuals, I acknowledge them explicitly in the relevant parts of the paper.

I deeply appreciate the thoughts of all of those who have contributed, but the responsibility for errors is mine.

One whose assistance I must note is the person with less knowledge of the industry than all those that I have spoken to. My wife is not a participant in this arena, except through her support for me, but she is a much better writer than I am. My thanks to Sue for willingly giving time from our summer break for her patient editing.

Contact details

This is a discussion paper and belongs to its readers. It may be cited with appropriate references, but please refer to it explicitly as a discussion paper. Comments are most welcome and should be sent to me at rusconihome@wol.co.za.

⁴ *My editor and 'waffle scanner' – my wife – takes care of jargon and has played a huge part in clarifying the writing and establishing an appropriate tone. Formal thanks to her later, but I would welcome comments on the writing style.*

CONTENT

The Context	8
<i>Motivation</i>	8
<i>South Africa's Institutional Investments Environment</i>	12
<i>Legal and Ethical Framework</i>	22
Active vs Index-Linked	29
Trustee Training	42
Asset Consultants	51
Fee Models	65
Hedge Funds.....	75
Marketing	84
Performance Surveys	96
Trading Dynamics.....	107
Socially Responsible Investing	118
Multi-Managers.....	134
The Way Forward	146
<i>Major Themes</i>	146
<i>Tips for Trustees</i>	151
References	157

THE CONTEXT

In which the motivation and scope of this study is outlined, followed by a description of the wide range of participants in the South African institutional investments industry and a consideration of the legal framework establishing their responsibility to retirement funds and their beneficiaries.

Motivation

Prior to the twentieth century, perhaps even up until the Second World War, the power of ownership rested in the hands of relatively few. The majority of companies were owned largely by individuals or families. The last fifty or sixty years have been characterised by the democratisation of ownership. Through the mechanism of mutual funds and pension funds, millions of people across the world became owners of capital, sharing in the wealth that it can generate.

This democratisation has had significant positive results, for it has raised the world's middle class on the rising tide of corporate success and provided the means for lower income workers to participate tangibly in the economic growth of the last few decades.

But in some ways it has failed. For the increase in the number and diversity of owners has widened the gap between these owners and the source of their wealth, the companies in which they invest. Owners have delegated the responsibility for managing their assets to intermediaries, birthing and rapidly growing the strength of the institutional investor.¹



Business Day, early December 2007, cartoonists Charles Peattie and Russell Taylor, www.alexcartoon.com.

¹ An institutional investor is, quite simply, an institution – bank, insurer, pension fund, collective investments vehicle – that owns and invests its assets. An asset manager is not, strictly speaking, an institutional investor; it is the delegated manager of the assets of the institutional investor.

This paper is concerned with the interaction between a particular type of institutional investor, a retirement fund, and the parties to whom it delegates the responsibility for advice and investment of its assets.²

Retirement funds come under the spotlight for four reasons:

- they form the largest single group of investors in the country, with assets of well over R1 000bn,³
- they represent the interests of a very wide range of investors covering the entire spectrum of the employed and probably reaching deeper into the lives of low-income South Africans than any other set of investments,
- they are overseen, by and large, not by professionals with deep expertise in investment matters, but by concerned lay individuals who are elected to the position of trustees of these funds,
- they are serviced by an enormously complex chain of service providers who may not always operate in the best interest of the beneficiaries of the retirement funds.

The institutional investments industry is not only important in sheer scale, employing thousands of individuals in a sophisticated web of activity, but it is significant in the impact that it has on the livelihood of the least sophisticated of working South Africans.⁴

The relationship between the owner, represented by the retirement fund trustee, and the manager, the service provider, lies at the heart of this discussion. John Bogle, founder and former CEO of the Vanguard mutual fund group in the United States, writes about this shift and its consequences in his book *The Battle for the Soul of Capitalism*

*Over the past century, a gradual move from **owners' capitalism** – providing the lion's share of the rewards of investment to those who put up the money and risk their own capital – has culminated in an extreme version of **managers' capitalism** – providing vastly disproportionate rewards to those whom we have trusted to manage our enterprises in the interests of their owners. (Bogle, 2007:xix, emphasis in original)*

² Through umbrella funds and insured arrangements, life offices also manage the assets of pension funds. Concerns about the transparency of these arrangements are legitimate and umbrella funds in particular are being subject to careful scrutiny. But they are not explicitly within the scope of this study. The problem with analysing the investments of the life offices is that it is difficult to know where to draw the line on such analysis. Life offices write a huge range of business and manage the assets underlying these products as an institution. Technically, the entire asset set of the life office forms part of the pool of institutional investments, but it is difficult to isolate that part of the life office assets that relate to pension saving, individual retirement annuities and underwritten occupational funds.

³ For international readers, the exchange rates at the time of completing this paper are approximately R6.75 to the US Dollar, R10.00 to the Euro and R13.20 to one pound Sterling.

⁴ To the extent that assets are preserved on resignation, institutions manage a significant proportion of the livelihood of the unemployed and informally employed as well.

Bogle reminds his readers that both company managers and asset managers are stewards of the assets of others. This paper seeks to emphasise that reminder.

The policy context

Old age provision in this country is not well diversified. South Africa has a system of social grants for the elderly that meets the basic needs of the very poor. It has a strong and very large⁵ private pension saving sector that meets well the saving needs of the wealthy.

But the system has two important concentrations of risk that, without adequate information and controls, can have detrimental effects on the interests of participants:

- **Defined contribution (DC) plans** dominate the retirement saving sector. At the heart of a DC arrangement is the notion that the individual bears the risk. Many point out that the individual stands to gain from the potential for good investment performance. This may be true, but upside potential comes with a corresponding downside. The DC pension fund member is largely poorly equipped to manage the risks associated with this volatility, let alone safely convert accumulated wealth into income after retirement.⁶
- **The private sector** is the sole provider of retirement saving service to middle- and upper-income South Africans. Unlike in all developed countries and a good proportion of emerging economies, tax-paying South Africans must save for themselves because state support is insufficient to provide a standard of living in retirement remotely approaching that enjoyed during the working years.

Anecdotal evidence suggests that a very high proportion of South African workers do not retire with sufficient assets to sustain an acceptable standard of living, relative to pre-retirement lifestyle. A number of causes account for this, not all of them directly dependent on DC risks and private sector provision. These are being addressed by policymakers and which do not fall within the scope of the study.

Research methodology

This paper is inspired by the work of Paul Myners, who produced a comprehensive review of the institutional investments environment in the United Kingdom a few years ago

⁵ As a percentage of Gross Domestic Product, assets invested in pension savings in South Africa form one of the largest pools in the world.

⁶ Consideration of risk in defined contribution funds would be incomplete without an acknowledgement that trustees could take a stronger interest in the risks to which individual members are exposed (and the costs that member accounts incur) but their professional indemnity cover may have the perverse impact of reducing their focus. Employers, furthermore, seek explicitly to remove their exposure to such risk, part of the reason for shifting to defined contribution in the first place.

(Myners, 2001). However, it does not claim to replicate that work, which was the result of a comprehensive consultation process.

It is framed instead as a discussion document that describes the environment and asks a number of questions regarding the dynamics of this environment. The intrinsic difficulties with a study like this one are that investment is complex, and providers of investment services, and their intermediaries, may have a vested interest in maintaining this sense of complexity.

In any market, providers may benefit from maintaining an aura of intricacy, almost mystique, concerning the services they offer. This is certainly the case in this environment in which products are difficult to compare and outcomes not evident for some time. It is very difficult for a study to distinguish the activities of very sophisticated entities that may not be in the interests of their customers. If the study assists fund members and their trustees to take a stronger, better informed role in the management of these funds, it will have gone a long way to addressing potential information imbalances.

This paper thus represents a first pass at understanding some areas of concern in South Africa's institutional investments environment. It does not present concrete recommendations to policymakers on how to respond to any evidence unearthed. But it does aim to ask on behalf of fund trustees a set of questions, that they themselves should be asking, in an attempt to demonstrate a few of the areas in which things may not be quite as they should.⁷

It is hoped that this paper and the questions that it poses will prove to be a useful contribution to trustee knowledge and an influence for positive behavioural change among their providers, but it is a discussion paper and comments would be most welcome.⁸

Back to the context

Institutional investors ... have already become the main players in financial markets. These investors manage not only large amounts of household savings from developed countries, but also, increasingly, savings from developing countries where the importance of privately managed capitalized pension systems has grown. Institutional investors can play an important role in deepening financial markets and providing additional liquidity for long-term investment projects. (United Nations, 2007: 13)

Institutional investment matters. As our policymakers consider a range of options for the design of the pension-saving market in this country, and the supervisor considers how

⁷ Regulation tends to lag bad practice. Consequently there are benefits in staying ahead of the game by asking the questions to which there may be uncomfortable answers and convincing service providers that transparent behaviour should be a marketable advantage, itself only possible if their customers value such an approach.

⁸ Any feedback may be sent to me at rusconihome@wol.co.za.

such structures might be regulated, it is very important that we ask how well the existing structures are working and how well customers are able to assess the offerings of their providers.

The main reason the State establishes systems of regulation in any area of activity is to provide confidence and stability in that system. The State may also intervene where markets are not operating efficiently. As pensions saving involves providers investing other people's money on their behalf, it is important that those people can be confident that the system is secure and that their own savings are secure. (Irish Department of Social and Family Affairs, 2007: 197)

We need to recognise also that the way in which the assets of owners are invested could have a significant impact on other parts of our economy.

... institutional investors largely operate outside of financial market regulation and supervision mechanisms that apply more generally to the banking system. If unchecked, the financial market operations of pension funds could thus be a source of financial instability. Also, as increasing financial investments are intermediated outside of the banking system, the control of monetary authorities over credit growth tends to weaken the effectiveness of monetary policies. Improved (possibly international) regulatory measures are needed to avert possible destabilizing effects on financial markets of the operations of large pension funds and to prevent the income security of older persons from being jeopardized. (United Nations, 2007: 13, continued from previous)

This country must ensure that, whatever structures are established for tomorrow's retirement savers, their capital is invested in a manner most appropriate to their needs.

It is the long term investor, he who most promotes the public interest, who will in practice come in for the most criticism, wherever funds are managed by committees or boards or banks. For it is in the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches us that it is better for reputation to fail conventionally than to succeed unconventionally. (Keynes, 1936)⁹

South Africa's Institutional Investments Environment

The discussion that follows describes the main types of institutional investors and the range of firms providing service to them.

Pension funds

South Africa's private pension saving market is large and well-developed. Assets under management at the end of 2004 amounted to some R1 098bn (Registrar of Pension Funds,

⁹ Quoted in the inside cover of Myners (2001).

2005) and at by the end of 2005, R1 284bn (Financial Services Board, 2007a), over 70 per cent of Gross Domestic Product, which is significant by global standards.¹⁰

While this is the latest available consolidated figure for the industry, all indications are that it has risen considerably since the end of 2005. South African Reserve Bank figures show the assets of private self-administered funds increasing from R379.1bn at the end of 2005 to R476.9 by 30 June 2007. The corresponding figures for Official Funds¹¹ are R601.6bn at the end of 2005 and R785.7bn at 30 June 2007 (South African Reserve Bank, 2007).

With these increases in mind an estimate of total industry assets of around R1 500bn is probably not that far off the mark. This is more than 80 per cent of the Gross Domestic Product.¹²

The industry is large, a very significant part of the national economy and probably its greatest power to invest for economic growth. Many argue, with some conviction and authority, that the existence of such a powerful investing force is extremely positive for the country. This may be true, but not unambiguously so, as referred to in the United Nations statement quoted a little earlier... *"If unchecked, the financial market operations of pension funds could thus be a source of financial instability..."*

The authors of that report go on to point out the dangerous influence of large pension funds... *"Improved... regulatory measures are needed to avert possible destabilizing effects on financial markets of the operations of large pension funds..."* (both from United Nations, 2007: 13).

Concentration brings dangers, particularly in an industry as dominant as South Africa's pension saving industry.¹³ But fragmentation also brings about difficulties because it inappropriately increases the power of financial intermediaries, asset managers for example, and South Africa's pension saving environment appears to have both.

¹⁰ Comparisons should be carried out with care. While other countries – particularly developed countries – have strong social security systems that tend to crowd out private saving, South Africa's private sector saving is complemented only by the system of Social Old Age Grants, which pays a monthly benefit in 2007 of R870 and does not require a social security tax from working-age residents. The private pension system has flourished in this environment, though, as this paper suggests, not with sufficient discipline to protect adequately the interests of participants.

¹¹ "Funds administered by the Department of Finance, Transnet, Telkom and the Post Office. Deposit administration investments excluded." (South African Reserve Bank, 2007)

¹² The 2006/07 budget quotes a GDP figure, for 31 March 2007, of R1,755bn (National Treasury, 2007a).

¹³ The assets of the Government Employees Pension Fund, alone, amounted at the end of 2006 to more than one-third of the annual national Gross Domestic Product.

Financial Services Board figures show that, despite consolidation in the previous few years in fund numbers, there were 13 390 registered funds at the end of 2005.¹⁴ Nearly 57 per cent of these funds had twenty members or less and 71 per cent fifty or less. Most of these funds, it is assumed, are small because they are sponsored by small employers. These employers do not have the resources to devote significant attention to managing pension funds. Anecdotal evidence, discussed in this paper, suggests that South Africa has generally low levels of financial acumen among trustees. Combined with the high number of very small funds with limited resources, this leads to serious concern that these funds are prone to the information advantage of their service providers.

While concentration can put inordinate power in the hands of a few, fragmentation undermines a system through spreading too thinly the intellectual resources of the trustees with a fiduciary responsibility to run the fund in the best interest of the members, potentially passing the power back to those who provide services to these funds.

South Africa's policymakers are well aware of the inefficiency inherent in this fragmentation.¹⁵ It is not within the scope of this discussion document to assess the policy options. The paper instead builds on the arguments of administrative and regulatory cost inefficiency by suggesting that supply-side issues and conflicts add to the problem, and not just for smaller funds.

Insurer funds

Long-term insurer assets totalled R1 411bn at the end of the second quarter 2007, but these assets back products considerably wider than those used for pension saving and do not form part of this study (South African Reserve Bank, 2007).

Self-administered pension and provident funds invested with insurers an amount of R216.3bn at the same date, 30 June 2007. This amount probably includes:

- multi-employer funds (commonly known as umbrella funds) established by insurers,
- retirement annuity products, which are housed in pension funds set up by the insurers and have all of their assets in insurer-provided products, and
- assets backing products purchased from insurers by pension funds, products providing death and disability cover, and perhaps a small additional set of investment-only products.

¹⁴ This is down from 15,587 at the end of 2000 (Financial Services Board 2004).

¹⁵ "... concerns arise as to the cost-effectiveness of administration and regulation for smaller funds. Larger funds tend to benefit from economies of scale in administration and are better able to meet regulatory requirements without imposing an excessive burden on members." (National Treasury, 2007b:22)

Mutual funds

Mutual funds, known in this country as Collective Investment arrangements, are also institutional investors. Total assets under management at 30 September 2007, was some R752.7m.¹⁶ A degree of overlap of this total with the corresponding totals for pension funds and insurer funds can be expected, but the total assets across all three industries, after correcting for duplication, is substantial.

Mutual funds are not explicitly considered as part of this study.

Pension saving against GDP is high relative to other middle-income countries. Making some allowance for insurer funds and mutual funds only adds to this impact. Even in absolute terms, South Africa has a large institutional investment market, comfortably exceeding, in absolute terms, the corresponding market in Mexico, which has a much larger population;¹⁷ roughly in line with the industry in Belgium and not far short of Singapore and Sweden (Bank for International Settlements, 2007).

There is little doubt that this has had positive impacts on the demand for appropriate investments and has stimulated the development of capital markets as a result. What is less clear is whether institutional investors, particularly retirement funds, are operating in a manner that best matches the needs of their ultimate beneficiaries, the members of these funds and their dependents.

The beneficiaries: fund members

We do not have a perfect understanding of the number of South Africans participating in the institutional investments environment.

Limiting attention to retirement funds, the Financial Services Board (2007) quotes a total membership figure of 9 264 148 for the end of 2005, of which 8 119 860 are active, noting the significant double counting across retirement arrangements.¹⁸ Some commentators place the number of active members at between 6 million and 8 million. The Department of Social Development estimates the number of contributors at 5.9 million (Social Development, 2007:9). To both of these figures should be added perhaps 1 million beneficiaries, those in receipt of a pension or some other form of benefit from a retirement fund.

¹⁶ Data available from the Association of Collective Investments web site, www.aci.co.za.

¹⁷ Total institutional assets in Mexico was US\$132bn in 2005, with US\$63bn in pensions, US\$47bn in mutual funds and only US\$21bn with insurers (Bank for International Settlements, 2007:5).

¹⁸ These figures represent a substantial reduction on the corresponding statistics for the end of 2004, (9 853 055 total members and 8 720 004 active members, Financial Services Board, 2006) perhaps casting a little doubt over the reliability of the numbers.

Life offices and collective investment funds look after the savings of millions of South Africans but there is likely to be substantial overlap between the set of members of occupational funds and the corresponding sets of life office policyholders and collective investment members.

Two contrasting views emerge from these numbers:

- the institutional investment market bears responsibility for the well-being of millions of South Africans and its success or failure has a significant impact on the financial security of these households, or
- for all of its sophistication, institutional investment reaches only a relatively low proportion of the nearly 50 million people living in this country, suggesting that ways must be found to render these financial services more accessible to more South Africans than are using them at present.

What is very difficult to determine is the significance of these assets to the people who participate in these vehicles. As the size of the industry is, by international standards, very large relative to the economy, institutional investors safeguard a substantial part of the livelihood of those who save into them.

The description turns now to the providers of service to retirement funds. Pension fund assets must be invested. If they are to provide good value to their beneficiaries,¹⁹ the members of funds and their dependents, they must be invested efficiently and safely, that is, at an appropriately low cost and in a way that protects the interests of these members against the possibility of fraud, negligence or other wasteful activity.²⁰

Investment managers

Any study on institutional investments must focus significant attention on the investment managers. All privately held assets are managed in some way, so these managers must form a key part of the scrutiny of this study.

But it is important to recognise that investment managers are not the only profit-making service providers to this market. A large array of firms services pension funds, directly, or through other service providers, forming a bewildering chain, all influencing the financial

¹⁹ Rusconi (2004), as part of its analysis of the efficiency of the South African system, comments on the significance of these costs to the members of funds. On a reasonable set of assumptions, among them, consistent saving over a working lifetime, a consistent reduction in costs of 10bp, in other words 0.1% of the value of assets each year, produces an improvement to the resulting pension of 1.9%. A 30bp saving improves the retirement outcome by nearly 6%.

²⁰ The research in this paper is not quantitative, but it is also not limited to explicit charges. It aims to describe some of the dynamics of the market for institutional investments that are not in the best interest of their beneficiaries and could be much more significant – in indirect financial impact – than the fees charged for services rendered.

interests of the retirement fund and its members, and all aiming to make a living from the provision of services.

What do investment managers do for retirement funds? They:

- **keep safe the assets**, though technically this task is the responsibility of custodians, taking care of the records and all trading data;
- **attempt to provide growth in value**, tempered by the requirement that this value is not subject to inappropriate levels of risk, by altering the mix of assets over time in an attempt to take advantage of pricing dynamics; and
- **act as intermediaries** to market traders, those who actually make the sales and purchases aiming to gain the desired increase in value.

It is worth noting that investment managers are essentially intermediaries. They outsource the responsibility for custody – though they sometimes ‘outsource’ it to themselves²¹ – and they outsource the task of executing on sales and purchases. They may also outsource at least some parts of the task of administering the portfolio.

Expect strong resistance to this simplification. Asset managers, it is argued, provide above-market returns through their ability to instruct trades that bring value to their customers. They outsource the balance of the responsibilities because it is precisely this ability to instruct trades smartly that they are good at. This argument is considered in a little more depth in chapter 1.

Investment managers differentiate themselves from one another in many ways, selling different types of products and employing different techniques in their attempts to generate the sought-after elixir of consistent outperformance.²²

Two of these variants are considered in more detail in this paper:

- **Hedge funds** confusingly fall into a number of types. Some employ more extreme and risky methods to achieve higher performance, and charge accordingly. Others establish specialised objectives and aim rather to meet these goals, providing diversification from more conventional asset classes.
- **Multi-managers** do not invest in market securities, but in other managers, aiming to provide better performance through their skill in selecting those managers that have a

²¹ I hear instances of custodians turning down queries from the trustees of pension funds on the basis that they were not appointed by the retirement fund, but by the manager of the fund's assets.

²² The way in which they package and market their offerings can distort the dynamics of the market. Providers of retail products have an incentive to “pack the shelves” with as many products as they can, subsequently removing those that did not perform well and leaving the star performers on display. Product multiplicity occurs in institutional investments as well, but this part of the market is further complicated by the bespoke products created to meet client needs. As these are less easily compared another set of assessment problems is generated.

greater likelihood of outperforming the market and their peers, and lower risk through allocating client assets to a number of managers.²³

Brokers and investment banks

The brokers are the market experts. Though they no longer spend their time on the floors of stock exchanges bidding for securities, they are responsible for executing trades, sometimes for themselves but usually for their customers, investment managers among them. They are intermediaries between the product packagers and the market.

As recently as ten or fifteen years ago, brokers were specialist firms that focused on buying and selling shares. Consolidation followed and most broker houses are now part of large investment banks. The execution of trades forms but one of a large range of complex market and administrative services, some of them considerably removed from the ultimate beneficiary, the member of the pension fund.

The relationship between an investment manager and its broker is complex. The financial motivation of investment managers is to grow the asset base, usually through generating investment performance that is superior to their peers and the market as a whole. The financial motivation of the brokers is to generate trades. Brokers compete with one another for the right to execute trades and this competition assumes interesting hues from time to time, characterised sometimes by unspoken agreements and *"quid pro quos"*. Some of these dynamics are touched upon in section 8.

What sort of income does institutional investment produce for brokerage houses? One of the large houses suggests that local institutional trade constitutes nearly half of all turnover on the Johannesburg Securities Exchange. At an assumed annual total JSE turnover of R2,000bn, an average brokerage charge of 12.5 basis points, this translates into income of approximately R1.25bn, of which a significant proportion is paid by retirement funds.

This is not the only source of income for investment banks. They also earn significant revenue in areas such as over-the-counter derivatives, index arbitrage, listed products like warrants, currency trading and proprietary trading in both equity and bond markets. Proprietary trading – typically foreign investment banks that have capital from global balance sheets – can make up 10 per cent to 15 per cent of the daily trade on the JSE alone, significantly enhancing liquidity on the exchange.²⁴

²³ Technically, this depends on the assumption that the investment performances of the respective managers are not perfectly correlated. This condition is easily met, but in South Africa's relatively small market, correlations may be close to one and the relatively low benefit of diversification does not come at zero cost.

²⁴ Investment banks also play an important risk intermediation role, taking on risk large chunks of shares from asset managers and pension funds immediately rather than trading them on behalf of the

Investment advisers

Institutional investors often employ advisers, sometimes referred to as asset consultants or investment consultants, to guide them through the process of selecting assets and service providers.

Few investment adviser teams are truly independent. Many of them are part of an actuarial consulting firm or larger organisation that provides actuarial and other consulting services to pension funds. In a number of these cases, the actuarial consulting firm itself is part of a parent or related company that offers a wider range of services, insurance and asset management, for example. Consultants in this instance must take great care to demonstrate that the advice that they provide is not affected by the interests of their parent companies.

This complexity makes it very difficult to gain a sense of the size of the network of investment advisers. A number of the larger actuarial consulting firms have significant resources in their investment advice units and some of the smaller entities provide asset consulting to retirement funds.

The industry is characterised by considerable blurring of services and sources of revenue. Some investment advisers charge by the hour or through a monthly retainer for specialised advice, some as a proportion of the assets of the fund. Some providers describe themselves as implementative consultants, shifting closer to the multi-managers in the sense that they actually put into place their best views on combining managers. A number of investment advice firms have been established by insurance intermediaries in order to reach smaller funds and gain revenue from physically administering the investments of the fund.

Paul Myners raises concerns of high levels of concentration of the specialist pension fund asset consulting industry in the United Kingdom where four providers dominate and there are, as he puts it, “... *low levels of both customer switching and targeted solicitation.*” (Myners, 2001:65) He comments also on the tendency of providers to bundle services together, though this usually refers only to actuarial and investment services, not the rather more comprehensive vertical integration characteristic of South Africa’s market. He mentions a number of mitigating factors and concludes that there “... *is no evidence of the classic competition problems of market power leading to monopoly profits.*” (Myners, 2001:70). He nevertheless provides a number of recommendations, which are discussed in section 3 of this paper.

client. Still to play a meaningful part in the South African environment are bank-arranged swaps to reduce pension fund or asset manager exposure to specific risks, for example, the mismatch between pension assets and liabilities, another form of risk intermediation.

We have a different problem in this country. It is almost impossible to identify a group of professional fee-charging advisers because the sources of revenue to investment advisers have become so diversified that it is difficult to describe coherently the services that they provide to their customers. More important perhaps is the question of the independence of the advice that they give.

Custodians

Every fund must take care to ensure the safe custody of its assets. In this country, custody is usually the responsibility of investment managers, though technically this may also be outsourced.

Custody services are not particularly expensive – 0.5 basis points per year²⁵ and R50 per transaction is a typical set of fees – but they are negotiated from case to case. Nevertheless, custody is not free and custodians can be expected to seek a profit. Funds whose managers trade more can expect to pay more in custody fees.

Custody presents opportunities for profit and, if the investment manager and custodian are the same entity, may risk the security of fund assets. Trustees should take care with the selection of their custodian and not accept the common claim from asset managers that they should provide both custody and asset management services.

Transition managers

A number of other services provided in the institutional investment market can be very lucrative but frequently go under the radar screen of the ultimate beneficiaries. Large-scale transitions from one mix of assets to another, often not in the interest of fund members, are expensive and risky to implement. This introduces further opportunity for the development of specialist providers.

Transitions in Europe are usually executed by an investment bank, which has the balance sheet to take on the risk but also the tools to mitigate this risk as effectively as possible through hedging strategies. The bank charges to take on the risk but the very competitive environment keeps the charges acceptably low.

South African portfolio managers – asset managers, multi-managers or directly investing pension funds – sometimes take a different route, perhaps because in the small market they are concerned that the investment banks, having understood the nature of the transition required, could take advantage of the information and trade against them. With this in mind, they appoint an intermediary to farm out the trades to a number of investment banks or to drip-feed them through the market over time. This can be very

²⁵ One basis point is equal to 0.01 per cent.

expensive because the intermediary charges a fee and the fund is exposed to market risk for the period over which the intermediary effects the transactions.

Transition fees, adding the layers together, can amount to around 5% of the money being moved, an enormous drain on the performance of the fund.

Supporting industries

The list of individuals or companies that service South Africa's retirement funds appears almost endless. A significant type of company not yet mentioned is the fund administrator, often not directly involved in the institutional investment process but obviously an integral part of retirement saving landscape in this country.

Scrip lenders, frequently departments of some of the entities already listed, make money by broking the loan of a set of shares owned by a pension fund to a counterparty who needs the share book for a limited period of time.²⁶

Asset managers and investment banks also make money from structured products. These are special investment constructs, using derivative products like futures and options, designed to meet specific needs like removing the possibility of significant loss. These products can be set up to achieve very precise objectives, but they are not cost free.

Other firms that contribute to the institutional investments industry include providers of housing loans, trust companies, legal firms, accountants and auditors, independent principal officers and trustees, training and communication specialists. To this could be added an additional range of entities that assist the service providers.

Revenue & profitability

Such is the complexity of the web of service providers that it is almost impossible to determine what level of revenue it supports. The sheer scale of the industry, particularly in relation to the economy as a whole, and anecdotal evidence of reasonable margins for most players, suggests that the institutional investments environment amply supports the majority of its service providers.

²⁶ Note that the entity broking the scrip lending makes only a fee for providing the service, but the owner of the assets takes the lion's share for lending the assets. This is just one good reason for retirement fund trustees to consider with caution any product arrangements that involve transferring assets to the service provider.

Legal and Ethical Framework

The role of the governance rules in pension funds is, first, to ensure that pension plan members are adequately protected from conflicts of interest and related problems, and, second, to guarantee that the governance structure is compatible with the incentives of the players or to at least provide contractual provisions that enable the players to overcome any incentive incompatibilities. Trustees have a fiduciary responsibility to the members of their funds that is entrenched in the fundamentals of trust law. (Dias, 2006:29)

Individuals take on responsibility to the members of the fund when they choose to accept a position on the Board of Trustees. Greater knowledge would be a help to them executing their responsibility but the absence thereof cannot be used as an excuse not to meet this duty to their members with due care. Providers of service, however, must also remember that they have a duty of care, at least, to all clients, including the members of the retirement funds they serve.

*The **fundamental principle** is that the board shall at all times act with the **utmost good faith** towards the [retirement] fund and in the best interest of all members. The board should always give full and proper effect to the rules of the fund and the board should deal with all matters relating to the fund and its members in accordance with its fiduciary duties, **fairly** and with respect. (Financial Services Board, 2007b, paragraph 6, emphasis in original)*

Some hold that the fiduciary responsibility of trustees is only to the fund, not to its members. This is discussed in box 1 by Jonathan Mort, a pension attorney whose contribution I gratefully acknowledge. My writing does not venture further into this argument. The starting point here is that, at the very least:

- trustees have a legally established fiduciary responsibility to the fund, and
- service providers owe a duty of care to their clients, the retirement funds, and the beneficiaries of their clients, the members of these funds and their dependents.

Many would argue that the law establishes a deeper responsibility than this – refer to Jonathan's discussion in box 1. For the purposes of this paper, it is sufficient to invoke this minimum basis and its implications. The discussion that follows builds an ethical case for tighter vigilance over retirement funds.

Nature of the trustee responsibility & extent to which this is understood

The law of trust includes a set of principles established for many years and present throughout the Anglo Saxon countries. It is unique in many ways. It permits and encourages members of a group, lay persons without extensive experience, to take a share in ensuring the safe-keeping of the assets of the group. It does so by giving to these members, elected to the board of trustees, the right to make decisions that affect the interests of all of the group members.

Since trustees have enormous power over the financial interests of the group members, their actions are subject to fiduciary responsibility. Each trustee is required to take the appropriate steps to exercise due care over these financial interests.

How is fiduciary responsibility demonstrated? A number of standards might be applied to test the integrity of trustee decisions. They should be made:

- with due care to the interests of all members of the group;
- without bias or favour for some members over others; and,
- in the context of appropriate knowledge, which might need to be acquired by the Board of Trustees²⁷ but which should also be free of bias or favour and subject to the same fiduciary standards.

Anecdotal evidence suggests that a number of trustees in South Africa are not aware of the seriousness of their responsibility to their members.²⁸ It would appear that not all trustees fully appreciate that

- they hold in their hands the financial interests of many people who have entrusted significant financial resources into their care;
- the decisions that they take always need to be taken with the utmost integrity and care;
- all advice received must be subject to the same set of standards, since the trustees take full responsibility for the outcome of such advice; and that
- legal provisions allow for very serious actions to be taken against them.

Oversight function vs operational responsibility

Some take the view that the primary responsibility of the trustee is to ensure that the operations of the fund run smoothly. Compliance with the rules is paramount in this thinking and priorities are the proper execution of administration, reasonable attention to the selection of service providers and diligent attendance at all meetings.²⁹

There should be appropriate controls in place to ensure that all persons or entities with operational and oversight responsibilities act in accordance with the objectives set out in the pension entity's by-laws, statutes, contract, or trust instrument, or in documents associated with any of these, and that they comply with the law. Such controls should cover all basic

²⁷ The trustees, collectively, are not all expected to have sufficient knowledge for all circumstances.

²⁸ PWC reports, for example, that 61 per cent of South African retirement funds have either not considered establishing a governance policy or had discussed priorities but not formalised them. Some 81 per cent of boards have not evaluated their own effectiveness or developed a mechanism to do so (PWC, 2007).

²⁹ The administrator takes responsibility for operational aspects of the fund, leaving the principal officer then takes responsibility for ensuring that the fund complies with legislation and that the instructions of the board of trustees are properly acted upon by service providers.

organisational and administrative procedures; depending upon the scale and complexity of the plan, these controls will include performance assessment, compensation mechanisms, information systems and processes, and risk management procedures. (OECD governance guidelines, 2005: 16)³⁰

However, trustees have a much deeper responsibility than this. They should properly delegate operational responsibility to the administrator of the fund so that they can focus their attention on more subtle and profound issues that affect the fundamentals of the financial interests of members.

*Fundamental to the governance of a fund is the extent of the **accountability** of the board and the principal officer. The principal officer is appointed by and **accountable** to the board, and the board is **accountable** to the members and beneficiaries and the Registrar for its governance of the fund. (Financial Services Board, 2007b, paragraph 6, emphasis in original)*

Trustees need to see themselves not as executives of a retirement fund, but as its directors, asking questions like:

- Is the process of selecting service providers rigorous and sound, free of self-interest at all times?
- Are service providers acting in the best interests of the members of the fund and are there ways in which to enhance this preferred alignment?
- Are the fees paid appropriate reward for services rendered?
- Are trustees at all times applying their minds to all decisions taken, or are they sometimes too dependent on professional advisors?

Skill levels and confidence of decision-making

Trustees have the right and responsibility to bring in professional help to assist with decisions in areas in which they believe they do not have the necessary skill. But the key here is the word 'assist'. Trustees cannot and must not delegate responsibility to a third party, because the consequences for trustee decisions cannot also be delegated. Trustees must actively take every decision, especially when supported by professional advice.

"We acknowledge as trustees that we do not have all the skills necessary for the proper administration of the fund and undertake to seek expert advice, which we will interrogate and test, in order to ensure that the benefits of the fund are optimal and the risks associated with that minimal." (Financial Services Board, 2007b, Annexure A, draft code of conduct, paragraph 14)

Trustees must also make every effort to improve their skill set, reducing the extent to which they are dependent on external support for decisions. Obtaining training from

³⁰ The OECD states in the same document: "Objective performance measures should be established for all the persons and entities involved in the administration of the pension fund." (OECD, 2005: 16)

independent sources should be a continuous part of trustee activity. The costs of such training should be borne by the fund, since it is in member interests that trustees equip themselves to execute their responsibilities with greater skill and confidence.

Independence & conflicts of interest

One of the most difficult issues for trustees to be aware of, continually, is the issue of conflict of interest. This is not a difficult area to define. It occurs when a party that has influence over or responsibility for some of the activities of the fund has financial interests that are out of line with those of the fund itself. Trustees need to ensure that they themselves are not subject to conflicts of interest,³¹ but they should also make every effort to avoid or address the potential for conflicts of interest that affect the integrity of the services offered by their providers.

"We undertake to ensure, as far as possible, that our service providers avoid or remove any conflicts of interest." (Financial Services Board, 2007b, Annexure A, draft code of conduct, paragraph 13)

Service provider and adviser fees should be explicit, expressed in rand terms, and should demonstrate either a clear alignment of interests with those of the fund and its members, or should be a pure fee-for-service basis. All providers of service should be prepared to disclose all of their revenue-generating activities to demonstrate that there is no conflict between any of these activities and the service proposed to the fund.

Trustees must also be independent. This is not the same as avoiding a conflict of interest. Independence, for example, requires sufficient knowledge to avoid the possibility of being unduly influenced by service providers in the process of making decisions.³²

*Members of the board should demonstrate their independence. Such independence is essential also for the credibility of the governance arrangements, and is demonstrated by any discretion of the board being exercised in a manner which is **impartial, fully informed and not influenced by inappropriate considerations**. (Financial Services Board, 2007b:6, emphasis added)*

Ethical business practice

Clearly, the trustees have a responsibility towards the fund and its members. Providers of service also have a responsibility expressed, at the very least, as a duty of care.

³¹ *"The fiduciary duty owed by the board and the principal officer requires that they **avoid conflicts of interest**." (Financial Services Board, 2007b:5, emphasis in original). PF130 goes on to describe in some detail how trustees are to identify and address conflicts of interest, including a full recording of any conflict of interest situation in the board minutes.*

³² *Such independence requires high quality training, itself independent of any other interests, which is discussed in more detail in section 2 of this paper.*

All service providers should consider the nature and implications of this duty, considering whether:

- parts of their business may suffer conflicts of interest that compromise this duty,
- the fee model that they use is consistent with this duty, aligning the interests of provider and customer,
- they report responsibly and transparently all facts that may be material to their customers, and whether
- packaged products and services are in the best interests of their customers³³ and consistent with this duty.

Millions of South Africans depend on occupational retirement funds to provide financial security in retirement. Trustees have an enormous responsibility to do everything in their power to see that the security of retirement savings is safeguarded.

Providers of service have a duty of good care to retirement funds and their members and should consider carefully whether their actions are consistent with this duty.

Box 1

Insufficient accountability?

Jonathan Mort, a leading pensions lawyer and recognised as an authority on the governance of pension funds – he was the primary drafter of PF 130 – advises me that there is some uncertainty in South African law as to whether trustees owe or do not owe a fiduciary duty to the fund members.

Apparently there is case law to the effect that trustees owe a fiduciary duty to both the fund and its members; but that some lawyers do not consider this to be correct because trustees should owe a fiduciary duty only to the fund in the same way that directors owe a fiduciary duty to their company and not the shareholders.

According to Jonathan, this debate about to whom trustees owe a fiduciary duty begs the far more profound and important issue of the accountability of trustees to members. In his view trustees should be accountable to the members generally for the governance of the fund, and not only in respect of accrued retirement savings. The reason for this is that it is the members who have the primary financial interest in the fund, even if such a fund may be a defined benefit fund with a balance of cost obligation owed by the employer.

He adds that to emphasize that trustees owe a fiduciary duty to the fund only is to perpetuate a mindset that does not acknowledge, at least sufficiently, such an accountability to the fund membership. Jonathan says further that it is the failure of trustees to acknowledge this accountability to the fund membership, and similarly to require an appropriate accountability of the service providers

³³ 'Under one roof' is a benign expression when applied to the concept of a warehouse selling a wide range of goods at a single convenient location. It should not be transferred to service offerings without consideration of its consequences. When retailers develop scale and reduce price to attract customers, they do not also aggregate products. They make it easier for customers to fill their shopping basket, but leave with them the freedom to purchase what they wish to. In financial services, 'under one roof' may provide value for money – that is certainly the argument of the providers – but it is often difficult for customers to terminate part of the offering without impairing the delivery of the others. Bundled pricing also makes it more difficult to determine whether the offering is cheaper.

to pension funds, which is at the heart of much of the inadequate governance of pension funds by trustees and service providers.

The article below illustrates some of Jonathan's thinking on the issue.

"Improving your trustees", Jonathan Mort

There can be no doubt that with the greater emphasis today on the proper governance of retirement funds, the spotlight is being increasingly focused on the duties and responsibilities of trustees. This must be good for retirement funds because the ultimate responsibility for the proper governance of retirement funds lies with the trustees.

I wish to raise two fundamental problems with the current thinking around retirement fund trustees. The first problem is the composition of the board of trustees, and the second is the accountability of trustees. In raising these problems I wish also to make some proposals that may be controversial.

In respect of the first issue, the way trustees are appointed could probably not be worse. Trustees are responsible for the management of vast amounts of money in a highly complex and difficult legal, actuarial, investment and regulatory environment. Yet the trustees appointed fulfil their function on a part time basis, usually for no reward or, if there is reward (even for those independent trustees remunerated mostly on an hourly basis) this bears no relationship to the extent of their responsibility, expertise and the personal risk they carry in fulfilling that function.

In occupational retirement funds the trustee boards are usually comprised of half being appointed by the employer, and the other half elected by members.

Typically the employer-appointed trustees are more financially astute than the member-elected trustees; but the employer-appointed trustees are usually caught in a structural conflict of interest where the fiduciary duty owed as trustee may, and often does, conflict with the fiduciary duty owed as employee.

This is compounded by the fact that usually the employer-appointed trustees are senior persons in the employer, often with some degree of decision making within the employer in relation to the fund, such as a financial director or HR director. And when there's a conflict between the interests of the employer and the fund, these trustees will find it very difficult to exercise, as they should, an independent discretion as to what's appropriate for the fund and its members. This would typically be found in issues such as the pension increase policy in a defined benefit fund, or where the employer wishes to terminate its participation in the fund.

As for member-elected trustees, the arrangement of employer-appointed trustees and member-elected trustees can make it difficult for those member-elected trustees in the service of the employer to be seen to be exercising their discretion which is correctly in the interests of the fund and the members but to the disadvantage of the employer.

This may limit their career prospects. And such member-elected trustees are also not free of the structural conflict of interest issue since, if the issue to be decided is one that preferred the members over the employer, it may be difficult for such trustees to consider fairly the interests of the employer. This applies especially to pensioner-elected trustees.

The different constituents appointing or electing trustees also gives rise to a common misconception by trustees that they are more accountable, even to the extent of releasing confidential information of the fund to the entity or body of persons that appointed or elected them as trustees. This failing is also found in sponsor-appointed trustees of retail retirement funds (RAs, preservation funds and umbrella funds). The truth is that each trustee owes the same duty to the fund and its members irrespective of how he or she was appointed or elected.

To make matters worse, the highly complex and difficult legal, actuarial and investment issues facing all trustees makes them inordinately dependant on the fund's professional advisers. It is, of course, entirely appropriate that trustees seek professional advice on the issues that face a fund; but there are few trustees (with the exception of most independent trustees) who are able to exercise an independent view of the actual advice received from such advisers.

It goes without saying that advice from such advisers may (and the history of administering retirement funds in South Africa is littered with examples) very often be in the interests of that adviser or his or her firm rather than the fund or its members. One has only to look at the advice sometimes given on the transfer of pensioner liabilities to an insurer to see that such a proposal may well be motivated more by the prospect of a lucrative commission than whether it is in the interests of the pensioners.

Is there a solution to this? In my view the only need for an employer to take an interest in a fund is to ensure that the governance of that fund is correct. In an occupational fund, I would prefer it if an employer had limited representation on the board of trustees; say no more than a third of the trustees. And such employer appointed trustees should not be persons who may in their capacity as employees be in a position to take decisions in relation to the fund, so no financial director or HR director.

Also, I would suggest that every fund should have an independent trustee, unless it is able to satisfy the Registrar that the skills on the board of trustees are sufficient to enable that board to be able to exercise an independent discretion.

This will add to the cost of administering funds, but a good independent trustee would add considerably more value than his/her cost.

The second problem relating to trustees is their accountability. By law retirement funds are not obliged to have an annual general meeting where members can pose questions to the trustees; and many retirement funds, particularly the retail funds, are reticent about the names of the trustees and instead promote the sponsor. The primary relationship should always be between the fund and its members.

The employer may facilitate that relationship, and so might the sponsor or administrator, but members should always know they have a line of communication directly to the trustees via the principal officer. This remoteness of trustees makes it difficult for members to feel that they can hold the trustees accountable. Equally, trustees do not feel accountable in consequence. What also aggravates this situation is confusion about exactly to whom trustees are accountable.

There is a view, to which I do not subscribe, that the trustees' primary obligation is to the fund. However, the primary purpose of the fund is to provide benefits to members.

So I believe the primary duty of trustees should be to protect members' interests.

As part of this, trustees should ensure that the solvency of the fund is preserved, but it is the members first. This confusion that exists about the primary duty of members adds only to the lack of accountability, at least in the minds of trustees, to their members. And it's the sense of accountability that must be promoted, because accountability is at the core of proper governance of any institution.

It's this accountability that'll ensure that the trust that needs to be engendered in retirement fund arrangements can be preserved and enhanced.

Published in *Collective Insights*, a Finance Week supplement, Winter 2007, p21-22

1

ACTIVE VS INDEX-LINKED SKEWED REPRESENTATION?

In which the distinction between active management and its index-linked alternative is described and it is asked why so little retirement fund equity assets are allocated towards index-linked investments.

Since markets have existed we have asked whether it is possible to outperform, with consistency, the average. More has probably been written on this question than on any other in financial markets literature.

Those in favour believe that an inefficient market – most agree that all markets are, to some extent, inefficient – must provide opportunities for outperformance and that some market players are able to exploit them with consistency.

Those against argue that, even if markets are broadly inefficient, it is not possible for any market players to sustain an advantage over their competitors sufficient to produce consistent performance and that apparent outperformance is often attributable to luck – random movements in an enormously complex set of factors – rather than skill. To this they add the reminder that it is not sufficient merely to obtain excess returns, but that outperformance needs to exceed the additional fees charged by these managers. Success, in other words, must benefit the asset owner, not just the manager.¹

Why is the issue important? The answer to this question is simple, its ramifications complex. The very existence of most investment managers depends on their continued ability to project themselves as better (1) than their peers, and (2) than the market as a whole. Nearly all asset managers fall into this category, certainly to a man and woman

¹ The discussion is limited to equity assets, acknowledging that, while index-tracking is not simple for this class of assets, it is considerably more complex for others, like debt securities.

those who are committed to trading securities in an effort to outperform the market. More than that, they believe that they have the skill to do so and honestly expect to.²

We find ourselves in an interesting situation, perverse even, because...

*... A man is incapable of comprehending any argument that interferes with his revenue.
(Descartes, quoted in Bogle, 2005a:144)*

Now if it were only the asset managers – those who firmly believe themselves able to pick winning stocks – whose interests were best served by perpetuating the confidence in stock-picking, we might not have a problem. But other parties, who should be concerned solely with the best interest of the client, appear also to have a strong motivation to cultivate the faith in active management.

This section does not attempt to answer the question of whether it is possible for an investment manager consistently to outperform an unbiased benchmark, after charges. It asks why, in the absence of clear evidence that this outperformance is possible, so little institutional investment money is directed to cheaper index-linked alternatives.

Active management versus index-tracking in a nutshell

Most asset managers in this country do more than look after the assets of their clients. They are granted the mandate, usually with limitations, to seek to improve the financial return on the assets, by buying and selling securities. They seek to use their information and skill to buy low and sell high, aiming to outperform their peers and the market average. These are *active managers*, distinguishing them from the *index-trackers* or *index-linked managers* discussed below.

It is credible that market experts have access to better-than-average sources of information and have developed better-than-average skills at interpreting this information. It is therefore tempting to believe that these experts are best able to turn these advantages into better-than-average performance.

The problem, the counter-argument runs, is that the market is dominated by experts, managing large volumes of institutional investments, with only a very small proportion of trade attributable to amateurs. It is simply not possible for all of them to consistently buy low and sell high because every trade has two parties, one buying and the other selling. Consequently, on average, active managers achieve performance no better than that of

² *"Individuals systematically overestimate their own individual ability: even professionals who believe in the efficient markets hypothesis also believe that they will (uniquely) be able to beat the market."* (Cannon & Tonks, 2006:106).

the average for the whole market. Furthermore, since active management is not a zero-cost activity, on average after costs, active managers must under-perform the market.^{3, 4}

How do active managers survive? The investing public and their institutional counterparts believe that some of them do outperform the market, that they can do so with consistency and that they can be identified with reliability. Systematic evidence to the contrary is very difficult to put together and the sheer weight of marketing material and carefully presented data⁵ leaves customers convinced that there must be some merit in selecting an active manager.

The alternative to an active manager is an index-tracker, a company that does not attempt to buy low and sell high but puts its resources into investing assets into a mix that, as closely as possible, matches the corresponding mix of the securities exchange index. These products are cheaper than their active management counterparts because they do not require the investment in information and skill. And they are expected to produce performance that, while sacrificing the potential for a strong upside, at least also avoids the corresponding potential for a nasty surprise on the downside.

It is technically not possible to track an index with perfection, so there is always the possibility of some loss or gain relative to the index, but, by and large, at a much lower fee, customers get what they aimed for, the index.⁶

According to most international, independent, sources ... two factors have fuelled the recent growth in passive management.⁷ Firstly, mounting research is showing the dramatic impact

³ The evidence for this statement is mixed. Richard Grinold & Ronald Kahn elaborate: "The initial studies of mutual funds showed that the average manager underperformed the benchmark, in proportion to fund expenses, and that performance did not persist from period to period. Some recent studies have shown that the average manager matches the benchmark net of fees, that top managers do have statistically significant skill, and that positive performance may persist. Other studies have found no evidence for persistence of performance." (Grinold & Kahn, 2000:481)

⁴ I have heard the argument that the South African market has local and international investors, with different objectives, both of which groups could outperform their benchmarks because they could, where the objectives do not overlap, profitably trade with one another. I think we would find the opportunity for consistent outperformance to be very small as the overlap in benchmarks is very large.

⁵ Though data is sometimes presented selectively, it often doesn't need to be, since a number of managers can be expected to outperform a market-average benchmark at least some of the time, even if their stock-selection is merely random.

⁶ This description would be incomplete without the acknowledgement that there are a number of investment products that are neither index-trackers nor traditionally active in nature. The so-called absolute return product is designed to produce the best of both worlds, an upside in line with the markets with protection against the potential for very poor performance. These products differ from the traditional active management alternatives, however, in that they seldom aim to beat a market-related benchmark, but an inflation-linked alternative. Refer to the appendix for two articles commenting on this investment form and to section 4 on some of the concerns around the fee models used under these products.

compounding fees and costs have on long-term performance. Secondly, the claim by every active fund manager that they have ... outperformed or have above-average performance in what is clearly a zero-sum game has tarnished their reputation. It is the second reason, more so than the first, that is most damaging. As William Sharp convincingly proves in his paper "The Arithmetic of Active Management", if the majority of active fund managers consistently outperform, there must be a group of equal size that consistently underperform (sic) yet nobody can identify this mysterious losing group. (Rousseau & Tayob, 2006:33, paragraph breaks removed)

Note that the central thesis of this section is not that outperformance due to active management is impossible or even that it is not possible on a sustained basis by some managers. In fact, there is emerging evidence that South Africa provides better opportunities than most countries for active management outperformance (see later).

Nevertheless, to state the obvious, active management outperformance is simply not possible by all managers over any time span, unless by fabrication or distortion. After fees, the average of all active managers is very likely to trail or lag behind the average index-tracker, even allowing for imperfect tracking and greater-than-zero costs on the part of the latter. The core of the message here is that the safer and cheaper alternative, unexciting as it may be, is under-represented in the marketing of managers and advice of consultants, and under-utilised by the trustees who must always consider the best interests of their members.

Why does the story sell?

If active management is a zero-sum game, before charges, how could it possibly be that so many believe that it provides a legitimate approach to the investment of equity assets, more likely to lead to success than failure?

Nicholas Taleb's brilliant description of systematic error in the assessment of probability, *Fooled by Randomness* (Taleb, 2007a)⁸ sets out a number of possibilities. These are flaws common to all of us, including the investment expert.

- **Causality.** We are strongly prone to connect events erroneously, rather than acknowledge that there may be no link between them. In other words, we claim causality where none exists. Journalists do this all the time. Every movement in the markets is accompanied by a reason, frequently without acknowledgement that there

⁷ This is another term for index-linking. Such growth has not been seen in South Africa except in isolated pockets. A few pension funds – very few – have a clear commitment to investing more than a trivial proportion of their assets in index-tracking instruments.

⁸ If you enjoy it, I recommend his follow up, *The Black Swan* (Taleb, 2007b) that makes it clear that we cannot understand a system until we understand the extreme events that it can and does – but only rarely – produce. The discussion in this section is drawn from both of these books.

may be another, or that cause is simply unknown.⁹ The sheer volume of information makes it difficult to postpone an attempt to link individual items or to acknowledge that such connections are not possible in the midst of the complexity.¹⁰

- **Conjectures.** Despite the modern view that truth has no absolute, we are inundated with conjectures posing as truth. This has become so much a part of modern life that we lose the ability or willingness to criticise these conjectures. It is not surprising that, in the enormous complexity of relationships that constitute the financial markets, the same takes place there. In our mental effort to understand, we develop models – heuristics – that attempt to link everything and frequently build erroneous relationships.
- **Induction.** Flowing from the error of causality – Taleb describes us as hard-wired to find links – we build patterns that don't exist. A caused B last time, so A will cause B again.

What is induction? Induction is going from plenty of particulars to the general. It is very handy, as the general takes much less room in one's memory than a collection of particulars. The effect of such compression is the reduction in the degree of detected randomness. (Taleb, 2007a: 130)

- **Inference** is a variation on induction. Given our tendency to build causality and induce a future based on insufficient evidence of a system in the past, it is perhaps not surprising that we are prone to errors of inference, making predictions based on very weak data.¹¹ The past is deterministic – there is only one outcome in evidence – the

⁹ Taleb cites the following "Dow up 1.03 on lower interest rates" on his Bloomberg screen and goes on to point out that such a movement, 0.01% of value, does not need an explanation, certainly not one as straightforward as this one. "Perfect noise", Taleb calls it (2007a: 214), part of the randomness around us all the time.

¹⁰ "We believe especially in near-term causes: a snake bites your friend, he screams with pain, and he dies. The snakebite, you conclude, must have killed him. Most of the time, such reckoning is correct. But when it comes to cause and effect there is often a trap in such open-and-shut thinking. We smirk now when we think of ancient cultures that embraced faulty cause – the warriors who believed, for instance, that it was their raping of a virgin that brought them victory on the battlefield. But we too embrace faulty causes, **usually at the urging of an expert proclaiming a truth in which he has a vested interest.**" (Levitt & Dubner, 2006: 128, emphasis mine)

¹¹ If an infinite number of monkeys were to type away – I borrow again from a Taleb illustration – we can be sure that one of them would produce Homer's Iliad. Now, what are the odds of the same monkey going on to type out the Odyssey, follow-on opus of the same author? The point is this: past performance in an environment of randomness has no bearing on future. The key is to understand what determines the performance rather than falling into the trap of making inferences on the performance alone.

future is not.¹² To this we add the tendency to attribute successes to skills, but failures to randomness.¹³

- **We do not have all of the evidence.** Today's portfolios, and their associated performance information, are but a sub-set of those that existed in the past. Survivorship bias is discussed more narrowly in the section that follows, but we should be aware that it distorts all of our thinking.¹⁴ Any complete study of track records must consider the records of those who perished along the way, not just those who succeeded.

These are just a few examples of the demonstrated set of biases that affect behaviour.¹⁵ They help us to build some understanding of our emotional belief that we would do better to entrust our wealth to an expert with a good track record rather than take the market average. Startlingly, research shows that the expert is even more prone to such biases than we are. He or she is just as exposed to emotion as we are, but has everything riding on their success. We should not be surprised that causality and induction, leading frequently to errors, strongly characterise all those who have much to gain from a continuation of existing beliefs.

"Nothing is easier than self-deceit. For what each man wishes, that he also believes to be true."
(Demosthenes, quoted in Bogle, 2005a: 144)

Taleb puts all of these flaws together in simple argument that surely rings true with all fiduciaries. He describes two Wall Street traders who, following a period of remarkable success, bankrupted themselves and lost their jobs on the back of their overconfidence.¹⁶

¹² Since there is so much data available, it is easy to find the evidence that matches the theory, particularly in the markets... "...successions of anecdotes selected to fit a story do not constitute evidence. Anyone looking for confirmation will find enough of it to deceive himself..." (Taleb, 2007b, xxvii)

¹³ Refer to Taleb (2007a:243). Unfortunately, this affects experts particularly badly. Taleb continues: "We have known about this wedge between performance and self-assessment since 1954, with Meehl's study of experts comparing their perceived abilities to their statistical ones. It shows a substantial discrepancy between the objective record of people's success in prediction tasks and the sincere beliefs of these people about the quality of their performance." (Taleb, 2007a:244)

¹⁴ Do not read a book describing the attributes of successful millionaires if it does not also consider the corresponding attributes of those who set out to succeed but failed. Perhaps the honest writer would find that many of these attributes exist among the failures as well, suggesting that luck plays a greater part than otherwise acknowledged.

¹⁵ There are more. We feel the pain of failure more than we appreciate the euphoria of success, for example.

¹⁶ He lists some of their failures, overestimating the accuracy of their beliefs in some measure, a tendency to wed themselves to their investment positions, no predetermined game plan in the event of losses, an absence of critical thinking, and, when things went awry, denial. These should provide some interesting questions for trustees to pose to their asset managers.

He closes his narrative as follows:

*How could traders who made every single mistake in the book become so successful? Because of a simple principle concerning randomness... we tend to think that traders were successful **because** they are good. Perhaps we have turned causality on its head; we consider them good just because they make money. One can make money in the financial markets totally out of randomness. (Taleb, 2007a: 93)*

This discussion summarises some of the flaws in the thinking of all of those who have an interest in the markets. The next section focuses a little more narrowly on the issue of active management versus index-tracking.

Some more of the complicating issues

Three important issues are worth addressing because they have an impact on how trustees' decisions between active management and index-tracking. The first tends to favour active management, the second index-tracking and the third shows that, while there is opportunity for active outperformance, managers could do better to capture it.

- **Emerging markets.** Proponents of the market inefficiency theory for South Africa, generally those of the view that active management can produce sustained outperformance, point to the evidence that smaller markets are more likely to have information inefficiencies than their larger counterparts. This rests on the assumption that fewer players results in a less efficient dissemination of information, allowing those who hold such information longer to execute profitable trades as a result.

The counter-argument to this is that inefficiency should be reducing over time as information is more rapidly transmitted, through advances in technology, and that the concomitant opportunity for consistent outperformance should be correspondingly reducing. The jury is out.

- **Survivorship bias.** Investment funds sometimes close. It should not surprise us that funds more likely to close are those with poor investment performance. This is very important, because it means that analysis of the performance of today's funds is prone to overstatement of average active manager performance unless it allows for those funds that are no longer part of the dataset.

Pawley (2002) shows that nearly half of all unit trust funds did not survive a period of 20 years, over the study period 1976-2001. If nearly half of the funds are closed, by how much is the performance of the surviving funds an upwardly biased estimate of the true average performance of all of the funds? A later study (Pawley, undated) estimates the impact on reported annual performance, over 20-year measurement periods, as 1.05%.¹⁷

¹⁷ Some might suggest that such bias is unlikely to affect the market for institutional investments. I would treat such a position with skepticism. Firstly, there is little reason to expect the institutional

Hogan (2005) demonstrates the impact of survivorship bias on the published performance data of United States mutual funds.¹⁸ He shows the upward bias in 5-year performance figures at the end of 2004 attributable to the removal of poor performers from the sample. Calculated separately for different types of funds, his figures range from 0.41% for small cap growth to 1.83% for large cap value portfolios. These are annual return errors, easily sufficient to present the appearance of success where it may not exist.

Survivorship bias is not just an important academic consideration. Fund managers presenting the performance of their portfolios, even if they include all of them, are likely to omit the performance of those no longer in existence.¹⁹

- **Alpha capture efficiency.** Peregrine Securities analysis (Polakow & De Araújo, 2005) reveals that the performance of around two-thirds of all domestic equity general unit trusts demonstrates no more than randomness and only one-third demonstrates skill (see summary in box 2). The authors of that paper suggest that this is not due so much to the absence of skill at the valuation stage, but rather the absence of clean and efficient transfer of analyst findings and judgments into active weights in the portfolios. They further note that this lack of transfer is often less a fault of the managers and more a consequence of regulatory constraints.

Box 2

Translating analysis into performance

In a research report (Polakow and De Araujo, 2005) focussing on the degree to which active fund managers in South Africa exhibit skill at stock-picking (or the lack thereof), Peregrine Securities transposed the problem from one of skill versus non-skill (or flair versus fluke) into a neat and coherent approach of using a simple statistical interpretation: non-randomness and randomness.

Empirical returns on a liquid universe of common domestically traded stocks were used, together with the typical regulatory constraints and risk-mandates that long-only fund-managers are faced with in

investment portfolios of a particular asset management house to systematically outperform the corresponding retail portfolios. Why would the manager give up retail performance to achieve this? Secondly, since portfolios are routinely constructed specifically for institutional clients, there is less standardization of portfolios in the institutional space than in the retail space and more opportunity for this type of distortion in aggregate data.

¹⁸ He shows the difference between the median performance of managers for each calendar year from 1999 to 2004 **for those portfolios in existence at the end of that year** and the corresponding median performance for each calendar year **for those portfolios in existence at the end of the period of analysis**. The difference is important because performance histories cover a period of years and include only those portfolios present throughout the period. For example, large cap value funds included in the Lipper survey and in existence at the end of 2000 returned 1.1% for that year, but many of them closed in the next few years, so the year 2000 median performance for funds still in existence at the end of 2004 was reported as 7.9%.

¹⁹ The portfolio need not necessarily have been closed. It could have been absorbed by a more successful counterpart. In this instance, the history of poor performance might be permitted to disappear because the portfolio no longer exists.

South Africa, with one important difference: the stocks are picked entirely at random. Fees are charged at typical values.

For defined mandates, the simulation delimits (for a specific reference period of history) a 'frontier-of-no-skill', above which defines 'non-random' stock picking and below which signifies noise (or essentially 'random' stock picking ability).

A history from a broad universe of general-equity funds trading the same universe are then overlaid with the finding that some two thirds of actively-managed funds (after costs) exhibit noise and only one third exhibit non-randomness. These findings for the South African general-equity portfolios closely resemble the findings from similar international studies.

It is important to note that Polakow and De Araujo's intentions were not to name-and-shame, but rather to understand any fundamental differences between what characterises actual funds above and below the frontier.

The results are insightful and point to the benefits of i) covering relatively fewer stocks better and ii) having a more rigorous process whereby views are better translated into active bets. The authors infer that far more of the same funds would move into the 'non-random' realm if investment process(es) facilitated a stronger correspondence between analyst calls and the active views that are implemented in such portfolios. By placing more overt bets into portfolios, the ability to garner alpha from one's skill-set are enhanced and the facility for closet-tracking (or hiding beneath the radar) are substantially reduced.

More recent research (Polakow *et al*, 2007) suggests that the degree of market outperformance opportunity in South Africa, as measured by the dispersion in returns of equity stocks, or cross-sectional volatility, is actually higher than in the developed world, and exceeds the corresponding outperformance opportunity of other emerging markets on average.²⁰

Active management is a complex process. This example shows that it is more than analysing the options and making the right calls: these need to be translated efficiency into trading decisions.

The bottom line on active versus index-tracking is that

- active management is almost always more expensive,
- active market participants cannot, on average, outperform their passive counterparts, so success depends not only on choosing active management but on choosing the right manager or managers, and
- active managers have a strong incentive to demonstrate the value that they provide to customers, and may do so in a manner that is not completely transparent.

In addition to all of the arguments put forward so far, some hold to the view that large actively-managed investment funds are constrained by their size, because their trades are so substantial that the price tends to move against them during the course of execution.

²⁰ Please note the point that this is making. The research is not claiming that, on average, active manager performance could exceed that of the market. This is not possible. It is suggesting that the opportunity for individual managers to return performance that exceeds the market is better than in many other markets.

This suggests that such managers must hold a proportion of their assets in index-linked classes and attempt to gain outperformance using the balance of their assets. This view appears to be supported by the majority of South Africa's asset management community, judging by the move towards breaking large houses into boutiques, but it is not translated into a larger holding in passive asset classes, or, if it does, this is not disclosed.

Active management prevalence: the business case

Despite a theoretically compelling rationale, index-tracking forms a very small part of the South African institutional investments market. Industry players estimate total assets in privately managed index trackers, including the Satrix exchange-traded fund²¹ at around R40bn, ignoring any GEPP assets in similar vehicles. This is a very tiny proportion of total pension fund assets.²² At the very least, we would expect rational trustees to recognize that this is probably not an either-or decision and to consider allocating not all of the assets of the fund, but at least a significant proportion, to index-tracking alternatives.

Global best practice currently seems in agreement that an allocation to both active and passive investments provides opportunity for both outperformance... and cheap market or benchmark exposure... resulting in higher satisfaction than a full exposure to either passive or active investments. (Rousseau 2007:4)

If the theoretical argument in favour of active management, particularly after costs are taken into account, is tenuous, why is this approach so strongly supported by retirement fund trustees? The answers appear to be self-evident:

- **Asset managers** operate on higher profit margins from active management than from index-linked management,²³ so have a very strong preference for active mandates over their passive counterparts. This alone would not be sufficient to sustain the predominance of active management, since other parties would balance this incentive,

²¹ This is an index-tracking fund that, for contractual reasons linked to the reason for its existence, must match the index with higher levels of precision than is commonly achieved by its competitors. It has struggled to attract institutional assets despite its reliable performance and very low charges.

²² Feedback from trustees at the October 2007 seminar of the South African Pension Fund Investment Forum (SAPFIF, part of the Europe-based network, EPFIF, www.epfif.com) suggested that the incidence of index-tracking is probably higher than this. The commentator continued that passive management is often carried out by active managers with charges closer to the rates common for active management.

²³ "The continuing trend among pension funds towards separating index-tracking from absolute returns is a challenge for some active managers, the UK's Investment Management Association (IMA) found. ... 'You have a whole slug of assets that goes to indexation, and the part that goes to active management has shrunk,' an asset manager commented in the IMA's 2006 Asset Manager survey. 'Everyone says that the fees are a bit higher, but if your assets under management have gone down, it's not a great help. What we are seeing is a collapse of the institutional fee cake.'" (Investment & Pensions Europe, 1 August 2007, www.ipe.com)

so we need to look a little further into the dynamics of the institutional investments environment.²⁴

- **Multi-managers** have a strong incentive to sustain the view that active management yields positive after-fees returns, that successful managers can be identified in advance, and that the skill required to do so deserves significant remuneration. A higher market allocation to index-linked alternatives translates directly into reduced fees to multi-managers.
- **Brokers and other investment professionals** have a strong interest in prolonging the view that active management generates higher performance. The so-called *deal flow*, primary source of income for these market traders, depends on a high level of confidence in active management.²⁵
- **Investment consultants** also have a vested interest in the position that active management has a high probability of producing better results. This belief sustains a significant proportion of their business, since manager selection is an important part of their work. The investment consultant who subscribes to Rousseau's view that just under one-third of the assets of a portfolio should be index-tracking vehicles²⁶ may earn just as much revenue as under the current scenario in which all assets are held in actively-managed portfolios, but it would probably be hard to convince the trustees that the fees are justified.²⁷
- **Trustees** ultimately sustain the existing allocation to actively managed portfolios, despite the uncertainty that this is the optimal approach. During a time in which the global trend is to allocate less to active strategies and more to index-linking, the large majority of South African retirement funds seem to be standing still, retaining a tiny proportion of total assets in index-linked strategies.

Perhaps the most instructive statistic illuminating this puzzle is the Satrix exchange-traded funds have succeeded in attracting some money from the retail sector, but virtually nothing from the institutional investments sector. This suggests a systematic resistance to index-tracking investments that has more to do with the trustees and the investment consultants than the asset managers and brokers. It would seem that individuals, given

²⁴ *I would argue that the preference for active mandates among asset managers is not just a pragmatic position. Active managers must believe that they are able to generate consistent outperformance: this belief allows them to sleep better at night! "It's amazing how difficult it is for a man to understand something if he's paid a small fortune not to understand it." (Upton Sinclair, quoted in Bogle, 2005b:22)*

²⁵ *As is pointed out in section 8, this belief does not produce optimal results. A significant proportion of trading ordered by asset managers and executed by brokers is wasteful.*

²⁶ *"Our own research in recently quantitative reports shows that all investors (including active investors) should have about 30% of their money in passive, low-cost investments to maximise their opportunity/cost ratio with a $\pm 4\%$ tracking error." (Rousseau & Tayob, 2006:33)*

²⁷ *More is written on the commitment of consultants to industry improvement in section 3 and on consultant fee models in section 4.*

the freedom to choose – trustees and investment consultants are not present in the retail space – allocate a greater proportion of their assets to index-linked funds than do pension funds.

Concluding thoughts: what should trustees be doing?

It is not for me to call for a higher allocation to index-tracking investments. Perhaps there are reasons to believe that some managers systematically and consistently outperform the market, after fees, after adjusting for survivorship bias and any other forms of possible misrepresentation of information, and that it is possible to identify them.

But when it comes to the active-passive debate, it seems that trustees are putting all of the eggs into one basket and hoping that it works. They should seek instead to

- understand the nature of the trustee responsibility and consider carefully whether the assets of members should all be committed to the belief that good active managers can be accurately selected;
- understand the vested interests of all parties involved in the fund, asking whether these interests may be clouding their judgment;
- understand the costs of active management and weigh them up against the likelihood of outperformance and the corresponding costs of index-linked alternatives;
- consider the reports of asset managers, and the intermediaries, with appropriate care and ensure that they do not present information selectively, asking them, for example, about the treatment of closed portfolios and whether all numbers are compliant with GIPS and, if not, why not;²⁸ and,
- require better analysis of performance figures from asset managers and consultants. A good rule of thumb is *if it looks too good to be true it probably is*.

Analysis of performance is important.²⁹ Both asset managers and investment consultants should provide a clear attribution of performance between the so-called *stock* and *style* impacts, showing precisely how much of the apparently miraculous outperformance is attributable to the allocation to resource counters, for example, and how much, positive or negative, to successful stock selection. Trustees should ensure that they understand this analysis, requesting reports to be redrafted if they are not written in a way that is sufficiently clear to them.

²⁸ These are Global Investment Performance Standards, ethical and professional standards for the presentation of investment information and advice.

²⁹ A high proportion of annual outperformance figures in recent years can be attributed to systematic differences between the portfolio allocation of asset managers and the corresponding allocation of the indices, often due to a substantial over- or under-allocation to resources stocks. The somewhat arbitrary construction of benchmark indices over the last decade or so is discussed in more detail in section 3.

Decent, intelligent, unbiased analysis, breaking down the portfolio into its component parts and providing a complete picture of historical manager performance, should be the minimum expectation of trustees.

Final word to an asset manager:

Remember that most new funds are launched to give the marketers something to sell. Your long-term needs as the investor do not feature highly in that whole process. If you struggle to understand what your fund manager does, a low-cost indexation strategy makes a lot of sense. (Peter Foster, Regarding Capital Management, Business Report, 15 March 2007, full article in section 6.)

2

TRUSTEE TRAINING MAINTAINING THE INFORMATION INEQUITY?

In which concerns are raised regarding the absence of sufficient formal trustee training, the independence of the trainers and the inappropriate emphasis of some of the training received by trustees, focusing too much on technical knowledge and not enough on the need for careful oversight of the fund.

The success of South Africa's occupational retirement fund industry, and the financial interests of millions of fund members, rests on the lay trustee.¹ As the majority of fund trustees are members of the fund themselves, their representation of the interests of beneficiaries is strengthened.

*The assets of a retirement fund are administered for the main purpose of providing the benefits promised in terms of the registered rules of the fund. The board of management (sometimes referred to as trustees) therefore holds fund assets in trust for those persons who will ultimately benefit from them. **They stand in a position of trust or fiduciary relationship to funds and therefore must act with integrity.** (Financial Services Board, 2007b:1, emphasis mine)*

To this, however, they need to add sufficient knowledge to carry out the business of the fund with competence and confidence. They are encouraged to utilize the skills of outside experts when appropriate, but the responsibility for decisions affecting beneficiaries rests with the trustees, and this means that they need to develop competence.

*As fiduciaries, the board, its alternatives and other persons duly appointed by the board to act on its behalf, have to deal with the assets or affairs of the fund **in terms of pension law, the common law, customary law, regulations, the (registered) rules of the fund, codes of***

¹ Not all trustees are members of the fund – some are external experts – and many trustees are professionally trained in some way that enhances their skill as trustee. But the integrity of the system rests largely in the hands of concerned individuals without special skill who are required to place the interests of the fund and its beneficiaries above all other.

conduct and policies that apply to the fund. Trustees may be required to exercise a degree of discretion in making decisions. (Financial Services Board, 2007b:1, continued from previous extract, emphases mine)

Is trustee training conducted in the best interest of the trustees, and the members of the funds that they oversee, or does it enhance the position of service providers, many of whom provide the training themselves?

The need for training

The recently issued Pension Fund circular 130 (PF130), a set of guidance notes for trustees makes clear the importance of training and the significance of the source of funding of such training.

Board members should be educated on an ongoing basis about new matters relating to the fund to ensure that they acquire and maintain an understanding of risk management, investment risks and strategies, benefit structures, legal issues, regulatory and compliance requirements, taxation, actuarial and reform issues. The cost of this information provision and training should be at the expense of the fund. Training and education requirements for board members should be an ongoing process, with an emphasis placed on continuous and lifelong learning. (Financial Services Board, 2007b: 7-8)

Under the framework of trust law and considerable weight of fiduciary responsibilities, trustees must exercise all due care in their duty to fund beneficiaries. The extent and seriousness of this duty is substantial:

- the law imposes obligations on the trustees and provides for substantial penalties for failing to exercise these obligations with due care;
- members often have a significant financial stake in the fund – sometimes it is their primary asset – and depend on the good care of the trustees to safeguard this stake;
- many trustees, by virtue of the fact that they are lay members of the board elected by the members of the fund to represent their interests, do not have significant financial knowledge or understanding of the complexities of running a fund;² and,
- service providers have a tendency to emphasise the complexity of fund administration and decision-making, not helped in many instances by opaque product design.

The weight and financial significance of trustee obligations combined with the gap between their financial knowledge and that of their service providers makes skills development a necessity. Nevertheless surveys indicate that formal training is rare.³

² It is precisely their lay position that allows these trustees to exercise their responsibility with empathy for the members of the fund, but these members often feel ill-equipped make known their concerns at aspects of the fund because they regard themselves as unable to defend their point of view or propose an alternative.

A PriceWaterhouseCoopers study of retirement fund governance (2007:20) states that

- some 41% of funds have not made any assessment of trustees' knowledge and understanding, and
- only 10% of funds undertake frequent review of trustee knowledge against requirements and take immediate action to close gaps where necessary.

It should not be surprising, then, that the same survey shows that

- *"81% of trustee boards have never evaluated their own effectiveness or put mechanisms in place to do so" (same study, page 18), that*
- *"37% of funds do only ad hoc performance assessments" (page 19), and that*
- *"only 15% of funds have a formal policy to identify conflicts of interest" (page 23)*

Deloitte (2005:33) analysis shows that

- a formal training policy for trustees is in place in only 18% of funds, with a further 15% doing so on an informal basis,
- some 30% of funds provide formal training to trustees, though a further 51% do so informally,
- only 13% of funds formally identify trustee training and education needs, annually, a further 66% doing so informally, and
- only 15% of funds formally evaluate the effectiveness of trustee training, while another 33% carry this out on an informal basis.⁴

These figures are an indictment on the care with which South African savings in occupational funds are being looked after. Every retirement fund in this country must give due care to the need to provide appropriate, independent training to its trustees.

New board members should, at the expense of the fund, post appointment and election, receive rigorous and comprehensive training on both the legislative and regulatory framework and governance principles in order to equip them to effectively carry out their functions as board members, and to enable them to minimise their risk or liability as well as to safeguard them against bad decision-making. (Financial Services Board, 2007b: 7)

Anecdotal evidence of trustees with significant standing and experience not having read the rules of the fund, the fundamental document against which all decisions must be

³ It is not clear from either of the surveys cited here what is meant by formal training, but it is interpreted as training that forms a "clear part of the activity of the Board of Trustees". It is no less than would be expected of the trustees of any trust that they ensure that they have sufficient knowledge to carry out their duties effectively.

⁴ The discrepancy between formal and informal figures is alarming. If the job is being done informally, one must ask, why should it not be formalized?

measured as a matter of course, raises serious concerns about the commitment to the simplest principles of trustee training.

Providers of training

Ironically, there isn't a shortage of trustee training in this country, but anecdotal evidence suggests a dearth of independent, skilled training. Trustee training is offered, in roughly decreasing order of frequency, by:

- service providers, that is administrators, actuarial advisers and investment managers,
- independent principal officers and trustees, and
- less commonly, academic institutions or entities responsible solely for training.

Informally, any intermediary looking to provide services to the trustees or the members of the fund provides information concerning trustee responsibilities, which may be described as training.

The problem

The training problem has both a demand and a supply angle to it. On the side of demand, as noted above, trustees are not devoting sufficient time and effort to training.⁵

"We acknowledge as trustees that every trustee is entitled to receive such training and orientation, at the expense of the fund if necessary, as is necessary or desirable in order for that trustee to fulfil his or her responsibilities as such." (Financial Services Board, 2007b, Annexure A, draft code of conduct, paragraph 7)⁶

Trustees may also not be aware of the need for self-appraisal. Each member should be willing to submit himself or herself, on a regular basis, to an examination of their appropriateness to the position of trustee.⁷

"We undertake to submit ourselves, individually and collectively, to such assessment as is appropriate, acknowledging that the purpose of such assessment is to ascertain our

⁵ Part of the problem is undoubtedly the time constraints given by the sponsoring employer, but better training of trustees would help to identify issues like employer constraints and foster an environment in which the employer is more willing to give to trustees the time that they need to run the fund more effectively.

⁶ PF130 has a number of annexures. Annexure A is a pro-forma Code of Conduct that trustees are expected to apply their minds to and, subject to any modifications that may be appropriate to that fund, adhere to.

⁷ Again, some might suggest, practical constraints make this impossible. Again, the response to this must be, are the responsibilities of trustees being taken seriously enough. If trustees are not prepared to submit themselves to tests of competence, what does this say about how seriously they represent the interests of members? How well are incompetent trustees able to defend the interests of their members?

performance, particularly in fulfilling our governance purposes.” (Financial Services Board, 2007b, Annexure A, paragraph 10)

Unfortunately the problem of insufficient and inappropriate training can be exacerbated by suppliers, who tend to make available just enough material to trustees to

- demonstrate the significance of trustee responsibilities and the complexity of the retirement fund environment, and
- establish a dependence by trustees on the service provider that may have a negative impact on the interests of fund members

It is not clear whether this is a deliberate strategy to capture the mind of the client, or a consequence of the demand for some training that service providers meet as best they can with limited resources, but its impacts can be devastating. Trustees believe that they have received unbiased, independent, competent training where it may be none of these things.

In many instances, fund service providers offer training as an “add-on” to their normal services; but this is considered by some industry participants as inappropriate, given that trustee training is not always a core competency of service providers and the potential over-reliance by funds on service providers. They believe that this could lead to training which is not independent and not focused to trustee specific needs or fund circumstances. (Deloitte, 2005:33)

Not all training is received from service providers. One large company outsources all training to an independent trainer, whose material the company vets. Another redirects all training to a professor at an academic institution. These are not perfect solutions, just better than the in-house training approach.⁸

What is the answer? Independence is the key criterion. The ideal is for trustee education to be provided by specialised training entities, whose interests are aligned with those of the trustees that they are training. This may increase the cost of trustee training, but good training could help to identify and avoid significant errors, delivering a substantial return on the investment to the fund and its beneficiaries.⁹

⁸ *In the first case, most independent trainers also provide principal officer and trustee services and have a natural incentive to market themselves. In the second, I understand that the service provider funds the academic chair occupied by the professor in question, calling into question the supposed independence of the training.*

⁹ *Trainers could be appointed to serve on a rotating basis, keeping the material fresh and providing different perspectives on tricky issues.*

Training bias: areas of concern

Four broad areas in which training might be improved are discussed below.

- **Nature of trustee responsibility.** If training is provided by those individuals or entities that have a vested interest in meeting fund needs, the tendency would be to emphasise how dangerous it is to be a trustee and how important it is to obtain the security of the right service providers.

This is not appropriate. The responsibility of a trustee is primarily to take all due care to safeguard the interests of the members of the fund. This cannot be done by the trustee without diligently applying his or her mind to the range of problems facing the fund and its members. Outsourcing technical activities to providers does not absolve the trustee of the responsibility for the consequences of the advice on members.

- **Trustee conduct and the need for debate.** Trustee training can be condensed into a set of rules and actions, missing the importance of critical analysis and debate. The best way for trustees to satisfy themselves that a course of action is optimal for the fund and its members is to weigh it up against one, two or even three alternatives, and to discuss the advantages and disadvantages of each, openly and with all members of the board participating.

Trustees should have appropriate opportunity to consider motions put before them, should insist on clear and transparent communication and should interact, where necessary, with the members whose interests they are considering. Trustees must be reminded that it is their responsibility to indicate their disagreement with any view put forward, even if this is due to incomplete understanding.

Trustees must see themselves as members of a board, not an executive. Their responsibility is primarily oversight, not implementation. They do not need to be expert in all of the details of running a fund. For this they have an administrator and they have a Principal Officer. If training laid greater emphasis on the thinking part of trustee responsibilities and less on the doing, the trustees would more effectively identify areas of weakness in the governance of the fund and put them right.¹⁰

- **Expert advice.** The use of expert advisers to assist pension fund trustees is a well-established practice in South Africa and around the world, endorsed by the Financial Services Board in its recently-issued circular, PF130,¹¹ and by the 30-country OECD in

¹⁰ *Developing a checklist of questions for trustees would enhance their ability to work as directors, but formulaic approaches must be avoided.*

¹¹ *"Board members are not obliged to have all the expert skills necessary for the day-to-day operation of a fund. It is reasonable for the board to engage professional accounting, actuarial, investment, legal and other experts for advice on issues which are the responsibility of the board, and to pay the professionals involved appropriately for that advice." (Financial Services Board, 2007:9)*

guidelines accepted by the OECD Council.¹² This is frequently stressed by trainers, nearly all of whom have a financial interest in South African pension funds appointing expert advisers.

What is less clearly emphasised is that the adviser must be carefully chosen and that trustees cannot avoid taking responsibility for the decisions that they implement, whether or not these decisions are guided by these advisers.¹³

So common has the practice become, that the South African retirement fund could almost be described as characterised by vertically integrated arrangements under which the same company writes the minutes of trustee meetings and provides both the advice¹⁴ and other fund services, such as the Principal Officer.¹⁵ This could be due partly to poor trustee accountability but reinforced by flawed training.

- **Tendency towards easy solutions.** Training seeks to make the lives of trustees easier, by providing tools and solutions to simplify the process. This is often motivated by the desire to sell the solution.

What the training is less inclined to do is to emphasise that many of these “solutions” themselves constitute advice and should be taken through the same process as that applied to the selection of an adviser. Furthermore “solutions” do not absolve the trustees of the responsibility to ensure that they apply their collective mind properly to each decision.

¹² “Where it is appropriate to do so, the governing body should seek expert advice and may delegate functions externally. ... The governing body should ensure that all its professional staff and, where appropriate, the external service providers have the relevant qualifications and experience required to carry out their functions in accordance with the objectives of the pension entity and the pension plan.” (OECD, 2005: 12)

¹³ “The expert advice or opinions obtained by the board should be considered by the board and assessed independently and the board should always be free to procure a second opinion where it is not comfortable with the advice that it has received.” (Financial Services Board, 2007: 9)

¹⁴ “The board should satisfy itself that any expert advice obtained is independently given. Where the professional gives expert advice in respect of a service provider or the employer or sponsor to the fund then the board should satisfy itself that such advice is not compromised by the relationship of that professional or his or her firm to that service provider, employer or sponsor as the case may be.” (Financial Services Board, 2007: 9)

¹⁵ The Principal Officer is part of the executive of the fund, not the board. Since the primary responsibility of the Principal Officer is to ensure that the fund is being run efficiently and in line with the requirements of the rules and the trustees, the individual fulfilling the role should be independent of the administrator of the fund, independently overseeing the administrative activities.

Concluding comments

Trustees [in the United Kingdom] can take advantage of a range of training opportunities. The Pension Management Institute (PMI) offers a one-hour examination for the Trustee Certificate of Essential Pensions Knowledge. A number of other bodies provide training for trustees, including the National Association of Pension Funds (NAPF), both nationally and at local level, fund management companies and consultancy firms. Trustees may also attend pensions conferences such as those organised by the NAPF and commercially, and there are also 'trustee circles' which meet to discuss issues of common interest. (Myners, 2001:48) ¹⁶

Despite the range of training options available to UK trustees, the Myners review recommends that more attention be given to trustee training:

*The review believes that trustees' skills levels would be improved by increasing access to good quality training. This is entirely consistent with trustees managing their affairs in a more business-like manner. **The review recommends that funds and their sponsors should increase their investment in training for trustees.** (Myners, 2001:48, paragraph break removed, emphasis in original)*

The South African retirement fund sector itself is not yet sufficiently well organised to provide high-quality training to its members. Progress is being made, through organisations like the Institute of Retirement Funds and the Principal Officers Association, to develop the intellectual independence of retirement fund trustees. The Financial Services Board, through PF130, has provided a helpful set of guidelines to trustees on what is expected of them. But more needs to be done to develop independent material that would assist lay trustees to execute their responsibilities with confidence.

Other sources of support for trustees must be considered. The CFA Institute, responsible primarily for the development of high good standards of professional qualifications and responsible behaviour of investment experts,¹⁷ has recently issued for comment a code of conduct for pension fund trustees for comment. South Africa has hundreds of qualified CFAs who should be emphasising the existence of this code of conduct and bringing it to the attention of pension fund trustees. The code is quoted in the box below and should provide food for thought to trustees and their providers.

¹⁶ Note that not all providers of training are independent. It is not true that certain sources of training are inappropriate, but if stronger sources of independent training were competing for the attention of trustees, it would surely improve the quality and impartiality of the additional support given to trustees by service providers. Perhaps material delivered by service providers could be considered as "interesting seminars" rather than formal training.

¹⁷ CFA stands for Chartered Financial Adviser. The CFA Institute is a worldwide organisation with more than 90 000 voting members, of which more than 800 are based in South Africa (www.cfa.ac.za/html/about_cfa_south_africa.html). All members agree to abide by the Code of Ethics and Standards of Professional Conduct. To describe themselves as "CFA" members need to pass a rigorous set of exams emphasising investment knowledge. The code is available for download at the CFA Institute Centre, http://www.cfainstitute.org/centre/issues/comment/2007/pension_code.html, accessed on 21 December 2007.

No one can quarrel with the need to ensure that trustees know what they are doing, but we need to create an environment in which lay trustees – who make such a major contribution to schemes – feel comfortable to operate. This means we need to recognise that they are not, and never will be, pension professionals. Effective training will therefore play a central role in the process, by giving these trustees confidence in their abilities to play their full part in running schemes effectively. (Kevin LeGrant, Head of Technical Services, Mellon Financial Corporation)¹⁸

Trustee training is an essential component of the efficient operation of South Africa's occupational retirement funds. It should go without saying that such training must be untainted by vested interests. The evidence suggests that this is seldom the case.

Trustees' lives could be exciting, were they to make it so. They could confront the big boys, as others are loath to do, were they alive to the possibility. That could be a worthwhile motivation for them to undergo training, were they to realise the full extent of the value they could add." (Allan Greenblo, Today's Trustee)¹⁹

Box 3.

CFA Draft Code of Conduct

Pension trustees must:

1. Act in good faith and the best interest of the scheme participants and beneficiaries.
2. Act with prudence and reasonable care.
3. Act with skill, competence, and diligence.
4. Maintain independence and objectivity by avoiding conflicts of interest.
5. Refrain from self-dealing and promoting personal interests.
6. Refuse any gift or benefit that could reasonably be expected to affect their independence, objectivity, or loyalty.
7. Abide by all applicable laws, rules, and regulations, including the terms of the plan documents.
8. Deal fairly, objectively, and impartially with all participants and beneficiaries.
9. Take actions that are consistent with the established mission of the scheme and the policies that support that mission.
10. Regularly review the efficiency and effectiveness of the scheme's success in meeting its goals, including assessing the performance and actions of scheme service providers including investment managers, consultants, actuaries, etc., on a regular basis.
11. Maintain confidentiality of scheme, participant, and beneficiary information.
12. Communicate with participants, beneficiaries, and supervisory authorities in a timely, accurate, and transparent manner.

Source: CFA Institute

¹⁸ Quoted on the inside cover of Deloitte (2005).

¹⁹ Editorial Director, September/October 2007, page 4

3

ASSET CONSULTANTS INDEPENDENT INTELLECTUALS?¹

In which the transfer of risk to members of South African retirement funds is described and the need for intellectual support to these members explained. Asset consultants play the crucial role of bridging the gap between the needs of members and the mandates of asset managers, but appear not to have fulfilled this responsibility widely enough and may suffer conflicts of interest.

Institutional investors may ... seek to transfer risk to the household sector. In shedding risk from their balance sheets, they will be following a similar strategy to the banking sector. Of course, households are the ultimate owners of all firms and hence the ultimate bearers of underlying risks. And households hold the largest equity buffer, which in principle could increase the resilience of the financial system to adverse shocks... (Bank for International Settlements, 2007, executive summary page 2)

South Africa, like many other countries, has witnessed a massive transfer of risk from institutions to individuals, particularly in the area of pension saving. Motivated by a desire to put retirement saving decisions in the hands of members,² the transfer from defined benefit arrangements to defined contribution alternatives has been more rapid and more comprehensive than in most other countries.³

¹ This section has benefited from the insightful comments of a senior actuary, for which I am most grateful.

² The motivation to transfer control of assets to members has been largely political – in most countries unions have clung on the security of defined benefit. But the need to establish legislation to address the unfair treatment of members of defined benefit arrangements during the 1980s and 1990s supports this motivation.

³ Many countries are witnessing a shift from defined benefit occupational arrangements to defined contribution. In the majority of cases, however, this affects only future entitlement, past accruals being preserved in the defined benefit arrangement, which often remained open to further accrual by members present at the time of conversion.

... But they may not be as able as institutional investors to identify, judge and manage investment risks. In particular, it is unclear how effectively households will cope with financial market volatility. If households were to prove unable to manage the risks in DC pension schemes effectively, or if they set aside inadequate savings to provide for future pensions, their future retirement income would suffer. Thus appropriate regulation and supervision as well as consumer protection remain important, as do efforts to educate households on financial issues. (Bank for International Settlements, 2007, following on from previous quote)

The shift from institutional to individual risk-bearing was not accompanied by sufficiently strengthened regulation and supervision or by improved measures to protect consumers.⁴ Neither has there been a wide-ranging regulator-led effort to educate members of retirement funds regarding the risks that have been handed to them.^{5,6}

It is surely not an exaggeration to say that members, the least able to manage the risks that they have been handed, are not being assisted adequately in understanding or coping with these risks.

Who is the intellectual lamp bearer of risk management expertise? Who is best positioned to make sense of the complexity facing fund members and translate it into sound counsel for these members?

Surely the consultant to the fund is best able to deliver this service, bringing a combination of independence and expertise to bear on a complex problem, applying original research and an awareness of global best practice and turning it into sensible, rigorous and robust tools for the members that trustees are required to guide? Surely only the consultant is free of the bias that affects all other providers of service to the fund and ought to be well-rewarded for the combination of expertise and independence that produces the sound and thorough thinking so badly needed by trustees and the members they serve?

This section asks whether South Africa's investment consultants have delivered this service to the best of their abilities and, if not, what may have compromised such delivery.

This discussion is not intended as an attack on the intellect or skills of investment consultants, or any other consultants offering services to pension funds. It is not intended

⁴ More recent initiatives aim to address this problem. The guidance note to pension fund trustees, PF130, is an example.

⁵ This is not to say that the Financial Services Board is not interested in consumer education – it has established a fund to deliver exactly that – but it is a facilitator rather than deliverer of such education initiatives.

⁶ This paper covers many of the conflicts of interest that affect adversely the nature of the advice given to trustees. By extension, similar conflicts affect information provided to members, so if the regulator has not been able to mobilize substantial resources to provide consumer education, questions must be asked about the quality of the education that has reached the fund member from other sources.

to suggest that individuals providing investment consulting are lacking in personal integrity or intelligence. I am firmly convinced that just the opposite is true.

What I am asking is whether the structure of some of their organisations might have compromised their ability to meet most effectively the challenges that face them and, most importantly, their customers.

Risk and responsibility

In defined contribution pension plans, participants are promised a future sum, received upon retirement that is dependent on the performance of the assets that were invested in a pre-established manner. Therefore, the payout depends on the size of the contributions made and the performance of the assets... An organization's efficiency depends on the allocation of decision rights and residual claims within the organization. Eugene Fama and Michael Jensen argue that decisions should be made by whoever bears the risk of the organization. According to the authors, many organizations [defined contribution retirement funds, for example] are managed by individuals who are not the sole residual claimants and who therefore do not fully bear the financial consequences of their decisions. In such organizations it is important for the residual claimants to retain decision control rights over the management by maintaining the right to hire, fire, and set the compensation of the managers. (Dias, 2006:25)⁷

To whom should these consultants be directing their attention first? Surely the focus of their expertise should be the bearers of risk and beneficiaries of the defined contribution fund, its members?

... in defined contribution plans, it is preferable that participants control the assets allocation and management, because they have the ownership of the returns. The fact that sponsors do not bear the residual risk on defined contribution plans means that they will not take into account the effect of their investment decisions on the expected returns of the participants. (Dias, 2006:25)

A change to the current governance dispensation of fifty-fifty sponsor/member representation on the Board of Trustees is not being suggested. Dias's thinking is consistent with the principles of the fiduciary responsibility of the trustees to the members of the fund. She emphasises this responsibility in the case of a defined contribution arrangement.

However, independent consultants have an enormous responsibility to help trustees – through them the members – to carry out their monitoring tasks with all due care, and to identify and deal with conflicts of interest that may amplify the risks to which members are exposed, particularly in a defined contribution environment.

⁷ The reference to Fama & Jensen provided by Dias is: Eugene F. Fama & Michael C. Jensen, "Agency Problems and Residual Claims", 26 J.L. & ECON. 328, 327-349 (1983).

Dias picks up on the issue of monitoring:

The comparative advantage in monitoring rests on the allocation of residual claims... in defined contribution plans, participants have more incentives to monitor the management [of the fund]. Monitoring activities are, however, a tricky issue in defined contribution plans. Because of the presence of multiple participants in a defined contribution pension plan, it is important to keep in mind that participants have a jointly residual claim and each of them does not internalize the full outcome of additional vigilance, creating a free-riding problem which decreases the optimal level of monitoring. (Dias, 2006:25)

At the risk of oversimplifying the point that Dias is making here, monitoring is difficult because of the distance between the service providers and the residual interest of the members. Bridging this gap is one of the essential responsibilities of the trustees, which should be supported by independent expertise.⁸

Is independent expertise available to South Africa's pension funds in sufficient scale to provide benefit to their members? Do we all mean the same thing by "independent"? What might be the consequences of compromises to independence that could introduce conflicts of interest?

Unconstrained benchmark proliferation

In the defined contribution funds that dominate this country, members bear the risk and benefits associated with the assets of the fund. It is crucial that the assets are soundly invested, in appropriate asset classes, and that the returns generated are correctly measured. Success can only be determined by specifying appropriate targets, or benchmarks, and measuring the extent to which investment managers produce investment performance that meets these benchmarks.⁹

The primary requirement of a manager benchmark – as expressed in the mandate granted that manager – is that it contributes appropriately to the overall objectives of the members of the fund. It stands to reason then that all of the benchmarks utilised by the trustees of

⁸ *The responsibility of the trustees to obtain assistance from qualified professionals where they lack the skill to oversee an aspect of the fund is well established in international practice (see Myners, 2001, for example, and the OECD, 2005) and in local guidance (refer to PF 130 issued by the Financial Services Board, 2007).*

⁹ *This oversimplifies the need. Investment return is only an appropriate measure to the extent that it meets the retirement needs of members. Specifying the needs is difficult, rendering even more challenging the establishment of appropriate return targets. Since return is generally only obtainable to the extent that greater risk is taken, specifying these targets should be sensitive to this trade-off and the fact that mathematically neat relationships between risk and expected return are of limited use to a member, who's main concern is risk on the downside. Regardless of these complexities – and independent consultants ought to be at the forefront of resolving these trade-offs for members – an appropriate return benchmark will always form an essential part of any investment strategy, since, without it, overall success cannot be assessed and the extent to which investment managers meet the goals required of them cannot be determined.*

a fund to measure the success of their selected managers ought to work together to meet the objectives of members.

A brief list of some of the equity benchmarks prevalent over the last twenty years suggests that insufficient attention has been given to member needs.

- The **Johannesburg Securities Exchange (JSE) All Share index**, provides an average of the value of all listed shares weighted by market capitalisation. It is the most commonly used generic benchmark method around the world, flawed but well-established.¹⁰ The Top 40 index and sector-specific alternatives, like those focusing on resources, industrial companies and financial counters, medium-sized or smaller companies, are all built on the premise that market capitalization is an appropriate determinant of company weighting in a portfolio.¹¹
- **Fixed allocations to resource shares** were popular for some time as managers battled with long alternating phases of market strength and weakness in resource counters, pushed often by international forces well outside of the control of the local market. The so-called 80/20 or 70/30 benchmarks were used, predominantly by investment managers rather than the consultants, as a defence against long bull or bear runs in resources that tended to dominate the performance of the portfolio, insulating managers against this source of risk.¹²
- The **half-weighted resource index** was popular for some time on the argument that resource counters are disproportionately represented on the JSE. This approach contends that market capitalisation is not an appropriate measure for determining the weights of the constituents of an index. Nevertheless, the existence of the rather arbitrary solution begs the question of whether member interests were remotely

¹⁰ *It is flawed because it depends on the extent to which companies – the drivers of economic value – have deemed it necessary to raise capital through listing. It also depends on the value that the market places on these companies at any one time. Despite these challenges, indices of value weighted by market capitalization, together with variants across sectors or the size of securities, have become well established around the world as standard measures of stock market performance. This doesn't mean that they are appropriate as pension fund benchmarks, but are the alternatives any better?*

¹¹ *While the JSE Actuaries Equity Indices were launched in 1978, they were incomplete as fair representatives of the whole market until just over ten years ago. "However, the share inclusion methodology seemed to be anything but methodical. Counters were included according to market capitalization until approximately 80% of the overall market cap had been accounted for – the remaining 20% was excluded. Fortunately, in 1995, a more inclusive methodology was established." (Umbono Fund Managers, 2004:5) In mitigation of the claim that insufficient attention has been given to member needs in the development of benchmarks, it should be emphasised that decent benchmarks of any description are relatively new in this country.*

¹² *The existence of these portfolios – and many similar variants – drove the development by investment consultant of the manager surveys that play such a significant part in the market today (refer to section 7 for further discussion).*

considered in the process. The method might have defensible rationale, but the solution would appear convenient rather than ideal.¹³

- The **capped index (CAPI)** was introduced during the course of 2003 to deal with the vexing problem of large counters in the general market index. The presence of such large counters is awkward because it is difficult and expensive to trade reasonable proportions of such shares. The capped index limited all holdings to 10% of the portfolio, spreading the balance of the market-weighted holding across the balance of the portfolio.
- The **shareholder weighted index (SWIX)** was launched together with the capped index to address the problem that large proportions of many shares were not traded because they were held in blocks by local or international institutions. Construction is complex, utilising concepts like *Shares in Issue*, *Local Ownership Banding Level* and *Free Float Banding Level* (Umbono Fund Managers, 2003). The rationale for the index is that share weighting should be determined by liquidity, the capitalisation effectively available through trade, rather than the market value of shares issued, so that the index reflects the investment weights of domestic investors.¹⁴

This list provides a brief illustration of the range of indices that has developed over the last few years. Each would appear to have some reasoning behind it, but they do not all appear to have a strong scientific basis. Furthermore, it is hard to see much logic in any of them from the perspective of the needs of defined contribution retirement funds members.

The benchmark decision: start with the member

What are members' needs and why are they relevant? A benchmark for a fund must take into account the parameters that are of most relevance to the members. These members are saving for retirement and are most likely to measure the success of their saving by the lifestyle that they are able to afford on the income that they receive in retirement. This suggests that inflation protection is important, but a conclusion as simple as this would be incomplete.

¹³ *The half weighting is convenient, not scientific. Readers interested in etymology – the origin of words – will recognise that 'conventional wisdom' was intended not to refer to 'the wisdom of the crowd or majority' as it is commonly used today, but 'the wisdom of convenience', in some cases not wisdom at all. The authors of FREAKONOMICS cite economist John Kenneth Galbraith, who points out that since social and economic behaviours are complex, "we adhere, as though to a raft, to those ideas which represent our understanding." They go on: "So the conventional wisdom in Galbraith's view must be simple, convenient, comfortable and comforting – though not necessarily true." (Levitt & Dubner, 2006:80, citing Galbraith's 'The Affluent Society', Houghton Mifflin, Boston, 1958)*

¹⁴ *The index was launched as an alternative to the Full Free Float Index. An anonymous commentator has suggested that rules for developing the index are somewhat arbitrary as subjective adjustments are made to remove share weights attributable to offshore investors. What would make this index appropriate as a performance benchmark for members of defined contribution funds?*

The lifestyle of a working individual – except those few that save a substantial part of their income – is usually determined by their means. Simply put, we spend according to our income, even if we do have the diligence to put aside a regular amount in saving. We are likely then to be satisfied in retirement if we have the means to continue the standard of living to which we became accustomed during our working years.

This means that the most important driver of the investment returns gained on savings put away during our working years is not inflation, but salary growth. Crudely put, just as our income grows so should the value of our savings.¹⁵

If salary growth is the key unknown, the benchmarks that we set for the investment managers providing services to retirement funds should relate in some way to salary growth.¹⁶ Since salaries are linked to economic growth, in aggregate and over time, benchmarks should also be linked to economic growth.

It is not suggested that selecting an appropriate benchmark is easy, but *80/20's*, *CAP's*, *half-weighted resources* and *SWIX's* are not obvious candidates for the benchmark most likely to match salary over the long-term. Performance benchmarks should be long-term in nature. Short-term goals are inconsistent with member retirement needs and tend to exacerbate a number of the issues raised in this paper. It is the responsibility of the investment consultant to bridge the gap between the long-term needs of the member and the shorter-term performance objectives of the asset manager.

In our pursuit of achievable objectives, have we forgotten the needs of the members? Should our independent intellectuals not lead us back to a careful consideration of what is best for the members of our retirement funds?¹⁷

¹⁵ Since the inflation rate over the long-term lags well behind the average growth in income, matching inflation is likely to be badly insufficient to provide sensibly for retirement. By a similar logic, since salary growth is a more important benchmark than any inflation target, but does not exceed inflation by a constant amount, those products that aim to beat inflation by a specified number of percentage points are not delivering the security – at least for retirement purposes – that they claim to provide. Furthermore they often do so at a cost that is unrecognized by retirement fund trustees.

¹⁶ It is hardly likely that each member's salary growth pattern could be matched with appropriate investments but, overall, members need investment returns that insulate them against their success in growing their salary.

¹⁷ The sense that we do not have the pool of independent professionals that we need to answer these questions is highlighted by the anecdote that a report written by a researcher at a local investment bank on global trends in pension fund investment triggered a request by an asset manager for the researcher to present his analysis to one of the country's leading investment consulting units. It is difficult to avoid the conclusion that the professionals had taken their eyes off the ball, not investing sufficiently in intellectual development and perhaps compromising their ability to provide up-to-date insights to their clients. This comment is not intended to apply to the whole community of investment consultants.

Responsibility of the expert

The benchmark problem is an example to illustrate the question of whether South Africa's independent consultants have led the crowd or followed it.¹⁸

These benchmarks have developed for good reasons, mostly to measure the performance of the asset managers fairly. The job of the independent consultant is to understand the rationale for these benchmarks and combine them in a way best suited to the needs of the fund and its members.

The asset manager mediates between the fund and the market, taking clear instructions on how to manage the assets. The consultant in turn mediates between the fund and the asset manager, or asset managers, ensuring that the chain is properly linked.

- Asset allocation is key to the fund and its members: it is the most difficult and most important problem faced by the trustees. Members approaching retirement may have a short horizon, for example, while the fund itself has a longer term perspective.¹⁹
- Asset allocation requires an understanding of member needs, the liability side of the fund, which should be expressed in terms of goals most relevant to each major category of member, long-term goals for younger members, for example, and shorter-term objectives for older.
- Building the bridge between the asset side and the liability side also requires a steady investment in research. Historical data and recent events need to be combined into a coherent framework that expresses tomorrow's uncertainty with care and humility.²⁰

After all of this, the consultant is in a position to set out mandates for the trustees to give to asset managers. Expressing liability-driven objectives in the language of the asset managers is one of the most important responsibilities of the asset consultant. This is where consultants bring together detailed understanding of the language of the asset

¹⁸ Others could be added to it. Has the rush to absolute return mandates, for example, served the interests of members? Over time, even a relatively short period, many absolute return funds deliver performance that follows reasonably closely that of a balanced mandate, except for the higher fees, implicit or explicit, in these arrangements. Absolute return mandates have a place in some investment strategies, but it takes a good consultant to understand what the asset manager is doing and how it fits in with the broader requirements of the fund and its members.

¹⁹ Members expecting to leave employment, hence the fund, within a short period are likely also to have a short time horizon, particularly if they plan not to reinvest their share of the fund assets in long-term classes, as they should, but to use it immediately. Do the trustees of a pension fund have a responsibility to invest the assets of the fund with these members in mind – they don't know who they are – at the potentially heavy cost to long term returns?

²⁰ Communicating uncertainty needs to start with a deeply-held understanding that the future is... well, uncertain. Perhaps the most common errors involving the use of past data is to use long-term history as indicative of expected returns, assuming that the equity risk premium is inevitable, for example, but to predict expected volatility on the basis of the recent past.

manager and sensitivity to the needs of the member, demonstrating to trustees both how the manager is measured and how this translates into value for the member.

This leaves the asset managers free to do what they do best, to perform well against a clear benchmark that can be replicated in practice.

This whole process requires more than expertise; it requires also an ability to communicate complex issues clearly, without merely telling the trustees what to do. Complexity should not be presented too quickly as a solution.²¹ Trustees must understand that they take responsibility for the asset allocation decisions and the mandates given to the asset managers and that their asset consultant forms a very important part of this process and must exercise great care, but cannot take the task away from the trustees.

This is not an easy set of problems to solve or communicate. Could it be that there are a number of structural impediments to the development and implementation of this consulting framework?

The essence of the problem

There are many firms or units that refer to themselves as investment consultants.²² What evidence is there that, as this discussion claims, they are providing the intellectual foundation to the industry that they should be? Claims and counter-claims are numerous,²³ but three are considered below, so closely related that they are difficult to separate.

The first problem is the culture of **ownership above service**. The drive to become indispensable to the client appears to have crept into investment consulting and other forms of professional consulting to South Africa's retirement funds. As a pure objective, it

²¹ So called "life stage" funds are a case in point. Converting an advice process into a product can be very dangerous. Members on a "life stage" option who choose to draw down assets at retirement with a relatively high allocation to shares run enormous asset allocation risks that the product does not adequately allow for. Advice to trustees must cover these risks so that trustees can communicate them clearly to members.

²² The emphasis of this discussion is on the asset consultants, but there are large numbers of financial advisers who believe that they have the skills to consult to pension funds because they have experience in the arena of individual member financial planning. Input has been received suggesting that, broadly speaking, they acquire their credibility from the brand and size of the company they work for rather than from personal rigour, and that they have a standard format for all client solutions, with an allowance for slight variation in manager selection in order to accommodate trustee preferences. They often use their parent company's administration platform, which may or may not be optimal for the client and are inexperienced in the pitfalls of the game. The message for trustees is the same: obtain independent input where needed, but make sure that it is independent and rigorous.

²³ In the course of this research, I have received lists of a number of other concerns that market commentators have with investment consultants. Some of these are subjective. I prefer to raise here the primary structural concerns and to ask trustees to apply their minds to the best way to utilise the services of their independent experts.

is a reasonable one: all consultants would like to have long and strong relationships with clients. However, if it compromises the integrity of the offering, it becomes dangerous.

Sometimes the consulting relationship extends to the provision of administrative services, for example, taking minutes for the trustees, managing financial transactions and providing the Principal Officer for the fund.²⁴

In some cases, the consultant has a sufficiently strong relationship with the trustees of the fund to effectively manage, or at the very least interpret the information that reaches the pension fund trustees.²⁵ Once again, this is not necessarily wrong, but it does beg the question of whether the consultant has too much control without the concomitant responsibility. Conversely it must be considered whether the trustees are taking the responsibility they should for their decisions.

The cross-sell ethos is the second concern. A number of the investment consulting units in this country are part of a larger organisation that sells other products and services to retirement funds.²⁶ The policymaker often refers to this as vertical integration. Again, it is not of itself a bad thing – most organisations strive to succeed in establishing relationships with clients across a number of functional areas and it can be efficient for the fund – but it is surely more difficult for any one of these units to describe themselves as providing independent advice.

Vertical integration has occurred in two main ways with respect to investment and more general consulting to retirement funds.

- Insurers with products aimed at retirement funds have established consulting units to service the needs of these funds and deepen the relationship.
- Consulting firms with a sufficiently large pool of clients to make the provision of other services economically viable have expanded their offering accordingly.

In both cases surely it is surely difficult for the consultants to describe themselves as providing independent advice?²⁷

²⁴ *The job of the Principle Officer is to ensure smooth administration of the fund. Is it possible for a Principle Officer employed by the company administering the fund to make an objective assessment of the administration? A glance through the list of retirement funds published by the Financial Services Board shows how many of them have the same registered address... that of their administrator.*

²⁵ *Evidence of this is not easy to gather, but it is widely reported that reaching pension fund trustees directly with information is very difficult if it could damage the standing of the consultant in the eyes of the trustees. In many cases, consultants are asked to explain information received by the trustees.*

²⁶ *I was part of one. I briefly ran the investment consulting unit at what was known at the time as Sanlam Consultants & Actuaries. I could not describe my unit as independent.*

²⁷ *Trustees unwittingly allow the intellectual property of providers to be passed on to their competitors by including consultants in meetings or asking them for second opinions.*

Key members of the top team at Lekana, the employee-benefits group within the FirstRand stable, have left. Several might follow Dave Steere, the managing director, into an independent consultancy. ... Concerned with "everything going on in the industry" about interest conflicts when a one-stop shop handles consultancy and other services, he and other colleagues had put to controlling shareholder Momentum a proposal for management buyout of the consulting operation. The proposal was rejected. Steere and company had no honourable choice but to leave. Perhaps for them, it's as well. The business opportunity for genuinely independent consultancies is glaring. (Today's Trustee, December 2006/January 2007, page 27, paragraph breaks removed)

The third problem issue is that of **other conflicts of interest**. Inappropriate incentives are difficult to identify and very difficult to deal with, but this section would be incomplete without an acknowledgement that some of the financial models in operation cast doubt on the independence of the consulting firm.²⁸ Conflicts that arise from the corporate structure within which the consultant resides are discussed above.

Transition management is a complex and lucrative activity. It is profitable because it is complex and because it involves the purchase and sale of large quantities of securities: if an organisation is able to bring to a brokerage a sufficiently large block of business, the possibility of sharing revenue from the trades is tempting. Investment consultants should surely not be providing transition services, partly because such services generate fees that are substantial and opaque, but mostly because these services have the potential to affect the integrity of the portfolio construction advice offered by the consultant in the first place.

Where transition management is required, trustees should consider contracting it separately rather than permitting the consultant to recommend and assess itself for the service.²⁹

Platform rental is another activity that can undermine the integrity of consultant advice. In an effort to move into more profitable activities, some consultants have chosen to describe themselves as offering *implemented consulting*, which means that they put into place their portfolio recommendations, running what amounts in some ways to a multi-manager portfolio. Since the administration of such a portfolio is complex, some consultants rent

²⁸ As discussed elsewhere in this paper, the term "independent" is often used selectively, perhaps conveniently omitting some words. "Independent of an insurer", for example, does not mean the same thing as "independent of inappropriate influences". Trustees need to watch the use of this word because its overuse has cheapened the concept of independence. The essence of the issue is whether any of the other activities, present or anticipated, of the individual, the consulting unit, or the parent company or any of its subsidiaries, could represent a conflict of interest, damaging the extent to which the consultant is able to give advice that is in the best interests of the customer at all times.

²⁹ South Africa should pay attention to the development of a Code of Best Practice for Transition Managers, known as the T-charter, developed by a working group in the interests of best practice and transparency (source: Mercer press release, 23 October 2007) and covering areas such as disclosure and conflicts of interest. The terms of the charter are likely to strengthen over time (Investment & Pensions Europe, 22 October 2007), but trustees should in any case request adherence to the terms of the T-charter wherever transition management is contemplated.

space on the platform of a multi-manager, outsourcing the administration to the multi-manager.³⁰ If an asset manager refuses to operate on the terms set out by the multi-managers, they are not on the multi-manager platform, the implemented consultant must either find complex ways to add these managers to their portfolio, or compromise the integrity of their offering by virtue of the relationship between the multi-manager and the underlying asset manager.³¹

Trustees should establish exactly what service their investment consultant is offering, how any administration or transition management is provided and whether either of this has the potential to compromise the integrity of the asset allocation and manager selection that should be core to the investment consulting service.

Independence watered down?

Two American anthropologists – William O'Barr and John Conley – released a scathing study of pension fund governance in 1992 that provided valuable insights into the process of pension fund investing. They found that three factors seemed to prevail: (1) The structure of most funds was primarily a function of historical accident. (2) Governance debates focused on responsibility shifting and blame deflection – most specifically with their fund managers. (3) Boards appeared to place a priority on strong personal relationships with investment managers and consultants. (Cabot-Alletzhauser, 2005:8, formatting edited)

Cabot-Alletzhauser, chief investment officer at a multi-manager, goes on to show in her sensitive assessment of a complex environment how low the fees earned by consultants are in comparison with other members of the retirement fund servicing community.³² She is not claiming that other activities are more profitable but she points out how difficult it can be for the independent consultant to invest in research on the back of its low proportional share of the revenue.

The issue is not so much whether trustees are paying their service providers too much but rather whether those payments are an equitable reflection of where accountability for the final outcome should lie. We suggest that a major mind shift is needed. Let's start with the provocative suggestion that consultants, or any other service provider whose input impacts performance, must be held just as accountable as asset managers. Real outcomes say they must by necessity. But investors are right to question the quality of the advice they're receiving. And thus begins the vicious circle. For consultants to provide any value in the space

³⁰ Permitting consultants to utilize the space on a platform is a natural revenue-provider for multi-managers. Since computer space is easily expandable, the cost of providing such a service is low.

³¹ This is quite apart from the conflict of interest inherent in a consultant offering implemented consulting and claiming also to provide independent advice. The former may create a vested interest in recommending one manager or portfolio type over another, surely compromising the quality of the independence provided by the latter.

³² This, she demonstrates, is not merely a South African phenomenon. But if dilution of independence in the pursuit of other sources of revenue is not appropriate, it remains inappropriate in spite of the adoption of such models by major players elsewhere.

they occupy they need to be able to significantly expand on their research capabilities and service offerings. (Cabot-Alletzhauser, 2005: 10, formatting edited)

"It is difficult to make money from consulting," seems to be the conventional wisdom, supported, it would seem, by Cabot-Alletzhauser's analysis. The corollary would seem to be that diversification is needed for survival. But it is also impacted by the traditional method of paying asset managers based on the size of the assets under management, an approach that, in the words of one commentator on this paper, "has no logical underpin" and results in "the asset managers generally [getting] far too much for doing too little". This is discussed in more detail in the next section of this discussion paper.

The essence of the problem is hard to pinpoint, but it would seem that asset consultants, while finding it difficult to "make money from consulting" also are "not held accountable" by their clients. This suggests that South Africa does not have, in the provision of investment consulting a buyer-seller market with transparent operation in which a service has demonstrable value and the provider of the service is appropriately rewarded.

What can be done?

Trustees are in a position to address these distorted dynamics by requiring that:

- **Consultants are independent of product providers**, which means free of the potential for any conflicts of interest. This is simply a requirement of the fiduciary principles underlying the responsibilities of the trustee and should not be open to argument.³³
- **Consultants are appropriately remunerated**, which should probably be a fee for service, in line with other professionals, at a level that reflects the skill of the consultant. If the additional value provided by the consultant can be determined objectively, a fee reflecting this value could be contemplated.
- **Consultants are regularly evaluated**. This should also form a natural part of the fiduciary responsibility of the trustees. Since the trustees are accountable to their members, their service providers should all be accountable to them. If evaluation is perforce subjective, then trustees must at least be able to demonstrate that they have applied their minds to the issue.
- **Consultants are chosen to match the tasks required**. Since consultants provide an independent service, it stands to reason that the consultant should be chosen to match the service. Establishing a short list of providers and then choosing one for each task that requires special skills and independence may take a little more work up-front,

³³ Some might suggest that this is impractical, particularly where the supply of experts is limited and the demand so high. There is a measure of truth in this, but putting greater value on independence would go some way to addressing this imbalance, helping to foster the development of truly independent consultants.

but it need not be an unduly complex process and should result in clearer delivery of service over time.

- **Alternative consultants are invited on a rotating basis.** The objective here is to broaden the range of thoughts to which trustees must apply their minds. Again, this need not be expensive: a short list of providers and occasional invitations to meetings may be sufficient.³⁴ One of the questions that trustees should ask of alternatives is how the incumbent consultant might be assessed.
- **Consultants are required to explain their approach** from among the range available. Any set of recommendations is underpinned by a philosophy. Consultants should be requested to explain the range of philosophies prevalent among their peers and explain the rationale for their approach.

There are encouraging signs of change. The number of independent consulting firms is growing. And the recent announcement by international consulting firm Watson Wyatt that it aims to purchase a stake in South Africa's Fifth Quadrant is heartening because it suggests that this country already has intellectual quality to attract the attention of the best in the world.

Members saving in South Africa's retirement fund industry need the support of independent intellectuals as never before. The intellectual power is available. Now this country needs to ensure that it is applied in the best interest of the individuals that it claims to service? The drivers of change must surely be the funds themselves.

³⁴ "A new consultancy service has been launched in the UK which is designed to advise pension funds regarding the selection of investment consultants. Until now, it has been largely the investment consultants who have driven the pension fund arena and the direction pension funds may actually move in, but with the increasing pressure to ensure the most suitable firms are employed to help manage assets, it was noted there appear to [be] few services scrutinising the practices and models consultants pursue." (*Investment & Pensions Europe*, 3 December 2007, www.ipe.com)

4

FEE MODELS ALIGNING PROVIDER AND CUSTOMER INTERESTS?

In which the rationale for asset-based fees and performance incentives is set out and it is asked whether these models are in the best interest of retirement funds.

Several apocryphal stories surround the quote, "But where are the customers' yachts?" One version of the story has JP Morgan showing a customer the yachts at a marina and explaining that this one belonged to an asset manager, that one to a fund manager and another was owned by a banker and so on. After many such yachts, the guest was prompted to ask, "But where are the customers' yachts?" (Assetbase, independent asset consultant, South Africa, July 2007 newsletter)

An asset manager is, as it is called, a manager. It is the servant of its customers who are the owners of the assets. It ought to be remunerated for carrying out faithfully what it promises to do, but it remains the servant of the owner.¹

If an asset manager makes himself or herself wealthy at the same time as making me rich and using the same methods then our intentions are aligned and we share the same objectives. (Assetbase, July 2007 newsletter, continued from previous extract)

This section asks whether the fees that retirement funds pay to their asset managers are designed to meet the best interest of the fund or to improve the bottom line of the investment houses, or both. The ideal is for master and servant to share the same objective, that is to maximize the wealth of the master. If the remuneration of the asset manager is highest when the retirement fund best achieves its goals, the system works. Too often, this link is weak or non-existent.

¹ This needs to be qualified by a warning. In some cases – perhaps too many – the parent company of the asset manager is indeed the owner of the pension fund assets. The method is simple: convince the trustees of the pension fund to purchase a life insurance policy, housing the assets within the policy. The assets are transferred to the books of the insurer and managed by its asset manager. Trustees should ask themselves whether such an approach is in the interests of the beneficiaries of the fund.

Money managers and prime brokers love 130/30 strategies. If you want to know why, just follow the money. While a pension fund typically pays 50 to 75 basis points for an active U.S. large-cap strategy, it pays about 25 basis points more for a 130/30 strategy. Many firms are converting existing active U.S. large-cap equity accounts into these strategies, which permit the manager to make bigger bets on stocks they expect to go up by leveraging their portfolios by 30% and shorting potential losers by an equal amount. The net effect is that the portfolios have a 100% exposure to the stock market. "Money managers are pushing this because they would like to have less constraints, but also because there's a higher fee charged in these accounts," said Paul von Steenburg, a vice president at consulting firm Wilshire Associates Inc. (Pensions & Investments, 28 May 2007, Pionline.com, paragraph breaks removed)²

This writer is clearly sceptical that the industry has the interests of customers entirely in the forefront of its mind when embracing the new strategy.

The intention of this discussion is not primarily to ask whether asset manager fees may be inappropriately high, but to question the basis for their calculation and the alignment of manager interests with those of their customers, that is the retirement funds and the beneficiaries that they represent.

"It is critical for a better system that pension funds try to influence the structure of fees more" [Urwin] says. Pension funds should be looking for cheap beta (market returns) and reliable alpha (outperformance through skill), says Mr Urwin. But the latter is difficult to find and only the best governed funds are likely to achieve it. A further problem is that products are not generally shaped to fit that investment proposition. They tend, instead, to offer expensive beta and unreliable alpha. "With stronger governance, funds will define their expectations more crisply." (Pauline Skypala, Financial Times Fund Management supplement, 15 October 2007)³

Investment manager fee basis

Asset managers use a well-established method of charging fees, that is as a percentage of the assets under management. This has the advantage of being well understood by most customers. It also apparently aligns the interests of customers and providers: the higher the assets of the customer, the higher the fee of the provider.

But is it the best basis for charging customers? It usually appears to be low relative to the performance of the asset manager. It is frequently not disclosed in the financial reports of retirement funds because the asset manager reports performance net of fees rather than including a separate line on the fee charged. It is easy to establish an increasing revenue stream on the back of strong markets.⁴ And so the asset-based fee seems here to stay.

² Accessed at <http://www.pionline.com/apps/pbcs.dll/article?AID=/20070528/PRINTSUB/70525070/1031/TOC&template=printart> on 21 December 2007.

³ Roger Urwin is global head of investment consulting, Watson Wyatt.

⁴ Is there any evidence of percentage fees on equity assets having halved over the period during which the JSE All Share increased from 15 000 to 30 000?

And it appears to be a very useful way of generating profit, for the manager. Table 1 shows the total revenue and expenses for a South African asset manager, each expressed as a percentage of assets under management, together with an operating profit.⁵

This manager has been operating on consistent gross margins – pre-tax admittedly – of 30 basis points for the last seven years.⁶

Table 1
Reported revenue and expenses for South African asset manager

	2000	2001	2002	2003	2004	2005	2006
Assets managed (rebased)	100	122	129	138	158	202	255
Revenue (%)	0.89	0.73	0.79	0.58	0.62	0.77	0.76
Expenses (%)	0.40	0.26	0.40	0.31	0.35	0.45	0.45
Pretax operating profit (%)	0.48	0.47	0.40	0.28	0.28	0.32	0.31

Source: annual statements analysed by Deutsche Bank Securities. Assets under management are rebased to 100 in 2000 in order to retain anonymity.

This is a successful business for a steward of others' assets. Even if asset-based fees were appropriate these profit margins suggest that this market is not operating competitively.⁷

The real problems with this fee method, however, are the following

- **Relevance to costs incurred.** The fee is not linked closely to the costs incurred by the manager and cannot therefore be described as a fair fee for service.
- **Incentive to gather assets.** The success of the asset manager is derived mainly from the volume of assets under management, not the performance of the fund.

Since the success of a manager in gaining new assets is often strongly linked to the past performance of the fund, this second issue appears at first glance to align the interests of the customer and the asset manager. But where a fund ought to be closed to new business because its success is making it difficult for the manager to trade shares without moving the price, the incentive to seek new assets in the pursuit of better revenue is at odds with customer interests.

⁵ The work carried out by Deutsche Bank is acknowledged with thanks.

⁶ It is not appropriate to scrutinise the fluctuations too closely, because they arise from a variety of factors, for example, the changing mix of clients.

⁷ This is obviously not a scientific study and should not be regarded as claiming high margins throughout the industry. Revenue and expense figures for the asset management operation of a larger firm are difficult to obtain. The point that is being made is that, for as long as fees are linked to assets under management, the cost of the service to the retirement fund is opaque and impacted by events outside of its control.

Performance fees

Performance fees are designed to enhance the fit of the interests of the asset manager to those of the customer. They reward good performance by paying a higher fee to the manager and (usually) reduce the fee in cases of poor performance.⁸ Retirement funds should benefit from a closer alignment of its financial interests with those of its fund manager. The investment provider benefits from an appropriate reward in times of strong performance.

However, there are a number of issues with performance fees, mostly concerning the tendency of the service provider to exploit its information advantage over the customer. Standard nomenclature (Schreuder, 2007) includes terms like:

- minimum and maximum fee
- fee hurdle
- sharing rate
- measurement period, rolling or cumulative
- high-water marks, with fee accruals suspended or refunded, and
- the circumstances under which the high-water mark may expire.

Despite admirable efforts at self-regulation by the Association of Collective Investments (ACI) through its Standard of Performance Fees, considerable scope for customer confusion exists, not least because a large proportion of institutional asset managers are not required to comply with these standards because the products that they sell are not collective investment vehicles.

The fundamental flaws

As Managers have a fiduciary duty to look after the interests of their funds and their Investors, the Board should ensure that any performance fee structure is fair. (Investment Management Association et al, 2005: 9)

In addition to the enormous complexity of performance fees and their consequences, four flaws consistently underlie the use of this type of incentive.

The first flaw is that **the downside is often not equal to the upside**. While managers might use performance fees to demonstrate their confidence in their ability to produce market-beating results, they seldom match this with the commitment to share the consequences in the event of poor results.

⁸ The downside potential for the manager is commonly not as large as the corresponding upside.

This inequity comes about in many ways, two of which stand out: (1) the benchmark set is one that could be attained more often than not, (2) where the benchmark is roughly in the middle of the expected range, the potential downside penalty is smaller than the potential upside revenue.

In the first case, consider an equity-rich fund established with a performance benchmark that ought to be attained with high frequency, say inflation plus a few percentage points. In this instance, upside performance is expected to be gained more often than its downside counterpart.

In the second, the benchmark might be at the median of expected performance, but the size of the penalty (on the downside) is smaller than the corresponding size of the bonus (on the upside) that the manager is expected to gain in the long term.

These outcomes are difficult to determine because they depend on the uncertain expected average future performance as well as the even more uncertain variation of performance around this average. We should assume the manager to have better insight into these outcomes than the customer. The article at the end of this section (box 4) illustrates this point with reference to so-called absolute return funds.

The second problem is that **the manager often has little constraint on risk**. A problem affecting even the best-designed performance-incentive strategy is that the manager is tempted to vary the risk taken in the portfolio to meet its own objectives rather than those of the client. If the portfolio is running slightly behind the benchmark in the weeks running up to the end of the measurement period, the manager might take more risk in an effort to bridge the gap. This type of risk variation is often not in the interests of the customer. It also focuses far too much attention on short-term performance at sometimes substantial cost to its more important long-term counterpart.⁹

It is possible to link risk-limitation strategies with the performance objectives, but hard to enforce them or to invoke sanctions when they have been breached, especially on the downside.¹⁰ This distortion is as much a consequence of the fixed performance period as it is a reminder that it is almost impossible to align the performance objectives of the two parties when their attitudes to risk are not the same.¹¹

⁹ Retirement funds are long-term vehicles. Service providers tend to focus too much attention on the short term.

¹⁰ Another problem with risk limitation strategies is that they tend to focus attention on short-term investment decisions, which is seldom in the interest of a long-term investor such as a retirement fund.

¹¹ The issue also hints at the problem of misalignment of incentives when customers enter or leave a fund and their periods of investment do not correspond precisely with the periods over which the corresponding performance is measured, for the purposes of performance fees.

The third flaw is that **performance incentives often reward luck as well as skill**. A well-designed performance bonus should reward skill, but not luck. Too few benchmarks are designed with this thinking in mind. An equity portfolio, for example, should use a benchmark based on the share index, a bond portfolio on the bond index and a mixed portfolio on an appropriate mixture of the two. Under these circumstances, the manager outperforming the index has achieved this through skilled stock picking or portfolio strategy, making it appropriate that he or she be rewarded.

Where the objective is expressed in terms unrelated to the portfolio, the performance fees reward luck as much or more than skill. Most benchmarks expressed as inflation plus a fixed target fall into this category, generating much higher performance fees in strong equity and bond markets.

The fourth problem is that **the manager has the incentive to treat customers differently**. Where two customers of an asset manager have the same mandate, but one of them pays a performance fee and the other does not, it is difficult for the manager to avoid treating one customer with a preference.¹²

This discussion barely scratches the surface. At a recent meeting of the Association of Collective Investments, an industry provider indicated the existence of performance fees based on a benchmark of zero, and performance fees based on gross-of-fees performance.¹³

Behind the claim of the alignment of the interests of providers with those of their customers, would appear to lie an enormously complex additional source of information advantage that is referred to frequently through this study.

Instances of successful negotiation by the customer do exist, however. I understand that a large South African retirement fund has negotiated a fee with its asset manager that is not related to assets under management. A fixed amount has been agreed to and inflation-related increases are to be awarded each year. A performance bonus is to be paid based on tightly defined parameters that are aligned with the needs of the retirement fund.

¹² *It should be incumbent on the manager to demonstrate that preferential treatment is not being given. "Managers will need to install robust processes to ensure that they can demonstrate that preferential treatment is not given to funds with more attractive management fees and that staff remuneration policies do not encourage inappropriate behaviour. Areas that will need to be addressed include customer order priority, allocation and release of internal research recommendations."* (Investment Management Association et al, 2005: 7)

¹³ *Source: Moneyweb report by Jackie Cameron, 11 May 2007, www.moneyweb.co.za.*

Box 4**"There is no such thing as absolute return investing", Rob Rusconi¹⁴**

"The term 'absolute return investing' has no meaning. It misleads the listener into thinking it has substance that it does not have, and in our opinion the term should not be used," write Barton Waring and Laurence Siegel in "The Myth of the Absolute Return Investor", Financial Analysts Journal, April 2006.

This article picks up on a subject I covered a few months back, but with plenty of help from the experts. Waring and Siegel are well known for their insightful analysis of the financial markets and they are quite willing to say it as it is.

The returns of any portfolio are a mix of a market-related and a non-market portion.

Consider a pure equity mandate. The manager seeks to outperform the market, or a specific benchmark, giving a return that is part market and part skill. The first part is called beta, the second alpha.

Beta represents the portfolio's exposure to the benchmark. It may be leveraged, through borrowing or investment in aggressive shares, in which case the beta exceeds one; or it may be defensive, through cash holdings or investment in defensive or market-neutral holdings, in which case the beta is less than one.

In simple terms, the portfolio beta represents the multiple of the exposure to the market.

You pay a manager for alpha, or the investment return in excess of the benchmark (more precisely the benchmark multiplied by the portfolio beta). Since a manager charges fees, you are entitled to expect alpha, but you should not forget that, for the market as a whole, the sum of all alphas, even before fees, is zero.

So do not be too surprised if you do not always receive it.

What does this have to do with absolute return investing? The promise of these managers is that the customer will get performance that is always positive and mostly above the market. Most South African absolute return managers prefer to express this as a target, rather than a promise.

Targets usually start at an investment return of inflation plus 3 percentage points, but inflation plus 7 percentage points is available for those who wish to shoot high.

Waring and Siegel demonstrate that it is not technically possible to make this promise unless the target is cash or some market return measure.

Since the returns of any portfolio are a mixture of elements - market and non-market related - all investing is relative.

Every portfolio aims to meet or exceed the performance of a benchmark, and the promise of absolute returns cannot be made with certainty.

Add to this the reality that many so-called absolute return mandates come with a fee related to performance, the apparent guarantee, and you have a marketing mix par excellence.

The manager need not even create too sophisticated a portfolio. With a reasonable market element the chances are good that, three years out of four, it will outperform the benchmark and superprofits will accrue to the investment house.

It is completely unsurprising that, to borrow another thought from Waring and Siegel, the average performance of absolute return funds, before fees, is, well, average.

Investors should appreciate what they are really buying and what they are paying for it, ignoring the marketing.

¹⁴ This article was published in Business Report on 4 May 2007, checked on 8 January 2008 and available at <http://www.busrep.co.za/index.php?fSectionId=642&fArticleId=3812801>.

To finish off in the words of our experts, the phrase "absolute return investor" propagates a myth. "Like most myths of active management ... it is apparently being promulgated to aid the marketing of yet another cynical investment practice: the mixing of alphas and betas at a single fee level (the higher one, naturally)."

Source: Business Report, 4 May 2007

Consultant fee models

A number of investment consultants aim to charge fees that are expressed as a percentage of assets, usually a handful of basis points. Perhaps not many succeed but anecdotal evidence of basis point charges by consultants exists.

This practice, accepted for assets managers despite its flaws, is more difficult to justify in the case of consultants. While the practice may be explained in terms of the added value to clients that translates into enhanced performance that is in excess of the fee, this is almost impossible to demonstrate objectively.¹⁵

How should consultants be charging their clients? They should surely be doing so in a manner that most closely aligns the interest of the client and the consultant.

- An hourly rate is the most transparent way of doing this. The client accepts the rate of the consultant on reputation and agrees to continue paying for the service for as long as it adds value.
- In instances of stable long-term relationships, this may be consolidated into a monthly or annual fee or retainer, but this depends on a high level of trust between client and consultant and must be supported by a clear description of the services involved, preferably with some risk-sharing arrangement should the time commitment be lower or higher than expected.

In all cases, whether services are rendered by an asset manager, an investment consultant or any other service provider, it is the responsibility of the trustees to make sure that they understand the rationale for the fee method and are able to justify the amounts paid for service in terms of the benefit provided by the service provider.

¹⁵ *If it were, the consultant would be happy for the benefit provided by it to be assessed independently. I have not heard of instances of consultants agreeing to such scrutiny.*

Concluding comments

It seems that, no matter the fee model, the business for investment managers is to gather assets.

There's a free-for-all going on in the 130/30 market, as money managers offering the strategies are testing not only fee levels, but also different fee structures, to see what works. "Some managers are willing to be flexible and negotiate (fees), especially the ones with only proprietary capital in the fund," said Florian Weber, a Los Angeles-based research analyst in Wilshire Associates Inc.'s manager research group. ... Each type of manager has a different expectation of what he or she can charge. And the race to grow assets is making managers more flexible in the way they charge fees. (Pensions & Investments, 26 November 2007, Pionline.com, paragraph breaks removed)¹⁶

That the asset-gathering reality may be at odds with the needs of the customer, in the case of retirement funds, to maximize long-term returns, seems to be an uncomfortable reality of the business. Like many markets, however, this one would work better if the demand side were stronger and full information more freely available.

This section closes with the transcript of a radio interview. A somewhat uncomfortable CEO of an investment management house is taking questions from Alec Hogg on staff remuneration. The interview is included to provoke further thought on the need to align the interests of investment managers and their customers the retirement funds. It is not intended as criticism of the firm or its remuneration model and references in the interview to the firm and its CEO have been edited out.

Box 5

Fund manager interview: staff performance incentives

Extract of Alec Hogg interview of CEO of a local asset manager on the MoneyWeb Power Hour, November 2006. References to the firm and its team have suppressed.

MONEYWEB: I don't want to belabour the point, but I think it's pretty obvious. Just help us out here. David and I were scratching our heads and thinking we've got to put our children into asset management, because operating expenses of R385m at [company name] – how many people do you employ?

CEO: We employ 150 people.

MONEYWEB: OK, so I was close to the mark. All right, 150 people, between them R385m, how much of that is salaries?

CEO: Right. You may know that when we started the business we paid very low basic salaries, and we still cap our salaries to our senior staff, so they get well below market-related salaries. However, there is a bonus pool. That bonus pool amounts to 30% of the pre-tax profits. However, in that number that

¹⁶ Article downloaded 27 November 2007 from <http://www.pionline.com/apps/pbcs.dll/article?AID=/20071126/PRINTSUB/71121047/1031/PIIssueAlert01>

you have in front of you, you have a number of costs that are variable costs, be it distribution or administration. So the bonus pool is significant in the case of [company name], but what we have done is we have actively managed a reserve. In other words, we don't pay out everything that sits in the bonus pool.

MONEYWEB: But it's still a big bonus pool? How big? Over R100m?

CEO: We don't disclose that as a separate line item.

MONEYWEB: Come on [CEO name]! If you were talking to a company you were investing in, and you asked them how big was the bonus pool, I'm sure you'd insist that they disclose it.

CEO: I've already disclosed that it's 30% of the pre-tax profit, so it's very easy to work out.

MONEYWEB: Well, it would be then comfortably over R100m. Plus you've got dividend stream to the staff of R37m, plus you issued share options worth another R51m – it is the place I wish I could have sent my kids, into asset management.

Source: www.moneyweb.co.za

5

HEDGE FUNDS

VALUABLE DIVERSIFICATION OR EXPENSIVE GAME?

In which the broad characteristics of South Africa's rapidly growing hedge fund industry is described, the diversifying characteristics of hedge fund strategies are discussed and the implications of their wide scope to invest without constraint are explored.

While speed and transparency are driving non-traditional sources of value in global financial markets, demand is spiking for new forms of money management – chief among them hedge fund and hedge fund "lite" products increasingly sought by institutional investors looking for better returns. But as the hedge fund story unfolds, investors are bound to discover that not all the reviews are good. Some will be bad, and others downright ugly. (Dence et al, 2007)

Hedge funds¹ form an ill-defined class of investments covering, broadly and rather crudely, "anything that doesn't fit in any of the other asset classes".² Over one hundred locally managed hedge funds are available to South African institutional investors.³

Hedge funds are seen by many to be clouded in mystique. They often receive bad reviews in the popular press, with hedge fund managers being caricatured as investment cowboys. We try to provide a more balanced perspective of the industry. One difficulty we have is that there is

¹ The descriptive and analytical work of Piele & van der Merwe (2004) is frequently referred to in this section. Their statistics may be a little dated but their writing most certainly is not. The paper is recommended to any trustees or other investors interested to learn more about South Africa's hedge fund industry.

² This rather unhelpful definition, improved on during the course of this section, is not as ludicrous as it sounds, since the variety of available hedge fund strategies, particularly in the global markets, where they have been around for over fifty years (Piele & van der Merwe, 2004).

³ The number of hedge funds is not known with precision. Hedge funds are not regulated and unregulated managers, while they must be registered with the Financial Services Board, are not permitted to market themselves. The Novare hedge fund survey (October 2007) has 131 hedge funds, with R26bn in assets, up from 90 a year earlier, but recognizes that some hedge funds are not included. The Symmetry survey (July 2007) provides performance and risk data for some 55 funds, but uses a set of criteria to determine whether to include each fund. Hedge Fund Intelligence (www.hedgefundintelligence.com/SA) states the total as 115 (web site accessed 17 September 2007).

no simple definition of what a hedge fund is. The broad category includes funds following a wide variety of strategies with very different approaches to managing risk. (Piele & Van der Merwe, 2004: 1)

"Hedge fund" was a term originally coined to describe the potential for these vehicles to protect investors against the other risks to which they were exposed, market risk often the most prominent. The expression is now used more broadly than this. While it is true that some hedge funds take high risks in pursuit of high returns, and nearly all hedge funds are free to leverage their risks, it is not true that hedge funds are, by definition, risky investments.

The popular perception of hedge funds is that of gung-ho day traders willing to exploit any loophole to make money with little concern for risk. We hope to show that the vast majority of hedge funds operate quite differently and it is the latter type of hedge fund that should be most attractive to institutional investors, even if they make for less sensational reading. We hope to show that most hedge fund managers are both more conscious of investment risk and better equipped to manage it than most traditional asset managers. Through detailed analysis, the investor should ultimately be able to understand the potential risks and opportunities inherent in different hedge fund strategies and be able to separate competent hedge fund managers from pretenders. (Piele & van der Merwe, 2004: 1)

But the fact remains that hedge funds are difficult to understand and that the detailed analysis suggested by these authors is too often out of reach of the pension fund fiduciary.⁴ If one of their primary benefits, for example, is to provide returns that are uncorrelated to the corresponding returns of conventional instruments, then conventional measures may not be sufficient to provide the appropriate insights into these returns.

One can learn a lot about hedge funds simply by examining the return numbers in great detail. But that should not be sufficient for the professional advisor. One also needs to understand how these returns are generated, what the techniques are for generating returns and what the techniques are for managing risk in the portfolios. By understanding how hedge fund managers manage their funds we are able to understand their performance numbers better. By interrogating their performance numbers in depth, we are better able to appreciate better how they manage their portfolios. By doing both, we hope to gain an understanding of the likelihood that hedge funds will continue to deliver attractive low volatility returns into the future. (Piele & Van der Merwe, 2004: 1,2)

Determining whether hedge funds add substantial value to pension funds and their members is not easy to do, partly because of their complexity and partly their freedom to utilise a very wide range of investment tools.

⁴ Some suggest that it would be better for the term "hedge fund" to be scrapped. Strategies should rather be described by the level of risk taken. Failure to describe strategies more carefully is not in the interest of those who provide these alternative instruments.

Opacity, however, is not in the interests of this niche industry. Hedge funds could explain simply and demonstrate through simple numbers the benefits that their techniques could bring to pension funds and their members.⁵ That might, in turn, go a long way to justifying the high fees charged by the managers of these portfolios.

The key benefit

The most important benefit that most hedge funds bring to a portfolio is low correlation of performance relative to the corresponding performance of the equity market. While trustees are correct to expect hedge funds to deliver returns, it is for diversification that they should consider the hedge fund as part of the pension fund portfolio.⁶

This suggests that the diversifying potential of a hedge fund, or a fund of hedge funds, should be measured not in isolation but against the needs of the pension fund portfolio as a whole.⁷ Trustees should expect this type of insight from their asset consultant, who ought to be able to carry out such analysis not only for hedge funds in the portfolio but for all other alternatives as well.⁸

The drawbacks

Some of the difficulties with hedge fund investment are discussed below. The length of the list is not intended to suggest that all hedge funds are inappropriate for retirement funds, but it does illustrate the care required by trustees when allocating investments to this type of asset class.

⁵ This may be difficult to do in some cases, where the strategies are not particularly complex, or not meaningfully different to mainstream asset management and do not deserve the additional fees that are charged in the name of diversification or the expectation of high return. Better transparency by all providers would assist the process of identifying charlatans.

⁶ There are always exceptions in the hedge fund world so this should be regarded as a generalisation. Some hedge funds, for example, aim for exceptional performance and play a different role in a portfolio. Some provide diversification against bond returns rather than equity.

⁷ Detailed analysis of the benefit of such diversification benefit, some in the industry suggest, is not possible without understanding the inner workings of the hedge fund. This is only partly true. At a first pass, a fair amount concerning the diversifying properties of a hedge fund or fund of hedge funds can be understood through analysis of monthly returns against benchmarks, sufficient probably for an initial screening of options. Thereafter, since hedge funds employ a complex variety of strategies, these should be well understood by trustees before selecting a hedge fund strategy and manager for a pension fund portfolio.

⁸ The primary value of the independent consultant is to demonstrate how the building blocks of the fund – the mix of products and investment managers – fit together. To be blunt, trustee, if your consultant cannot model an absolute return product or a hedge fund, as part of the broader portfolio, clearly demonstrating its contribution to the overall risk-return profile of the fund, you need to ask why you are paying their fees.

- **High fees.** The hedge fund industry has a reputation for high fees, most commonly an annual 2% of assets plus one-fifth of the performance in excess of the benchmark.⁹ Since specialist skills are required to run a hedge fund, a higher fee than for conventional long-only portfolios may be justified, but a base fee as high as 2% produces a substantial incentive to gather assets, even if this is tempered by the impact of the performance-sharing component.¹⁰

What makes high fees questionable is not that they may not be justified, but that trustees seldom know what they are buying, particularly when the product is more about diversification than about performance.¹¹ The flexibility and freedom of hedge fund management requires an element of trust from the customer. Hedge fund managers – and the industry in general – could improve trustee confidence in their products by providing better, standardised and comparative information, and being more transparent about the nature of their offering.

Two scenarios could dull the allure of hedge funds. Both may prove inevitable with time. A significant market downturn could be difficult for some hedge fund managers to survive, unless they modify their strategies significantly in response. The recent high returns have seen some hedge funds adopting a significant equity market element into their portfolios, not really what retirement funds should be paying those high fees for.¹²

The second scenario would be a growing incidence of synthetic hedge fund strategies. Some of the large investment banks overseas are replicating average hedge fund returns at a fraction of the price. This should introduce more robust price competition and a clearer description by hedge funds of the value they bring to customers.

- **Layers.** The information gap has the effect of introducing layers between the market place and the pension fund member, a theme repeated throughout this research, but particularly important in the hedge fund space. Some of these layers exist within the operations of the hedge fund manager itself, which uses a wide range of tools in the

⁹ Since hedge funds are often market-neutral, the benchmark is usually not the equity market, but something lower than this, cash, for example, but sometimes even zero.

¹⁰ "Today's investor is paying a high price for inventive but costly financial engineering. The standard 2 percent management fee coupled with a 20 percent performance fee is plenty of incentive to attract new investment firms into the market, but it's also setting the stage for institutional investor backlash over the long term." (Dence et al, 2007)

¹¹ Two percent of assets can be difficult to justify when the best outcome of a market-neutral fund may still trail the equity markets over the long-term. Again, hedge fund managers – at least those with market-neutral strategies – need to explain and demonstrate the benefits of diversification.

¹² There is evidence that many hedge funds – remember the term, they are expected broadly to provide returns that diversify against the market – are running strategies with a high beta component, in other words with high exposure to the market. Since exposure can be obtained by investing in an index-tracker, trustees must ask why they are paying their hedge fund manager to do the same. A downturn should split the flock between those running expensive market-following strategies and those that provide genuine diversification. Trustees should set out to ask the right questions before that happens.

pursuit of performance, within the constraints of the mandate. Some of these tools are expensive, partly explaining the high fee.

Others exist outside of the hedge fund itself as the complexity of the industry lends itself to the inclusion of intermediaries in the value chain. Novare (2007) reports that 60 per cent of all hedge fund assets come from fund of hedge fund investors, a proportion that has grown considerably over the last two years.¹³

These multi-manager arrangements add expense to the value chain and provide opportunity for opaque charging behaviour.¹⁴

Piele & van der Merwe (2004) list the advantages of fund of hedge fund strategies as diversification, analytical expertise, accessibility¹⁵ and the provision of strategies geared specifically to the needs of the fund. They highlight the disadvantages of cost and conflicts of interest between the fund of funds and the underlying hedge funds.

- **Difficulty of assessment.** If the institutional investments industry is characterised by information inequity and perceptions that service providers may seek to take advantage of these, then the apex of the problem lies in those areas of greatest complexity and opacity. There is little doubt that, to be effective, hedge fund managers require relatively free reign, but in return they need to be transparent about their intended strategies and very clear about the sources of strong and weak performance.

This concern is exacerbated by the practice of selective reporting. Hedge funds should be willing to be included in market surveys in the interests of customer education and they should encourage surveyors to expand the data they collect to demonstrate the true contribution of the hedge fund to a wider portfolio.¹⁶ Surveyors themselves should do everything they can to reduce the impact of selective reporting and survivorship bias.

As hedge funds still suffer from misperceptions about high risk and volatility (fueled in large part by media focus on sharp moves made by global macro hedge funds), the HFA aims to educate the investing public and legislators around the world on the true benefits as well as

¹³ Novare (2006) reports the corresponding proportion at 52 per cent for a year earlier, and 35 per cent the year before that.

¹⁴ The expense may be offset by reductions in the fees paid by the funds of hedge funds to the underlying hedge funds, but the offset is likely to be lower than the incremental cost introduced by the additional party in the value chain. Piele and van der Merwe (2004:56) appear to suggest that rebate arrangements set up to the benefit of the client are rare.

¹⁵ Improved access is provided in two ways: (1) funds of hedge funds frequently accept clients at lower rand entry levels than standalone hedge funds, and (2) funds of hedge funds sometimes have access to hedge funds that are otherwise closed to new investors because they have attained their capacity constraint. The second may beg the questions, who interest is the hedge fund serving if it is open to some and not to others?

¹⁶ This assumes that the surveys provide a fair representation of the performance and investment characteristics of the hedge funds, and that designers are free of bias or conflict of interest. If such surveys do not exist, hedge fund managers should seek to encourage their development.

potential risks associated with investing in the different hedge fund strategies. (web site of the Hedge Fund Association)¹⁷

Intermediaries have an important role to play here as independent expert assessors of these hedge funds. Unfortunately, the judgement of some of South Africa's so-called independents may be affected by conflicts of interest, a serious threat to the integrity of performance measurement and perhaps the hedge fund industry as a whole.

- **Questionable diversification within the class.** Carefully selected hedge funds ought to provide good diversification from other asset classes. This could be enhanced by sensibly combining hedge funds themselves. Hedge funds provide the investor access to a huge range of investment strategies, in theory at least. Unfortunately, the majority of hedge funds in South Africa still fall into just two categories, equity market neutral and equity long/short strategies, both of which aim to reduce or remove the market element and gain returns through stock picking.¹⁸

There are good reasons for the lower numbers of funds in other categories, an absence of tradable securities, for example, and the number of alternative strategies appears to be on the increase as the market deepens. It is nevertheless difficult to justify combining hedge funds on the basis of diversification of risks when the available universe is this narrow.

It is not clear that funds of hedge funds are the ideal vehicle to address this absence of diversification, particularly when the variety of fund types is simply not available. Furthermore, under very poor investment conditions, diversification can evaporate as nearly all funds are affected by the same events.

Although portfolio construction and manager bets account for the lion's share of [poor] performance, the primary culprits in July and August [2007] were liquidity constraints and diversification, said Ryan Tagal, Morningstar's director of hedge funds and alternative investments. ... Russell's Mr. Tsujimoto agreed that hedge fund of funds were the victims of "a period of crisis when correlations went down to one. That's what happened in late July and early August. Investors want hedge funds without correlation to each other, but periods of market stress tend to severely reduce correlations, making it hard to find return." (Pensions & Investments, 17 September 2007)¹⁹

¹⁷ Available at www.thehfa.com, accessed 17 September 2007.

¹⁸ Novare (2007) reports that 23 per cent of hedge funds, including those managing unit trust assets, describe themselves as equity market neutral and 42 per cent as equity long/short. Because these funds are longer-established and larger, the breakdown of assets into these strategies is respectively 28 per cent and 48 per cent, more than three-quarters of the market. Add to this the 12 per cent in so-called "multi-strategy" arrangements, which may well be dominated by the two most common strategies provides evidence of considerable concentration of risk into just two investment approaches. There has been very little evidence of diversification into other strategies over recent years.

¹⁹ Available at <http://www.pionline.com/apps/pbcs.dll/article?AID=/20070917/PRINTSUB/70914061/1031/PIIssueAlert01>, downloaded 17 September 2007 and again 20 December 2007.

- **Potential for poor performance.** Of course, one of the issues that trustees must be concerned about is the risk of poor performance. Novare's survey (2006) provides a chart of industry-wide performance on a quarter by quarter basis since late in 2002.

The image confirms the overall impression of reasonably steady positive returns, below the performance of the equity markets but protecting against poor JSE performance. But it also shows that hedge funds can perform poorly, with a number of hedge funds returning negative results in any given quarter.²⁰

Poor performance is also possible on the back of operational risk. Running a hedge fund is complex and failure possible.²¹

- **Appropriateness to liabilities.** Much has been written in the preceding pages about the diversifying benefits of hedge funds, but the arguments presented consider assets only, ignoring the liabilities. Asset optimisation in the absence of a complete understanding of the liabilities is wasteful.

It is not clear that the members of a defined contribution fund need the diversification provided by hedge funds. Since their long-term liabilities are defined with reference to salary growth, these members need acceptable exposure to economic growth, which they can gain through equities and, to a less extent, bonds. Hedge funds reduce volatility risk, but it is not necessarily true that they add to the risk-adjusted return gained by members, where risk is defined with reference to member liabilities. This is a complex issue that ought to be better analysed by all professionals operating in the industry.

Is the hedge fund industry being honest with its clients?

Hedge funds are investment funds that operate on a private basis and as such are not regulated by the Financial Services Board (FSB) in South Africa. Hedge funds are not regulated because they typically employ strategies, such as short selling and the use of leverage, that fall outside of the current regulatory framework. In most geographical regulatory jurisdictions hedge funds are either unregulated or lightly regulated. (Piele & Van der Merwe, 2004: 1,2)

The question posed is difficult to answer, by the very nature of the hedge funds. They are not regulated because they cannot easily be regulated within existing structures of regulation. By virtue of the unusual methods that they employ, many hedge funds are

²⁰ Perhaps even more concerning is the tendency of the average hedge fund performance to move with the corresponding figure for the equity market on average. The hedge fund industry is dominated by long/short strategies that reduce exposure to market risk but do not remove it completely, so we would expect this relationship to persist. Nevertheless, it ought to remind trustees that they must understand what they are purchasing and must measure their hedge fund manager on diversification just as much as on performance.

²¹ "...the investor can not take for granted that the operational infrastructure backing the fund is sound and the investor should therefore investigate the back and middle office infrastructures before making an investment into the fund." (Piele & van der Merwe, 2004:55)

more exposed to disaster than their conventional counterparts and are prone, as a group, to reputation risk, particularly on the failure – spectacular at times – of any of their peers.

The U.S. Securities and Exchange Commission is examining hedge funds for signs of insider trading, demanding information about relationships between managers, employees, family members and public companies.

SEC officials told hedge funds to list clients and workers who serve as officers or directors of publicly traded companies, along with the names of any relatives who hold such posts, according to a 27-page letter to industry executives obtained by Bloomberg News. The SEC confirmed its authenticity.

... Unusually high trading in shares and options before takeover announcements by companies including TXU Corp. and First Data Corp. has intensified scrutiny of how market-moving information spreads among hedge funds, investment banks and leveraged buyout firms. The SEC's office of compliance and inspections referred 223 cases of potential securities violations to the agency's enforcement division in the latest fiscal year.

Since April 2006, the SEC has filed insider trading-related lawsuits against more than a dozen investment bankers, analysts and executives whose jobs require them to safeguard clients' secrets. That's more than during all of the 1990s. (Bloomberg, 18 September 2007)²²

Hedge funds are opaque investments. This is both a strength and a weakness but it makes clients invested in this class of assets more prone to the activities of the unscrupulous and more difficult to regulate. Of course, this doesn't mean that hedge fund managers are dishonest, but if mutual funds, the simplest of investment vehicles, could be so susceptible to misuse of client money,²³ the opaque world of the hedge fund surely provides more opportunity for mismanagement of client assets.

Without question, vigilance is crucial. Trustees are looking after member assets and cannot escape the responsibility to ensure that the way in which these assets are invested must be in the interests of members. The value that these services contribute to the fund should demonstrably exceed the fees paid for them.

It is difficult to conclude either way on the level of transparency of hedge funds to their clients, signs of positive change are encouraging.

... a survey by Cape Town-based Novare Investments has found that the domestic hedge fund industry, whose assets increased by 70 percent to R26 billion in the past 12 months, has improved transparency by disclosing portfolio holdings more frequently. While reporting fund values daily is the norm in the unit trust industry, hedge funds tended to report less often. But Carla de Waal, a portfolio manager at Novare, said 31 percent of hedge funds now posted values every day, compared with just 21 percent a year ago. These funds held 38 percent of

²² "SEC Scrutinizes Hedge Funds in Insider-Trading Probe (Update4)", written by Jesse Westbrook and Jenny Strasburg, downloaded on 19 September 2007 from the Bloomberg web site at the following address: <http://www.bloomberg.com/apps/news?pid=20601087&sid=ayGbWUu2.UXU&refer=home>

²³ See Bogle (2005a) for a lengthy description of the issues in mutual funds.

the industry's assets. Newer funds were the most progressive; 45 percent of the funds started in the past 12 months provided daily updates on their portfolio holdings. (Tonny Mafu, Business Report, 26 October 2007, paragraph breaks removed)²⁴

Transparency of daily holdings is a big stride in the right direction. It would be helpful if hedge funds also saw themselves from the perspective of the retirement funds, making clear the benefit of the diversification, and in some cases performance potential, to the members of the funds. If hedge funds cannot make clear their position in a broader portfolio, trustees of retirement funds should not be expected to either.

Conflicts of interest

There is one important area of concern in the South African hedge fund environment. In at least two instances, consultants providing services analysing hedge funds also have an interest in a fund of hedge funds and hence cannot be described as independent in their assessment of hedge funds. More generally some fund of hedge fund managers are not independent of the hedge funds that they use.

Some FoHF managers are not independent of the hedge funds used in their portfolios impacting the objectivity of their selection process. The FoHF manager may manage direct hedge funds within their firm and use these in its FoHF products. Alternatively, the FoHF manager may have a shareholding in some of the hedge fund management companies whose funds are included in their products. The FoHF manager may enter into a fee sharing arrangement with particular hedge funds that they employ. In some cases, where a company offers both FoHF and direct hedge funds they may get past the conflict of interest issue by undertaking to exclude hedge funds in which they have an interest from the FoHF product. This is also less than ideal. (Piele & van der Merwe, 2004:56)

This type of practice damages the credibility of the hedge fund industry and undermines the financial security of the members of the funds serviced by these managers. Trustees must – in this area as in so many others in the industry – exercise great care in the selection of service providers.

²⁴ "Hedge funds make effort to shed light on holdings", downloaded on 8 January 2008 from Business Report at www.busrep.co.za/index.php?fSectionId=561&fArticleId=4098661.

6

MARKETING CONTRIBUTOR TO TRUSTEE UNDERSTANDING?

In which concerns are raised about some supplier approaches to attract retirement fund business and the apparent willingness of some trustees to accommodate these methods.

*From a social point of view, marketing probably provides a mixture of [1] useful information, [2] misleading information, [3] an impetus to good performance, and [4] zero-sum game raiding. The possibility of spreading favorable information by marketing probably acts as a spur to good performance and product innovation. **But most methods to keep IA [individual account] costs low involve a reduction in marketing expenses, under the assumption that much of it is zero-sum and not the most efficient way to provide useful information to new investors.** (James et al. 2001: 16; emphasis in original, numbering added for clarity)*

James and her colleagues imply that marketing effort adds significantly to industry costs but little to overall value. Marketing often aims to switch a customer from one provider to another rather than encouraging new customers to save.¹

Policymakers are concerned about marketing and sales methods and their contribution to system cost. Judging by trends in retirement saving reforms from around the world, they appear to be of the opinion that, if overall cost is a problem, design intervention should aim to squeeze marketing activity out of the system.

This section asks whether

- marketing activities are in the interest of the retirement funds to which they are directed, and

¹ These comments apply more to occupational retirement funds than to individual savings. In South Africa's voluntary pension environment, marketing may encourage an incremental improvement to savings rates, with both microeconomic and macroeconomic benefit. In the institutional space, however, savings levels are less likely to change and marketing is more about attracting another provider's customer than about motivating additional savings.

- advertising is designed to improve trustee understanding of investment issues.

In an afterthought, the chapter asks as well whether providers of service to retirement funds are adequately disclosing additional revenue sources obtained through their relationship with the funds.

Anecdotal evidence suggests that asset-based fees have not fallen in proportion to the significant rise in market values and that profit margins are reasonably high at present – refer to further discussion in section 4. This would suggest that asset managers are not competing strongly on price and begs the question of whether marketing activities are working in the best interest of customers, since winning the customer may be at least as important as generating strong asset performance.²

Marketing: education or enticement?

The Australian Pension Regulatory Authority (APRA) recently issued a letter raising concerns about the activities of some regulated superannuation entities. All retirement funds in Australia are subject to what is known as the *sole purpose test*. This means essentially that they must state themselves (APRA, 2001) as

- meeting one or more of the core purposes, essentially the provision of retirement benefits or spouses' benefits on death after retirement, and
- meeting one or more of the ancillary purposes, broadly the provision of other forms of benefit such as withdrawal, disability or death benefits, or any alternative benefits approved by APRA.

The goal of the sole purpose test is to establish whether expenditure contemplated or carried out by the superannuation entity is consistent with its reason for existence, as encapsulated in the sole purpose statement described above. The reason for APRA's concern is that, in the run-up to the national launch of individual choice of retirement funds, evidence of inappropriate marketing expenditure, incurred or planned, was growing. The purpose of the letter was to remind the managers of these retirement funds that such expenditure should be supportive of the objectives of the fund to provide retirement benefits to its members.

In the past, APRA has taken action where advertising or promotional expenditure has not been primarily to inform and educate existing members. Expenditure on marketing and promotional activities will continue to be considered in the normal course of our supervision activities in regard to the superannuation industry (APRA, 2005).

² It is of course a generalisation to suggest that asset managers never compete on price. In pockets, price is an important determinant of the provider selected. But this appears to be limited to very large funds, where buying power is strong and trustees highly conversant with the issues involved.

Why is the issue being raised in this paper? It is surely not appropriate to submit privately-owned entities responsible for providing services to retirement funds to the same tests as the retirement funds themselves? No it isn't. But umbrella funds and retirement annuities are registered retirement funds. Their trustees should exercise all due care concerning the expenses that they authorise, testing these against the fundamental objectives of the fund.

How does this thinking apply to other service providers?

- **Asset managers** have a strong incentive to use performance figures to their advantage. The absence of hard evidence that active managers can produce sustainable outperformance notwithstanding, all around the world the numbers are used to project the appearance of skill, enticing customers to trust the provider to do it again. Later discussion provides and comments on a few examples. Within reasonable limits – the voluntary adherence of all providers to a set of common standards like the Global Investment Performance Standards would be a good start – it is probably not appropriate to try to prevent this.³

The key to responsible marketing is a well-informed customer. The best managers recognise that they have a sustainable advantage over their peers that is founded on good information. These are the companies that tend to invest more in objective information, making it part of their brand.

It is often the same companies that take a different approach to investments, an approach that is better aligned with the long-term interests of customers because it is less focused on short-term performance. Where this approach succeeds, responsibly highlighting it in promotional documentation is appropriate.

Stronger, objective intermediaries, in this case investment consultants, would help to keep asset managers transparent about the information that they present. The conflicts of interest that beset some of these so-called independents dampen their positive impact.

- **Multi-managers** are in a similar position to their peers in the individual manager space, with a similar incentive to sell the proposition that active management can add value providing the investment manager is soundly selected. Multi-managers may be tempted to play a little more on the fears of customers, mainly the fear of failure, and for this reason may be content to describe a small but steady excess performance, above the market, as sufficient to ward off the threat of failure. Is this responsible marketing? Like the single asset managers, multi-managers may not go so far as to present incorrect information, but certainly suffer the temptation to misrepresent by omission.

³ *It is not appropriate to prevent the use of performance data to win customers. The appeal is that it is done responsibly, which means not using data selectively and taking every opportunity to inform rather than deceive a customer.*

- **Investment consultants** have the advantage that it is very difficult to assess their skill and that – presently at least – there is very little testing of the value that they bring to customers. While the angle might be slightly different, more in line with avoiding the pitfalls of poor performance or regulatory omission, investment consultants still have a strong incentive to use marketing to play to the fears of their target market.

All of these providers are motivated to convince their customers that (1) they have their interests at heart and (2) they have the skill to meet the complex needs of their customers. As such, they should put considerable effort into demonstrating their sober, intelligent and honest attitude to the responsibilities faced by their clients. A stronger emphasis on education would assist in conveying this attitude.

Travel and entertainment

Probably the most troubling aspect of the attitude of providers to their potential market is the apparent belief that trustees can be enticed with gifts. These come in various forms and at various levels of expenditure, but the most significant of them is probably the willingness to take trustees to faraway places under the guise of training.

... if [a trustee] is paid [for his services], then how much would be sufficient to reduce (preferable eliminate) the backhanders that bedevil the industry? Whether it takes the form of entertainment, travel or even educational grants, trustees and service providers are locked in a game dangerously akin to bribery. None dare speak its name, but it's prevalent nevertheless. (Alan Greenblo, editor, Today's Trustee, December 2007/January 2008, page 5)

A prominent asset manager is reputed to have taken a group of clients to an exotic international location, supposedly to attend an investment conference. The need for a helicopter ride during the trip is difficult to justify.⁴

For providers, this is ostensibly a rational purchase of face time to develop an advantage over competitors, but all of them surely declare that they are willing to subscribe to professional conduct standards like the CFA Institute Code of Conduct and the corresponding code of conduct of the Investment Management Association of South Africa?⁵

⁴ I was told recently of a day outing involving a helicopter trip to a Kwa-Zulu Natal game reserve. The chief executive of the asset manager in question denied that it ever happened. An ear to the ground hears many such anecdotes. I have heard stories of less sophisticated trustees traveling to a distant board meeting being plied with exotic drink the night before the meeting, rendering them unable to apply their minds to the tricky issues at hand on the day of the meeting. Would that this were not true.

⁵ "Members will conduct themselves with integrity, honesty, fairness and dignity and act in an ethical manner in all their dealings with the public, clients and other industry participants and in addition

They should ask themselves whether such activities are consistent with these standards.

Trustees aren't shamed to expect sweeteners, nor service providers to offer them. For the former, it's justifiable compensation [goes the argument]. For the latter, it's the cost of doing business [the argument continues]. Either way, without an enforceable code agreed to by both on the giving and disclosure of gifts, the line to corruption is indistinct. (Alan Greenblo, editor, Today's Trustee, December 2007/January 2008, page 5)

What concerns observers is that trustees are willing to be taken on such trips. This reflects a view that being a trustee of a fund is something to aspire to, not because it represents an outstanding opportunity to look after the financial interests of the members but because it provides other interesting opportunities to experience the world. The cycle needs to stop somewhere.

*From trinkets ("quite harmless") to overseas trips ("for experience"), from laptops ("helping trustees do their work") to scholarships ("helping trustees educate their kids"), a party of freebies for the fortunate swings along. In excess, parties cause hangovers. Here, they take the form of **trustees' objectivity being impaired**. (Today's Trustee, December 2006/January 2007, page 23, emphasis mine)*

The giving and taking of gifts is unambiguously wrong, yet appears to be widespread. Recent trustee support from the Financial Services Board includes a draft code of conduct, essentially to help trustees to do their job better, but it is not yet clear whether and how boards of trustees are using these guidelines.

"We acknowledge that each of us as a trustee may be sanctioned, whether in the form of censure, suspension subject to the terms determined by the other trustees, or expulsion from office, for any breach of this code; and that any such sanction may only be imposed after that trustee accused of such breach has been furnished with the opportunity to defend himself or herself." (Draft Code of Conduct, Financial Services Board, 2007b, Annexure A, paragraph 11)⁶

So, part of the responsibility lies with trustees. They need to recognise that inappropriate enticements are just that, inappropriate and enticements. They rob the trustees of the objectivity they need to make the right decisions by distorting the selection process and forcing personal interest in front of the fiduciary responsibility to seek the best for the members of the fund.

thereto will be expected to display utmost good faith, professional conduct, skill, care and diligence at all times." (IMASA Code of Conduct, page 2, downloaded from www.imasa.co.za on 13 January 2008.)

⁶ PF130 has a number of annexures. Annexure A is a pro-forma Code of Conduct that trustees are expected to apply their minds to and adhere to.

Advertising

... by creating new funds to match the market fads of the moment, this industry too must assume much responsibility for the unwise choices made by so many fund investors [referring to the technology bubble]. It's worth reiterating that investors have paid a high price for the fund industry's departure from its time-honored and sound tenet "we sell what we make" to its new and opportunistic tenet "we make what will sell". That new tenet accurately reflects the fund industry's eagerness to jump on the bandwagon of the latest market whims. (Bogle, 2005a: 188)

This section provides a few extracts from advertising material and comments on them. The material needs to be put in the context of three important points.

First, the asset management industry has changed a great deal in the last few decades. It appears to have let slip from its collective thinking the fact that it is a servant to the owners of capital. At the risk of generalisation, the thinking has shifted from asset managers being the caretakers of capital for its owners to the accumulators of capital for themselves.⁷

This pervasive substitution of direct owners of stocks – principals – by intermediaries – agents – has created a host of new challenges to the return of owner's capitalism. (Bogle, 2005a, page xxi of the introduction)

Second, we are inclined to infer causality where randomness could play a significant part.⁸ This increases our tendency to consider short-term performance even where we should be considering success in the long-term. This is worsened by the tendency of experts to attribute success to skill and failure to randomness, also focusing on short-term evidence rather than the longer-term alternative.

The attribution bias... gives people the illusion of being better at what they do, which explains the findings that 80 to 90% of people think that they are above the average (and the median) in many things. (Taleb, 2007: 244)

The third point links and illustrates the first two. It is the heavy focus on short-term performance. While has a number of impacts, among them a sustained belief in active

⁷ If it were not so, would there not have been greater pressure to compete on fees and simple performance measures? Asset managers may still describe the assets as "assets under management" but the simple fact is that for as long as fees are based on assets the economics of asset management is to increase the size of the assets under management.

⁸ Refer to the more detailed description in section 1, discussing the preponderance of the active asset management style over its index-linking alternative.

asset management, at the level of the equity market it can lead to speculation on price rather than assessment of value.⁹

Why did our investment systems go wrong? The main reason... is that financial institutions came to focus their investment strategies not on the intrinsic value of the corporation, but on the momentary precision of the price of its stock. They seemed to ignore the essential truth that the value of a corporation is neither more nor less than the discounted value of its future cash flow, not only a point endorsed by wise oracles but a mathematical certainty. (Bogle, 2005a:69)¹⁰

So, customers and providers alike forget the responsibility of the steward, infer too much from recent events – especially performance – and focus too much on the recent past, extrapolating it to the long-term future.¹¹

Will fund customers keep supporting the enormous overhead required to sustain ineffectual, unproductive stock picking across an array of thousands of individual funds devoted to every inverting “style” and economic sector or regional subgroup that some marketing idiot can dream up? Not likely. A brutal shakeout is coming and one of its revelations will be that stock picking is a grossly overrated piece of the puzzle, that cost control is what distinguishes a competitive firm from an uncompetitive one. (Holman Jenkins, editorial opinion page of the Wall Street Journal, 10 December 2003)¹²

A few examples of advertising follow to demonstrate the way in which information is presented. It is not my intention to criticize advertising in particular or marketing in general but to urge greater responsibility to be exercised. More opportunity needs to be taken to explain concepts to potential clients and providers should focus more on process and less on performance.

Each citation is anonymous as the intention is to make the point about the way the information is set out rather than to finger its source, but they all appear in publications aimed at retirement fund trustees.

Investment excellence & superior returns. For the last fourteen years, we’ve been recognising investment opportunities where others don’t. As a result, we’ve earned our fair share of awards

⁹ A local expert writes that failing to participate actively in the market is irresponsible because it risks adding to market volatility. Firstly, there is little evidence that market liquidity at present is lower than it used to be despite the increased prevalence of index-linked investment internationally. Secondly, long-term investors don’t care about volatility in the price that the market sets for its securities. They care about the value of these securities and purchase them for their long-term worth.

¹⁰ Member liability profiles provide a strong argument for longer holding periods, but not the only one. Some investors prefer to buy and hold rather than speculate on price movement. “Berkshire Hathaway’s ... legendary investor Warren Buffett ... describes his favourite holding period as ‘forever’”. (Bogle, 2005: 96)

¹¹ One of the results of this is that portfolio turnover has increased dramatically, increasing the costs to the owners of capital, who had fallen into the trap of chasing price rather than investing in value.

¹² This is cited by Bogle (2005: 213).

– with another slew of podium finishes at this year's Standard & Poor's. ... But more important than the rewards are the results, and these have always been consistently outstanding. (April 2007)

References to awards pervade investment advertising, implying to the investor that it is possible to achieve returns tomorrow by identifying yesterday's winners. Seldom do these references provide any concrete evidence that the manager in question is better than its peers. To understand whether it might be, we need to know what proportion of the portfolios available received awards and to compare this to the corresponding proportions for all other asset managers. Even then, it is not possible, without careful analysis, to know whether returns were achieved through skill, through taking on more risk, large and inappropriate bets on particular asset classes, for example, or through luck.

This advertisement does present one piece of slightly more credible information (but puts it in brackets) referring to annual awards for the asset management house rather than some of its products. If those who run awards like this do so scientifically, there may be some basis for describing this asset manager as having performed better than its peers.¹³

Still, as Taleb explains at length in both of his books, we are fooled by randomness.

Take a closer look at our investment performance. Markets have evolved. So has the way we manage your investments. 15 Investment Boutiques driven by award-winning fund managers. Focus and choice. Backed by exceptional, in-depth research. (September 2007)

Advertising is often deliberately spare on words, so it is difficult to comment on them. This example is no different. It recommends (separately) to readers that they study the performance of the manager at the web site, but apart from that says very little. The reference to the award-winning managers is difficult to dispute and so is the claim of attention to research, but these do not constitute evidence of skill.¹⁴

¹³ *The problem with annual awards is that they consider investment returns over the short-term, perhaps rewarding skill that trustees do not want. In an effort to avoid short-termism, those who run the awards may consider longer performance periods. However, since the awards are usually presented annually, longer periods of assessment, produces overlapping performance from year to year, likely to generate persistence of winners, as one outstanding year, due to luck or skill, could result in awards for some time thereafter.*

¹⁴ *The web site lists an impressive number of retail funds that have won awards but fails to mention the proportion of funds winning awards in comparison with the market as a whole, or provide the performance of funds that have been closed to new business. It reports the quartile position of each of its star funds, but doesn't similarly show the positions for all of its other funds. It picks out the desirable performance characteristics of some of its top performers (winner over a three-year period, for example) but remains silent on the less attractive features (no mention of performance over the most recent year). Where it presents survey performance of institutional funds on a single sheet, it doesn't make it clear whether all portfolios have been included or not, and it uses overlapping performance periods, last 3 years, last year and year-to-date, statistically flawed but a common tactic where recent performance has been very strong.*

The boutique model that a few asset managers are using at present has some important advantages from an investment management perspective, focusing the attention of portfolios managers on the limited part of the market that forms part of their brief. A business spin-off, however, is that it may require the opening of additional portfolios, increasing the chances of winners or podium positions in future.

One need only look at the performance of equity-only mandates that [manager name] have been given to see that over time, and even in trending bull markets, active asset managers are able to add significant value.¹⁵

This and the next few extracts are part of an advertorial. This statement, together with the title “the long term value of active asset management” could imply that active managers provide performance that exceeds the corresponding performance of the market benchmark.

The graph above shows the performance of a [manager name] equity mandate against the All Share Index. While there is symmetry between the lines, one can clearly see that the [manager name] mandate managed to avoid the market blow out in May 2002 which bottomed out in March 2003. Since outperforming the market, the fund has maintained and grown the advantage over the long trending bull market...

A few points should be made about this extract and the chart provided with it:

- The chart appears to illustrate the performance of just one mandate of this manager. While the mandate might cover a number of clients, it is also possible that data harvesting has selected the best-performing portfolio.
- The chart starts at June 1998 with the portfolio and its benchmark at 100 and ends in June 2007 with the portfolio at around 600 and the benchmark between 500 and 550. Reading from the chart, the cumulative outperformance is around 14 per cent and the annualized outperformance 1.5 per cent, not particularly dramatic for a selected portfolio. This probably exceeds fees for institutional investors, but with performance incentives taken into account, not by very much.
- As is so often the case, the left-hand scale is linear, not logarithmic, so the gap between the portfolio and the market, from a level of around 150 in 2003 to 600 in 2007 widens considerably, even though the portfolio did not outperform the market during that period.
- Attention is drawn to the performance between May 2002 and March 2003. It is quite clearly excellent as the portfolio line falls much less than the market line. What is not pointed out by the text is that the portfolio was ahead of the market in September 2001, lost all of its lead by May 2002 only to gain it back in the market crash. An

¹⁵ The term “trending bull market” is an interesting one, because it suggests that such bull runs are identifiable as they occur, adding to the perception of predictability and the tendency to draw links between the past and the future.

investor starting in the fourth quarter 2001 may have merely broken even by the end of the first quarter 2003, despite the excellent performance during the crash.

- It is possible that both the poor performance up to May 2002 and the strong performance thereafter were due largely to external factors, like the relative performance of market sectors, rather than to stock-selection skill. The article is silent on this possibility.

The extract below is from the same article.

It is impossible to predict the vagrancies (sic) of the market. Investors that buy the market (ALL Share Index) must live with the reality that they are at the mercy of the market. As active managers, [manager name] believes that through fundamental analysis of the listed companies we invest in, combined with a macro economic assessment of the market environment, we are able to select quality companies that are not as adversely effected (sic) by down markets as other companies might be, and are able to rebound faster in bull markets.

It then goes on to state that the standard deviation of the performance of the mandate since July 1998 was 20.2% against a corresponding figure for the All Share Index of 21.9%.

Quite apart from the fact that the figures are not defined,¹⁶ it is also not clear whether the difference is statistically significant or whether it is sufficient to protect the needs of the client to any meaningful extent.

The article ends as follows:

Delivery of superior market performance at less volatility (risk) than the general market is surely worth the cost for the value that active management is able to add.

The evidence presented in the article is not sufficient to arrive at this conclusion. However, it is presented convincingly. Many readers may take the view that this particular asset manager has what it takes to run their portfolio with distinction.

I stress that the authors of these extracts are not intended to be identified and the quotations are not intended to draw attention to the asset managers concerned. They merely illustrate the way in which data can be used to put asset manager performance in a positive light. I am not suggesting that advertising is inappropriate, but I do believe that the readers of such advertisements should read and digest them with care.

I complete this discussion with an article by a member of the asset management industry that builds on the points made in this section.

¹⁶ Are they annualized standard deviations (one assumes so) of daily returns (or monthly)?

Box 6**"Performance can only be measured over long term", Peter Foster¹⁷**

When did you last see a fund manager admit it had a track record that was below average? Probably not very often.

Have a look at the fund advertisements, then try to reconcile the fact that on any given day over any given period, some managers will be above average and some will be below. So why, then, does it seem that everyone offers "superior" performance?

For one, it's easy to work the numbers. Even a poorly performing fund will have a time when there's something that can be laid about it in a positive light. Another ruse is to keep switching the funds that are advertised, thus keeping the overriding brand in the "top quartile".

This product proliferation is one of the oldest marketing ploys in the book. Just look, at how successful cellphone firms have been in confusing the consumer and thereby maintaining indecent margins. South Africa now has more than 700 Unit trusts. The key question is, do investors really need what fund managers are selling? Should they not use Jack Nicholson's words in the movie *As Good As It Gets*: "Sell crazy someplace else. We're all stocked up here."

The chosen time frame over which returns are shown influences the outcome. For instance if we had been using the Julian calendar instead of the Gregorian one, most Raging Bull winners would have been different last year.

Bill Miller, the legendary fund manager at Legg Mason in the US, outperformed the Standard & Poor's 500 each calendar year for 15 years running, yet admits to owing a large part of this to luck, as no other measurement period would have arrived at the same result.

So how good is your fund manager? As it works out, your chances of getting superior market-beating returns have historically been very low. Of the broad equity unit trusts with a 10 year track record, only 25 percent have beaten the market index over that time.

Even over the past 12 months (the favoured forecasting time frame), only 15 per-cent of all equity funds outperformed the index.

In developed markets such as the US, large amounts of new money are ending up in index funds – passive funds that charge low fees and aim to match the market index return.

The "active versus passive" argument is an old one but it seems investors, in the US at least, are voting with their feet. Only 3 percent of local unit trust investments are managed in this way.

In assessing a track record, we urge investors [trustees of retirement funds, for example] to look over long periods: five to 10 years is a good start. Returns should be measured peak-to-peak or trough-to-trough. Some funds do well in an, upswing, others in a downswing. Very few do well through thick and thin.

Review the objectives of the fund and how it is managed.

Make sure these make sense; and suit your individual requirements.

Remember that most new funds are launched to give the marketers something to sell. Your long-term needs as the investor do not feature highly in that whole process.

If you struggle to understand what your fund manager does, a low-cost indexation strategy makes a lot of sense.

Source: Business Report, 15 March 2007

¹⁷ Peter Foster works at Regarding Capital Management. This article was published in Business Report on 15 March 2007 and is available at <http://www.busrep.co.za/index.php?fSectionId=564&fArticleId=3731579>, download checked on 29 December 2007.

An after-thought: disclosure

The retirement fund industry may be so weary of the ongoing evidence of non-disclosure of revenue that it scarcely seems helpful to continue the discussion. Unfortunately, a study of the institutional investments environment would simply not be complete without alerting trustees to examples of poor disclosure which continue to afflict the industry.

Some retirement funds seeking to withdraw assets from guaranteed fund arrangements¹⁸ have been surprised, at that late stage, to discover aspects of their product they were not aware of until applying to leave the fund.

This is compounded by the frequency with which providers make errors in preparing quotations for retirement funds seeking to enter a guaranteed fund. Significant compensation by providers to retirement funds has occurred when such evidence has been uncovered.

Full disclosure of all relevant facts and careful attention to detail must become the standard.

Evidence of inappropriate payments to service providers also continues to emerge in discussion with principal officers and trustees. The first part of this paper describes the enormous range of services provided to retirement funds and their members. These include the issuing of housing loans, using the member's notional retirement fund assets as collateral, and the establishment of trusts to safeguard the financial interest of the dependent children of deceased members.

It would seem that some providers of trust services and housing loans – generally banks – are prepared to pay back to retirement fund administrators a portion of their fee in order to secure the profit stream. The motivation to do so is clear, as retirement funds usually appoint a single entity to provide trust services and housing loans, and the fund administrator probably has significant input to the process of determining a reliable service provider. What is less clear is how the payment is justified and, where it is justifiable, why it is not disclosed to fund trustees.

I understand that this practice has been halted in many instances. Trustees need to continue to be vigilant, requesting details from their service providers of all forms of financial compensation associated with the retirement fund.

¹⁸ *Guaranteed funds, sometimes referred to as smoothed bonus funds, offered by insurers, are themselves institutional investors. Retirement funds cede their assets to the insurer by purchasing a policy of insurance backed by the assets of a guaranteed fund. Though the retirement fund owns the policy, the assets are owned by the insurer. As shown in this discussion, it can be surprisingly difficult for the retirement fund to regain access to these assets.*

7

PERFORMANCE SURVEYS ALL THAT THEY APPEAR TO BE?

In which the mushrooming of manager surveys is outlined and the diligence required to run a sound performance survey is described, with an appeal for a return to a consolidated retirement fund survey run by an experienced independent entity.

From humble beginnings not many years ago, manager performance surveys have become ubiquitous. Every consultant seems to have one and every other consultant uses somebody else's survey as part of their advice. The number and complexity of surveys seems to be growing by the month.

Do these surveys serve a useful purpose; or are they more about marketing, projecting an impression of competence rather than executing a rigorous examination of manager competence?

The origin of performance surveys

Surveys of investment manager performance date back no more than 12 or 13 years, but surveys of the investment performance of retirement funds in South Africa go back much further than this. From as early as the 1970s, pension fund investment performance was assessed through the Consulting Actuaries survey that gathered information across retirement funds and ranked performance by fund rather than by manager. A few company mergers later, the survey found itself in the hands of Alexander Forbes and died a natural death as some of the other consultants began to withhold performance data on the basis that it was not in the interest of their clients to provide such information.¹

¹ While it is possible to have some sympathy for this argument, it suggests a successful effort by consultants to control the information emerging from funds. Trustees chose not to insist that industry-wide data collection would be in the best interests of all industry participants. It nevertheless must be acknowledged that independence of the data collection agency would have been helpful. This section considers ways in which the Consulting Actuaries survey could be revived.

During the 1990s, managers held sway over their benchmarks, sometimes altering their approaches to take advantage of perceived changes to the investment environment. A plethora of performance benchmarks emerged as managers tried to take advantage of long-term swings in the major sectors.² A number of the benchmarks appear almost arbitrary in their construction.³

The emergence of manager surveys was supported by the intention of investment consultants to find some way to compare managers fairly,

- putting managers that followed equivalent mandates side by side,
- rating manager performance relative to the corresponding benchmark as well as in absolute terms, and
- seeking to ensure that arbitrary changes to benchmarks over time were not possible, or, where they did take place, that they were properly allowed for in the performance measurement.⁴

As surveys grew, both in prevalence and complexity, so did the dependence of customers on their results. It was only a matter of time before the surveys themselves came to be regarded as benchmarks, flawed as they may have been in their construction.⁵ The idea that beating peers was more important than outperforming an objective measure of performance became the convention.⁶

This only worsened matters, because each investment consultant developed its own benchmark. Some of these merely complicated the need for peer group measures, though usually with a different peer group and therefore a different benchmark. Some surveys

² Managers did not hesitate to take advantage of the distortions introduced by benchmarks. A prominent portfolio manager of a large asset management house stated, at the end of 2004, that all unit trusts had outperformed the market. This was, in fact, true, but silent was the fact that they outperformed the market because, they underweighted resource stocks in comparison with the broad market capitalisation, and resources underperformed the market on average. So they beat the market because of the mismatch between their allocation and that of the market. Did the same portfolio manager announce later that in 2005 nearly all managers had underperformed the benchmark?

³ The mushrooming of benchmarks is discussed in section 3. The half-weighted resources index, for example, was developed to reflect the reality that managers were under-allocating to resource securities. This is putting the cart before the horse. The important question to ask is whether such an allocation is in the interest of members or not.

⁴ Continuing the examples set out in the previous two footnotes, if a manager, without changing its investment process, could have been measured against the general market in 2004 and a half-weighted resources index in 2005, it could have appeared very good in both cases. This gaming is what the surveys sought to avoid.

⁵ Refer to the later discussion covering the complexity of drawing up a good survey.

⁶ The simple fact that peer group outperformance is not an appropriate performance benchmark needs to be stated: it bears no relevance to the needs of the members. Benchmarks must start with these needs.

developed increasingly sophisticated in-house measures in an effort to present the definitive independent measure of performance.

It is time to rethink the area of performance measurement, the potential for conflicts of interest on the part of consultants and confusion on the part of their clients.

Survey complexity

Running a decent survey is a complicated process. The discussion below sets out a few considerations for establishing a reliable measure of asset manager performance.

Rules of participation. Initial decisions are crucial. The designer must include as many managers as possible while avoiding the inclusion of portfolios or management operations that ought not to be part of the pool, because they differ significantly from the others.

The size of the portfolio is commonly used as an exclusion factor, on the basis that small portfolios contribute very little to industry figures and are not accessible to the majority of clients.⁷ A comprehensive survey would list elsewhere the performance of excluded portfolios.

Treatment of performance history. The decision concerning the minimum track record is probably more significant than the corresponding decision on the portfolio size threshold.

Balance is required, on the one hand between increasing the number of included funds and improving the reliability of the data of those included.

- Adding portfolios with a short track record increases the population of funds in the survey, but it mixes portfolios with different track records and can distort the data.
- Forcing portfolios to establish a good track record before including them improves the reliability of the data in the survey, but risks excluding relatively new funds that could reasonably form part of the peer group for performance-comparison purposes. More dangerously, it opens the results to the distortions of survivorship bias.⁸

The rules should include a description of the treatment of performance history where the portfolio characteristics have altered significantly, where past reporting errors are uncovered and when portfolios are closed. Clear, consistent policy needs to be developed

⁷ This is a difficult decision. The choice of the size threshold can have a significant impact on the average performance of the included portfolios.

⁸ This is considered in more detail in the chapter on active management, section 1. The longer the qualifying period the higher the proportion of portfolios that never qualifies for it. Since these are likely to be poorer performers, the qualifying period itself introduces an upward bias to the average of reported performance. Survivorship bias appears in other ways as well, that surveys must take into consideration to avoid falsely reporting that the average portfolio performance exceeds that of the benchmark.

where managers choose to delay the reporting of their performance even when the period of history exceeds the survey minimum.

Allocation to categories. Portfolios must be assigned to appropriate groups to make comparison as fair as possible. Completely depending on the description of the portfolio supplied by the manager is not necessarily appropriate, as the manager may benefit from having the portfolio included in one group in preference to another. Careful, experienced scrutiny of portfolio characteristics is required.

Category design. Even before portfolios are allocated to groups, these categories must be defined. Categories should be set up with clear boundaries to make it easier for users to understand them and to avoid the rather arbitrary portfolio allocations that might otherwise occur.

Careful judgment is required once again concerning the number of categories to set up in the survey.

- Too many categories gives homogeneity of type in each group, facilitating ranking and comparison, but resulting in a small number of portfolios per category and increasing the incidence of “best of breed marketing”.⁹
- Too few categories improves the number of portfolios per group, but mixes portfolios with fundamentally different characteristics. This can lead to managers structuring their portfolios in order to lead their categories rather than to benefit the retirement funds that they serve.¹⁰

Surveyors depend on voluntary participation by fund managers. Categorization decisions, and other aspects of the survey design, can have an impact on whether managers choose to participate in the survey at all. This was recently demonstrated when a significant multi-manager withdrew from one of the larger surveys on the basis that categorization was felt to reflect poorly the attributes of that managers’ portfolios and that actual performance was being allowed to dominate the survey, rather than performance relative to the benchmark.

⁹ I use the term to express the temptation by asset managers to profile the portfolios that perform better than their peers in their marketing material. Managers would prefer many categories, increasing their chances of stabling winners, even if lucky rather than skilful. As a large component of performance is ascribable to luck rather than skill, this allows even poor managers to feature well in performance surveys with many categories.

¹⁰ If a category is defined by its equity exposure, with a maximum of 60 per cent, say, and a minimum of 40 per cent, clients may select portfolios on the basis that they meet their needs of an equity exposure around half. Managers, however, have an incentive to lean towards an equity exposure in the high fifties in an effort to improve long-term performance relative to peers.

Some categories are quantitatively identifiable, for example, by the equity content of the benchmark strategy. Others are more about the way in which the asset manager goes about seeking performance.

Two examples follow.

- Asset managers may describe themselves as “benchmark cognisant” or not.¹¹ Surveyors face the decision of whether, taking into account all of the other aspects of the survey design, to combine these two groups or keep them separate, remembering that they depend on the declaration of the manager concerning its approach.
- Multi-managers may select asset managers but retain the overall allocation to the main asset classes constant, or they may seek to improve return by taking tactical positions in asset classes. Surveyors may choose to differentiate between these approaches. If they do not, they must then decide how to allow for the sometimes substantial swings in the asset mix.¹²

Comprehensive house information. Since it is possible for asset managers to submit portfolio information selectively,¹³ it is very important to understand all of the assets managed by the house and to determine

- what proportion of the assets are included in the portfolios submitted by the manager, and
- why excluded assets have not been submitted.

There are legitimate reasons for excluding parts of the assets managed by a portfolio,¹⁴ but the surveyor must ask all the right questions to establish that the approach followed

¹¹ At the risk of over-simplification, some asset managers aim to invest in such a way as to produce performance that is better than a specified benchmark and others aim to maximize the absolute level of performance. The former tends to think of its allocation to stocks as larger than or smaller than the corresponding allocation in the benchmark. The latter purchases stocks based purely on its interpretation of whether they offer good value or not and does not pay much attention to the corresponding benchmark weighting.

¹² This illustrates one of the most important problems with the survey, that users make decisions on the basis of simplified information. Proper analysis of the multi-manager attributes the overall performance to its components, permitting an understanding both of the contribution of the multi-manager, selecting managers and switching between asset classes, and of the stock-selection success of the underlying managers. This important detail is difficult to include in a survey.

¹³ The essence of the survey objectives is to ensure that performance data in the survey is representative of the range of portfolios available to prospective investors. It is crucial, then, that managers are not able to provide information for a sub-set of the assets under their management in a way that improves their reported performance but is not completely representative of the portfolios available to investors. A simpler way to address this possibility is to disclose the assets of the portfolio to which the performance is ascribed.

¹⁴ A retirement fund client may have established an unusual mandate for an asset manager that does not fit in with the categories established under the survey because it has performance and risk characteristics that are unique to that mandate.

by the manager is appropriate to the survey requirements. This analysis and questioning needs to be carried out for each asset class in the survey.

Customer information. The included assets should be broken down in a number of ways. Segregated and pooled portfolios should be identified¹⁵ and the size of each portfolio reported. Segregated portfolios may be grouped into composites and reported together where they have the same mandate, simplifying the presentation of data, but this means that surveyors must understand changes to the mix of these composites.

Benchmarks. Each portfolio of each manager must be assessed against the corresponding performance of its benchmark. The managers determine the benchmark; the surveyor needs to ensure that benchmark performance is correct and needs to consider with great care how the respective absolute and relative performances are presented.¹⁶

After all of these issues have been resolved, the nuts and bolts of clear, fair, consistent reporting of performance need to be understood and the numbers provided by asset managers scrutinised for errors and inconsistencies. Performance figures should adhere to international reporting standards and surveyors may choose to indicate those managers that are able to certify this consistency.

Reasons for differences between surveys

With all of these differences and the huge number of portfolios administered by each asset manager, it should not be surprising that surveys produce different results. My scrutiny of surveys from different sources, apparently on the same date and covering the same categories of funds, produces no common numbers, a variety of fund names and a raft of inconsistencies.

¹⁵ In contrast to pooled portfolios, which group together the assets of a number of clients, segregated portfolios are ring-fenced arrangements that contain the assets of a single fund whose mandates may differ in small ways from the corresponding mandates of pooled counterparts. They may have different performance benchmarks, which should also be identified. They may also be more efficiently run producing better net performance than an otherwise identical pooled portfolio. Since they are not accessible to new investors, they must be identified as such, but are included to provide a full picture of manager performance.

¹⁶ Presentation of data has been shown to have a significant impact on how it is perceived. Where portfolios, broadly heterogeneous in their characteristics, are grouped together despite differences in their benchmarks, presentation may determine whether the absolute performance figure or the corresponding difference between this figure and the benchmark – the relative performance – receives the attention of readers.

The main technical reasons for these differences are

- the treatment of historical errors¹⁷ and of the track records of portfolios with altered characteristics or new portfolio managers
- the approach to the delayed announcement of new entrants and the corresponding treatment of survivorship bias¹⁸

Even inconsistency in the approach to rounding can make a difference where new surveys seek to piece together the track record of funds.

These are just some of the technical reasons for disparity in results, but they are insufficient to explain the substantial variance in the figures reported in surveys. There must be further differences in inclusion rules and categorisation of information.

Problems

These differences suggest a number of problems with these surveys.

- **Survey competition.** In an environment in which every significant investment consultant deems it necessary to run and publish a survey and to find ways in which to differentiate that survey from its competitors, observers and potential customers are being buried under an avalanche of virtually incomprehensible information. Attempts are usually made to explain the rationale for each survey design, but it is extremely difficult to convey this accurately.
- **Potential inaccuracy.** Since surveys are not independently audited, misrepresentation and errors are possible. In theory, asset managers should be checking that their performance is correctly captured in survey output, but the growing proliferation of these surveys may make it increasingly difficult for them to carry out the verification.¹⁹
- **Gaming.** Nobody knows the portfolios of a manager better than the manager itself. Despite the best efforts of surveyors to avoid misrepresentation of manager data, it is theoretically possible for managers to hide uncomfortable information and highlight the

¹⁷ A manager reports, for example, that an error going back three years has recently been discovered. Surveyors must treat such reports with care, since errors that adjust performance up are more likely to be reported than the corresponding errors that result in a performance reduction.

¹⁸ The first of these is a type of survivorship bias. Managers know that 36 months of performance is required for entry to a survey, for example. At the end of the 3 year period, they choose whether to report the performance. The sudden appearance of a portfolio some time after the 3 year threshold must be treated with care by the surveyor.

¹⁹ Managers have a natural incentive to correct errors that understate performance but not the corresponding overstatements.

more positive data. It takes good survey design and dedication to the data collection process to be sure that this does not occur.²⁰

- **Categorisation.** The decisions by surveyors regarding the allocation of funds to groups can have an impact on outputs, not least because of the...
- **Voluntary participation.** It is unrealistic to expect surveys to include all relevant data, but some of them are systematically flawed by the absence of some managers from the information set.²¹

These are tricky issues, but many of them can be addressed through attention to detail. Two rather more fundamental flaws remain and these are more difficult to address.

Abuse of information

By and large performance surveys only serve to confound the client as the client has been conditioned to reflect on relative performance. Performance should be assessed in light of the fund's stated policy with due consideration given to the characteristics of the fund being selected in relation to the stated asset management policy. As the asset consultants often control the asset allocation decision, managers are selected on the basis of specialist mandates driven by performance. Any rational assessment will show that the crucial area is in fact the asset allocation decision combined with the appropriate choice of manager relative to the risk profile chosen. (South African market player, anonymously obtained)²²

The first problem is the misuse of survey data. Despite the flaws in survey information, and the perplexing variety of data produced, surveys are treated as definitive by a number of market players. As a result, trustees may select managers based on recent performance alone, without even the most rudimentary adjustments for portfolio differences and performance volatility. Short-term thinking tends to predominate, weakening the quality of manager selection decisions because of the increased scrutiny of 1-year and even quarterly performance data brought about by the availability of the surveys.

Advisers of trustees frequently use the performance surveys in the same way, backing up their recommendations with unrefined references to recent performance. Easy access to

²⁰ The surveyor needs to understand the rationale for including or excluding each portfolio in the manager's set, as the manager is naturally inclined to argue for the inclusion of good performers which do not really belong and against the inclusion of poor performers that should be part of the set. This can take many forms (see next footnote).

²¹ Consider a portfolio designed to meet absolute return hurdles but with greater exposure to the equity market than most. This portfolio is likely to perform better than its absolute return counterparts in strong equity markets and better its equity counterparts in poor equity markets. The surveyor has to guard against inappropriate category selection by the manager but provoking the manager not to participate at all is also to be avoided, because it distorts the balance of performance of portfolios included in the survey and reduces the inclusiveness and hence the credibility of the survey.

²² Comments were requested for me by a third party. I do not know who made the comment, but trust the judgment of the third party to use only a credible source.

this data makes poor advice easier to dress as credible. The variety of surveys makes it easier to show a recommended manager in a positive light.

Conflict of interest

The second problem is the dual role of investment consultants, judge and jury, auditor and adviser. The issue is wider than the surveys alone, but as many of the larger consultants publish surveys and many of their smaller counterparts use their results to back up their advice, the surveys are an important element of a flawed dynamic.

Asset consultants play two significant roles that may be better carried out by different parties.

- They audit published investment results, checking that disclosure by the investment managers is correct and consistent with other information. Since retirement funds may have multiple asset managers whose performance is combined to produce the overall result for the fund, this is a natural role for the consultants to play, as they have the information and skills to carry out this work.²³
- They give advice on the selection of asset managers. It must be difficult, in this enormously complex environment, to avoid seeking to portray the recommended managers in a positive light, whether intentionally or inadvertently. Surveys are merely a subset of the more detailed analysis that should support any advice on asset managers. If unbiased, accurate surveys are difficult to carry out, much more challenging is the exhaustive analysis required to give advice. Calculations nearly always need to be carried out quickly. The potential for analytical error is substantial and the possibility of misrepresentation of information cannot be ruled out either.

The intention is not to cast a shadow on the value of asset consulting. Independent, high quality analysis of asset managers and consequent unbiased advice can be of tremendous benefit to retirement funds. But if auditors are, for reasons of conflict of interest, not supposed to provide advice as well, perhaps the same should apply to asset consulting.

A final problem should be visited before examining the way forward.²⁴ Today's surveys do not give trustees any way of assessing the quality of advice given by their asset consultants, since outcomes are difficult to compare. If there could be a way to track the

²³ Differences between the output of a survey and the corresponding return for a portfolio of a manager in the fund concerned can be significant, for legitimate reasons. The cash flows of the fund over the period, for example, have an impact on the performance of the fund that is not reflected in the corresponding figures in the survey. The auditing function is an important one because it helps trustees bridge the gap between what is disclosed in the surveys (not without complexity for all the reasons already set out) and what is reported by the fund managers to their client the pension fund.

²⁴ This is discussed more fully in section 3.

result of the advice, trustees could be more comfortable in the knowledge that they are in a position to assess whether the advice is of benefit to the funds and the members.

An industry-wide effort

Reference has been made to the early versions of performance surveys that focused on retirement funds rather than asset managers. The Consulting Actuaries surveys were valuable because they allowed funds to compare their results with the corresponding results of their peers. A sufficiently detailed approach to the attribution of components of performance to its constituent parts would provide the opportunity for trustees to assess the value provided by every member in the value chain. Early versions of the Consulting Actuaries survey did not have the sophistication or data to provide this opportunity, but South Africa now has the opportunity to do this properly.

What is required is to combine the benefits of two different approaches into a single, independent study:

- **Fund by fund** analysis allows comparison of funds with their peers, leading to separation of performance into its constituent parts and assessment of the contribution of each party to the fund. This type of analysis would need to be re-established.
- **Manager by manager** analysis is a skill that is growing in effectiveness. Even if the proliferation of reports is not helpful to the industry and its participants, the understanding of what constitutes a competent analysis of portfolio performance and how portfolios ought to be differentiated is growing all the time.

The best of the manager by manager approaches should now be combined with the fund by fund analysis, providing a full breakdown of the performance. This is not easy to do in practice, but would be helped by a clear description of the objectives of the survey.

Just as the analysis of a portfolio should include a breakdown of performance between the selection of stocks and the tactical allocation to asset classes or equity sectors, the construction of an industry-wide survey would allow proper performance attribution across a number of areas:

- **allocation to major asset classes**, shares, bonds and cash, for example, and the split between local and international classes;
- **allocation to sub-classes**, bonds by duration, for instance, or equity sectors;
- **security selection success**, the contribution to the asset return from trading shares and bonds; and,
- **allocation to managers**, which would demonstrate the contribution of the multi-manager or investment consultant, or the selection by trustees if they do it themselves;

This complex measurement would require considerable investment, but is within the reach of the retirement fund industry given the intellectual development of some of today's surveys and the lessons learned through this process. Information would be provided both by the funds and the managers and the progress would be much more rigorous than at present. Investment consultants would no longer need to spend time and effort on their own surveys and could turn their attention to assessing the needs of their clients better, understanding market and product developments and matching retirement fund needs to the available investment skill set, taking into account all relevant issues.²⁵

This type of survey is already in place in Botswana, where the small number of funds and managers makes it easier to implement, and in Kenya, even with a larger set of retirement funds.²⁶ In South Africa it would have to be implemented on the initiative of either the largest funds or the regulatory authorities.

Serious consideration of the benefits of such an approach is urged in an effort to do what is best for the fund and their members.

²⁵ *Early sections stress the need for investment consultants to put effort into asset allocation and to carrying out the research required to model asset classes with more reliability.*

²⁶ *The September 2007 survey in Kenya includes 114 participating retirement funds.*

8

TRADING DYNAMICS

ALWAYS IN THE BEST INTERESTS OF THE CUSTOMER?¹

In which trustees are urged to request the information from their asset managers necessary to demonstrate that trades by each manager are executed in the best interest of their customers.

In relationships with clients, CFA members shall use particular care in determining applicable fiduciary duty and shall comply with such duty as to those persons and interests to whom the duty is owed. Members must act for the benefit of their clients and place their clients' interests before their own. (CFA code of conduct, standard IV, B.1)²

Active investment managers trade the assets in a portfolio in an effort to improve the outcome for their clients. This objective is obviously key. Modern analytical tools and data management allow it to be tested.

Active management is all about successful selecting and timing the trades, but trading itself can be a complex process. Too few retirement fund trustees realise that successful asset management is not just about choosing the right security to buy or sell at the right time, it is also executing these trades efficiently.

Since the costs of trades are carried by the portfolios, it is appropriate that performance fees take these costs into account, in other words that such fees reflect the net – after fees – performance of the portfolio. However, asset managers should also be accountable to

¹ The technical information presented in this section has been provided by Colin Smit of The Electronic Trustee, appropriately anonymised. Colin's support is gratefully acknowledged.

² This extract is cited from what was then known as AIMR (1999:4), the Association for Investment Management and Research, and is now the CFA Institute. CFA stands for Chartered Financial Adviser. The CFA Institute is a worldwide organisation with well over 100 000 members. To describe themselves as "CFA" members need to pass a rigorous set of exams emphasising investment knowledge.

their clients regarding how effectively they execute trades and whether all trades are executed in the best interests of their clients. Questions to ask of managers include

- whether all trading on client portfolios is executed solely for the financial benefit of the clients,
- whether brokers are selected to minimize cost and maximize return rather than in the interest of the relationship between manager and trader,³
- whether there are any activities by managers, accidental or deliberate, that are detrimental to the performance of the fund (see box 7, for example).

Retirement funds put their assets in the care of these managers, who are stewards of these assets, servants to the owners. The trustees of the funds have every reason to expect that these assets are used solely to the benefit of the funds, which in turn are taking care of crucial member savings. These are merely examples of the types of questions that trustees should be asking managers to answer, and expecting their asset consultants to report on with regularity.

Box 7

Softing

One of the activities that distorts the integrity of the trading relationship is the payment of what is known as “soft dollars” by asset managers to brokers for the provision of investment research and other information. The essence of the problem is that the manager uses client assets to “pay” for this information.

“Soft dollar practices involve the use of client brokerage by an investment manager to obtain certain products and services to aid the manager in its investment decision-making process. The practice of using client brokerage to purchase research has become extremely complex...” (AIMR, 1999: 171).⁴

It is called a “soft dollar” practice, or “softing”, because it does not involve an explicit payment for services. Preferential terms for directing trades are more common, either through directing a higher proportion of trades than appropriate through that broker, or paying rates that are undeservedly high.

Softing has become extremely sophisticated and can be very difficult to detect, but it is covered by a set of voluntary standards issued by the CFA, and the corresponding code of conduct issued by the Investment Managers of South Africa, both of which investment managers should be required to adhere by retirement fund trustees.

Implicit charges

Transaction costs are inevitable and occur throughout all phases of the investment cycle, from asset allocation through to portfolio construction and execution. Explicit costs, such as trading commission, settlement fees and taxes, are clearly visible and can be negotiated by the parties

³ The term broker is used in this section to refer to the entity that executes the transaction ordered by the asset manager, not an insurance intermediary. The broker carries out the order at a fee agreed with the asset manager, usually a small percentage of the value transacted.

⁴ The latest version of the Soft Dollar Standards issued by the CFA Institute, published in 2004, but identical to the AIMR 1999 version, is available for download at <http://www.cfainstitute.org/centre/ethics/softdollar/pdf/SoftDollarStandards2004.pdf>, accessed 24 December 2007.

involved. Hidden or implicit costs should receive the most attention as they can, and should, be managed. ... While implicit costs may be more difficult to measure, research has shown that they often account for the majority of transaction costs and have a far greater effect on portfolio performance. (Bashi, 2005: 18)

Implicit charges directly affect portfolio performance, but are seldom adequately disclosed. Since these costs are met directly by the fund, they have an unavoidable effect on performance. They are an important determinant of manager efficiency and possible bias in its activities⁵ and should be assessed along with the other activities of the manager.

Real enhancements to portfolio transitions derive from four factors:

- *the return captured from the new holding,*
- *less the forgone return from the old holding,*
- *less the cost of selling the old holding,*
- *less the cost of buying the new holding.*

That calculation gives the real cost of a transition. (De Jongh et al, 2005: 18)

Bashi describes four types of implicit cost:

- The **manager timing cost** is the loss (or profit) resulting from the price change in the period from the time the manager decides to trade to the time the instruction is given to in-house trading desks.
- The **trader timing cost** is the loss (or profit) from price movements in the time that it takes for the in-house desk to forward the instruction to the broker.
- The **market impact cost** is the loss (or profit) from price movements that occur during the delay from receipt to execution of instruction in the hands of the broker. A strong driver of the market impact cost can be price-moving effect of the trade itself. One way of reducing the market impact cost is to spread out the trade, but this in turn can increase the opportunity cost.
- The **opportunity cost** is the cost incurred by brokers for the delay to a trade in the hope that a price improves.

To these must be added the **bid-offer spread**, the difference between the price at which the asset can be bought and sold at the same moment,⁶ and the costs of **brokerage**, the fee for physical execution of the transaction by the intermediary, and **tax**, levied on every transaction.

⁵ This point is important. Trading patterns, as described further on in this section, should be investigated not only to explore costs but to rule out the possibility of activities by managers, the stewards, that are not in the interests of the retirement funds, the owners.

⁶ Deon Hugo (2004) estimates a bid-offer spread of up to 7% for small counters and as low as 0.1% for liquid stocks. The two articles that he authors in Fifth Quadrant's 2004 edition of 'Dimensions' cover the costs of trading and brokerage and are recommended to interested readers. They are available at www.fifthquadrant.co.za.

For very large funds, costs can be significant, enough to make activities to reduce them worthwhile:

The Universities Superannuation Scheme (USS) pension fund expects to reduce its administration costs by around £750,000 a year by applying a commission recapture programme to its trading. Europe's eighth-largest pension fund, with £30bn in assets under management, has appointed Russell Investments to help it claw back some of the costs of trading its global portfolios through brokers signed up to a recapture scheme. Although the actual amount a pension fund can reclaim on each trade may appear minimal on a daily basis, it eventually amounts to approximately 2-3 basis points of trading commission over a year depending on the asset class, according to Russell. (Investment & Pensions Europe, www.ipe.com, 28 September 2007, paragraph breaks removed)

Trustees of smaller funds should at least be seeing to it that this trading activity is not wasteful.

De Jongh *et al* (2005) describe the system for analysing these costs. Data requirements are intensive, including, for example, the precise time of every instruction from manager to broker, along with the details of that instruction, but this information is now available in South Africa.

The Electronic Trustee has access to this data, where retirement funds have authorised it, and carry out analysis of the trading of managers in an effort to uncover activities that are not in the best interest of their clients the retirement funds. The rest of this section describes examples of their research.

Broker relationships

An investment manager often has discretion over the selection of brokers executing transactions. Conflicts arise when an investment manager uses client brokerage to purchase research services that benefit the investment manager, which is commonly called "soft dollars", "soft pounds" or "soft commissions". Whenever a manager uses client brokerage to purchase goods or services that benefit the manager, the manager, as a fiduciary, must disclose to clients the method or policies followed by the manager in addressing the potential conflict. ... The requirements [of various countries' security laws] typically state that ... at all times, the manager must seek best price and execution. (AIMR, 1999:91)

*"Best Execution refers to executing Client transactions so that the Client's **total cost** is the most favourable under the particular circumstances at that time." (AIMR, 1999:176, emphasis in original)*

All trades must be executed, as far as possible, by the broker that gives the best price and execution. The reason for this is simple: the retirement fund has no interest in who does the trade, but most definitely has an interest in it being completed effectively and cheaply.

The same principles apply to the South African asset management industry:

Members must secure best execution at all times by taking reasonable care to ascertain the best available price for the client in the relevant market at the time of the trades of the kind and size concerned and then make arrangements for the transaction to be effected on that basis. (IMASA Code of Conduct, page 3)⁷

The data examples that follow have been provided by the Electronic Trustee.

Table 2 shows the allocation by a single retirement fund of brokerage fees, for four different managers, across 14 brokers covering between 60% and 90% of all brokerage paid by these managers on this fund. Table 3 shows, for the same managers and the same brokers, the execution efficiency averaged over all trades for each manager × broker combination.

A number of interesting observations can be made from this data:

- The managers use a variety of brokers, though with considerable overlap between managers A, B and C. This is probably a good thing as it demonstrates a competitive market for trade execution.

Table 2				
Allocation of brokerage				
	Manager A	Manager B	Manager C	Manager D
Total broker fees (Rm)	0.248	0.691	0.288	1.369
In bp on value traded	19	23	19	22
%				
Broker 1	16	10	5	
Broker 2	13	16	4	16
Broker 3	11	13	14	7
Broker 4	5	7	2	
Broker 5	8	10	10	
Broker 6	5	11	7	17
Broker 7	1	10	7	8
Broker 8		1	11	
Broker 9		9	20	4
Broker 10	1	1	8	
Broker 11				12
Broker 12				10
Broker 13				8
Broker 14				9
% of total paid	60	88	88	91

Source: analysis by The Electronic Trustee; managers and brokers are the same as in table 3

⁷ IMASA is the Investment Management Association of South Africa. The code of conduct was downloaded from the web site of the organisation, www.imasa.co.za, on 13 January 2008.

Table 3				
Execution efficiency				
	Manager A	Manager B	Manager C	Manager D
VWAP impact (Rm)	0.145	-0.237	0.064	-1.464
VWAP impact (bp)	11	-8	4	-23
bp				
Broker 1	26	4	26	
Broker 2	23	-21	12	12
Broker 3	19	-3	3	-63
Broker 4	4	-2	-22	13
Broker 5	13	7	-15	
Broker 6	25	-10	0	-77
Broker 7	-5	-25	-5	2
Broker 8		-38	-8	
Broker 9		13	0	-3
Broker 10	20	15	-8	
Broker 11				-6
Broker 12				11
Broker 13				-17
Broker 14				-13

Source: analysis by The Electronic Trustee; managers and brokers are the same as in table 2. VWAP refers to volume-weighted average price and the impact is the effect of trading efficiency.

- Total broker fees are reasonably consistent across managers,⁸ though as is demonstrated below, it should not be inferred that all brokers receive the same fees.
- There appears to be no correlation between the amount of business given to a broker and the effectiveness of the execution by that broker. Manager D passed on more business to broker 6 than any other, yet that broker managed to lose nearly 1% on the trades that it executed. This doesn't appear to be in the clients' best interest.
- Broker performance varies across managers. Broker 6 achieved a positive 25bp execution outcome for trades instructed by Manager A but a negative 77bp loss on trades instructed by Manager D. In view of the volume of trade sent by Manager D through Broker 6 – over R100m in value – it would seem unlikely that this could be ascribed to random events.

Other research by The Electronic Trustee appears to provide evidence of favouritism by managers, with some brokers consistently sent instruction, for execution that day, a mere 15 minutes before close of markets, and others being given greater discretion in the execution in order to do so as effectively as possible.

⁸ As a percentage of the asset amount traded, from 19bp for manager A and C to 23bp for manager B.

Table 4					
Broker fees					
	Mngr E	Mngr F	Mngr G	Mngr H	Mngr I
Total broker fees (Rm)	0.736	0.525	1.529	0.244	0.372
In bp on value traded	16	23	21	12	18
bp					
Broker 14	7	25	21	10	25
Broker 15	22		20	14	6
Broker 16	23	25	19		12
Broker 17	23		21		25
Broker 18		20	24	15	24
Broker 19	23	25	21	15	25
Broker 20		25	19	21	25
Broker 21	21		21	18	25
Broker 22	12	25		28	25
Broker 23			22	12	16

Source: analysis by The Electronic Trustee; managers and brokers are the same as in table 5.

Table 4 shows a set of broker fees for five managers and ten brokers. Fees show some consistency, making the anomalies noteworthy:

- Broker 14 gives Manager E a huge discount. Not only is the same discount denied to three of the other managers, but it is also a much lower fee than charged to that manager by all of the brokers except Broker 22, which also appears to be favouring the manager with some special arrangement. Similar comments apply to the arrangements that Manager I has with Broker 15 and Broker 16.
- Manager H has secured a good deal from just about every broker, suggesting that it brings something extra to the arrangement. Scale might be expected, but appears not to be the case judging by the fees. Also Broker 22 appears to have bucked the trend and receives the highest fee of the whole lot, at 0.28%, despite charging Manager E only 0.12%.

Table 5 shows the corresponding execution efficiencies for the same set of managers and brokers. The brow furrows once again at some interesting results:

- The range of outcomes is wide, in some cases for the same broker, for example, Broker 21.
- Broker 22 appears to have rewarded Manager H with a positive execution efficiency, one of only two positives that the manager has been able to achieve, but has not achieved a positive result for Manager E, where the fee is very low. This begs the question whether the fee plays some part in determining the care with which the broker executes the trades.

Table 5					
Execution efficiency					
	Mngr E	Mngr F	Mngr G	Mngr H	Mngr I
VWAP impact (Rm)	0.246	0.209	1.159	-0.308	0.027
VWAP impact (bp)	5	9	16	-15	1
bp					
Broker 14	10	7	-2	-18	13
Broker 15	41		42	-3	-7
Broker 16	33	1	57		1
Broker 17	7		7		-6
Broker 18		31	-4	-6	-3
Broker 19	11	13	6	-3	0
Broker 20		-4	-28	1	11
Broker 21	8		49	-22	-1
Broker 22	-17	11		10	7
Broker 23			-8	-61	-6

Source: analysis by The Electronic Trustee; managers and brokers are the same as in table 4.

- The only other positive execution result obtained by Manager H is by Broker 20, also paid more than the others. All other execution outcomes by Manager H are negative and the overall VWAP impact for this manager – and this manager only – exceeds the total cost of all trades. Could it be that brokers are not treating the instructions of this manager with the same care that they accord the other managers, a type of reward for poor fees?
- Though less significant in impact, it is interesting that Manager I's cheapest broker also achieved the poorest execution result.

The intention of this example is not to suggest that it is possible to dig out the inappropriate behaviour of managers or brokers. It serves to point out that trustees should at least be exploring it, making it clear to their providers that they are exploring it, and requiring of their investment consultant to take this issues into consideration in the reports delivered and advice given concerning the managers.

Managers can save their clients' money both through the fee negotiation and through directing trades to those brokers that demonstrate their effectiveness in execution.

Futures close-out and unit trust quarter-end

If investment managers are using client assets to their own ends, there are two useful ways of exploring the possibility, through their behaviour in the last few days prior to a quarterly close-out of the futures market and in the last few days running up to the unit trust reporting date. In both cases, asset managers, anxious to enhance their reported

performance, could be tempted to use client assets to manipulate share prices through aggressive directional trading.

Table 6 illustrates the differences in the behaviour of four different managers in the run-up to the futures close-out.

The evidence suggests that Manager K was not moved to trading action by the approach futures close-outs.⁹ Managers J and L were marginally more active over the four 5 day periods. Manager M appears to have had a significant interest in ensuring that either specific shares or the market achieved specific levels, leading to a substantial increase in relative turnover. In this instance the excess trading has led to a significant cumulative loss to the client over the course of the year, 0.3%.¹⁰

Table 6 Manager trading behaviour in run-up to futures close-out				
	Manager J	Manager K	Manager L	Manager M
Number of transactions ¹¹	109	85	53	33
Value traded (Rm) ¹²	21	27	26	57
Average value traded in close-out weeks (Rm) ¹³	5.2	6.8	6.5	14.3
Average value of shares traded in 5 days (Rm) ¹⁴	4.4	12.1	5.5	8.0
Relative activity index (%)	118	56	118	178
Economic impact on portfolio (bp)	-2	+3	+6	-30
<i>Source: analysis by The Electronic Trustee; footnotes explain the terminology used.</i>				

⁹ The average value of trade in close-out weeks (R6.8m) is lower than the average value of trade at other times in the year (R12.1m).

¹⁰ This is not a significant performance loss, some would suggest, and it is in any case reflected in the performance of the fund. This might be so, but the manager appears to be using the assets of its client to achieve its own ends. The reputation loss of the 0.3% is far outweighed by the gain that is achieved through the inappropriate use of client assets.

¹¹ Managers generally trade single share futures. The number of transactions reflects those executed during four specific 5 day periods over the course of a year.

¹² This is the value of transactions during the 4 working days prior to close-out day plus close-out day, 5 days in total, for the year in total.

¹³ This is the average value of buy- and sell-transactions over each of the 4 futures close-out periods, 5 days in each case.

¹⁴ This is the overall value of all buy- and sell-decisions in the portfolio in the year divided by 52 weeks.

Table 7 shows similar analysis in the run-up to the quarterly unit trust performance cut-off date.

Manager J's relative activity was highest but was marginally profitable. Managers K and L's respective levels of activity were marginal with L making bad choices. Manager M took a large hit in a few shares.

The fundamental question is who stands to gain most from this activity, especially when the retirement funds do not have an interest in the performances of unit trusts?

Table 7 Manager trading behaviour in run-up to unit trust quarter-ends				
	Manager J	Manager K	Manager L	Manager M
Number of transactions ¹⁵	114	58	30	6
Average value traded over quarter ends (Rm) ¹⁶	5.8	7.8	3.2	8.2
Average value of shares traded in 5 days (Rm)	4.4	12.1	5.5	8.0
Relative activity index (%)	132	65	58	103
Economic impact on portfolio (bp)	+6	+4.5	-6	-17
<i>Source: analysis by The Electronic Trustee; footnotes explain the terminology used. The managers in this table are the same as those in table 6.</i>				

Multiple manager wastage

The examples shown so far demonstrate the inefficiencies of execution of managers and the potential for managers to execute in their own interests but not in the interest of their clients.

The final example demonstrates the overlap between multiple managers used by the same fund and questions the effectiveness of such strategies. Table 8 shows the aggregate trading costs incurred by three different funds utilising multiple managers.

The evidence suggests that the benefit gained from diversification across managers is at least partially removed by the cost of neutralising trades – purchasing and selling activities that cancel one another out from the perspective of the retirement fund but incur costs that are carried by the fund – in the case of the 6-manager funds an effective 2.2% per year.

¹⁵ These portfolios do not hold unit trusts as investments. The number of transactions is the total over the four 5-day periods in a year.

¹⁶ This is the value of transactions during the 4 working days prior to the quarter-end plus quarter-end day, 5 days in total.

Table 8			
The cost of overlapping investment mandates			
	Fund I	Fund II	Fund III
Number of asset managers employed	2	4	6
Value of transactions in same shares occurring within 3 days (Rm)	249	303	540
As a % of the fund value	8	19	33
Value of transactions neutralised (smaller value of buy or sell, Rm)	79	94	197
Value neutralised as % of transactions in same shares	32	31	31
Opportunity impact of losing the benefit due to neutralisation (Rm)	-24	-21	-36
Impact on fund (bp)	-74	-130	-220

Source: analysis by The Electronic Trustee.

Concluding comments

This section attempts to demonstrate just a few examples of the activities carried out by asset managers that may not be in the best interest of their retirement fund clients. It is not intended to cast doubt over either the efficiency or integrity of asset managers in general, but it should alert retirement fund trustees to the types of issues that they ought to raise in discussion (directly) with their asset managers.

Anecdotal evidence gathered by The Electronic Trustee in the course of communicating these issues to retirement funds is that investment consultants, by and large,

- do not require asset managers to report on the issues, and
- do not consider the issues in the selection of managers or in other advice given to their clients.

Asset managers have a tendency to bury clients under huge amounts of data as frequently as monthly, and investment consultants are tempted to control the information that reaches the client as a means of enhancing their own position in the triangular relationship.

Neither of these is appropriate. Retirement funds should be provided with the information most appropriate to their decision-making, in a form that is easily understood, and they should be receiving it directly from the asset manager together with any supporting advice provided by the investment consultant.

9

SOCIALLY RESPONSIBLE INVESTING SOUTH AFRICAN FUNDS MOVING FORWARD?

In which the imperative for a socially responsible approach to asset selection by long-term investors like retirement funds is set out and the reasons commonly cited for not considering social responsibility are explained. The work of an independent researcher is quoted to illustrate serious flaws in the governance and management of South African retirement funds that may help to explain the poor attention given to socially responsible investing.

Socially responsible investing (SRI), environmental, social and governance (ESG) objectives (ESG), corporate governance... terminology probably familiar to many but actively understood and acted upon by few.

... private engagement [with company management] plays an important role, but given the structure of corporate South Africa – where an elite band of fund managers engages on behalf of the public – it is important that activism and good corporate governance should not only be done, but be seen to be done. At present, it seems that whatever happens, no matter how poor or corrupt management is, the key challenge is to keep everything private: "Don't let the kids [the saving public] see that the grown-ups [corporates and fund managers] have stuffed up again." (Ann Crotty, Business Report, 29 August 2007, parentheses in original)¹

Why should trustees consider the possibility of socially responsible investing in the midst of all of their other duties? If socially responsible investing is indeed appropriate, how widespread is it in the South African pension fund environment? What can be done to increase its value as part of a responsible investment policy?

¹ "Botha and Molefe end the ABM Ice Age with a punch at the mastadons", article downloaded from <http://www.busrep.co.za/index.php?fSectionId=553&fArticleId=4006633> on 29 August 2007.

What is SRI?

Socially responsible investing is not easily defined.

[James] Frater [of Fraters Asset Management] says, while the companies in the [JSE SRI] index are screened and included on the basis of their score on social responsibility criteria, Fraters prefers its shareholder activism approach. He says while Fraters applauds the attempt by the JSE to create an SRI index, the index has many shortcomings. For example, companies report on their social responsibility by answering a questionnaire, and the index has many global criteria for companies that may have different social, environmental and economic effects. (Laura du Preez, Personal Finance, 3 September 2007)²

Different terms are frequently used, sometimes interchangeably and sometimes unhelpfully.

Freshfields Bruckhaus Deringer (2005:18) quotes The Enhanced Analytics Initiative³ definition of ESG issues as meeting one or more of the following criteria:

- the focus of public concern, for example, genetically modified organisms,
- qualitative, not readily quantitative in monetary terms, for example, corporate governance or intellectual capital,
- reflecting externalities that are not well captured by market mechanisms, for example, environmental pollution,
- often the focus of a tightening policy and regulatory framework, for example, greenhouse gas emissions, or
- arising throughout the company's supply chain, for example, labour issues at supplier factories.

Perhaps it is best to describe SRI, or any of its variants, including employment equity or black economic empowerment as...

... an investment decision-making approach that has regard to issues that may not have immediate or short-term impacts on the value of the portfolio but could have significant negative or positive impacts for asset owners in the long-term.

This includes all of the issues listed in the definitions quoted earlier and others that might be regarded as important in this country like ethical business practice, transparent reporting, community support and involvement, and black economic empowerment.

² "Your guide to SRI funds: we report on socially responsible investments available in South Africa", article downloaded from <http://www.persfin.co.za/index.php?fSectionId=662&fArticleId=4016365> on 7 September 2007.

³ More information is available at www.enhanced-analytics.com.

While the importance of SRI is easier to perceive in the context of long-term investment objectives – and pension funds of all investors should be taking the longer term perspective in their decisions⁴ – it should not be assumed to be without any benefits in a shorter time frame.⁵

Why invest responsibly?

Why should pension funds take a responsible approach to the selection of assets? Two main reasons – both surprisingly straightforward – emerge from an analysis of the motivations set out by commentators:

- It is the right thing to do, and
- It is in the interest of investors.

Probably the most important error made in this arena is assuming that it must be an either-or, a moral judgment or an investment judgment.

There is no evidence that socially responsible investing reduces investment returns, particularly in the long-term (Ragnartz, 2007). There is also no international legal foundation for the position that, even if it is the right thing to do, if it might reduce returns in the short-term it cannot be contemplated by trustees because, as some claim, “*their only duty is to maximize returns*” (Freshfield Bruckhaus Definger, 2005, discussed in more detail below).

So, SRI should be considered by trustees because it is, without question, a responsible way of investing the assets of the fund and because it may be a way of enhancing investment returns. At the very least, if trustees choose not to follow principles of SRI in their investment strategy – which should always be stated and available to all members – they should be able to explain why not.

In some instances, furthermore, members have an interest in certain forms of SRI. Mineworkers, for example, would be motivated to invest in mines with strong safety records and a responsible approach to working conditions and environmental pollution.

⁴ I acknowledge the tension between the fund view on the long term and the perspective of some of its members that may be rather more short term. Sacrificing the former in favour of the latter, however, fundamentally undermines probably the only opportunity that most of the members have to invest properly in their long-term future, their retirement. Trustees should apply their minds to this issue.

⁵ Marathon Club (2007) provides an excellent guide to long-term investing, the importance of thinking over a longer time horizon and the qualities of an investment manager likely to succeed over the long-term. A number of the market conduct issues raised in this paper can be traced in some way to an exaggerated focus on short-term performance which, if it does not translate to longer term success as well – and the Marathon Club suggests that it generally does not – is not in the interests of pension funds and their members. (Refer to extracts from the Wildsmith study set out towards the end of this section.)

Disadvantaged groups – often minorities, but not always – should have an interest in investing in companies with a focus on addressing these disadvantages constructively. Low-income members would like to invest in firms with a responsible approach to community development. In instances such as these, it is appropriate for the trustees of pension funds representing these groups to take actions to ensure that investments are in line with these needs.⁶

This section does not consider these special cases in further detail. It aims instead to set out the motivation for all pension fund trustees to consider the responsible investment of the assets of the fund.

Methods of investing responsibly

If socially responsible investing is appropriate for all funds, how might it find its expression in the way in which investment decisions are made by trustees?

Erich Potgieter, director and investment consultant at Fifth Quadrant (Potgieter, 2004), suggests that SRI could be considered at four levels:

- **active asset management** can be considered part of socially responsible investment because it assists in generating an efficient operation of the capital markets, setting prices more effectively,⁷
- **enforcing good corporate governance** is an important part of SRI for the trustees of a pension fund invested in the equity markets,
- **explicit targeting of mainstream investments** to aim for those that make a positive contribution to society and avoid those whose activities may be harmful,⁸ and
- **focus on unlisted socially responsible opportunities**, generally higher risk due to constraints such as evaluation costs and lower liquidity, but often expected to deliver a higher return and more readily identifiable as in the public good.⁹

⁶ This should be tempered by a responsible approach to the potential for conflicts of interest. It is not appropriate for a pension fund representing mineworkers simply to invest in the shares of employers, because this creates a dangerous hazard, concentrating the risk experience by the members of the fund who are also employees of the firms.

⁷ I include this point out of respect for Dr Potgieter's writing, but it is one on which not all would agree. Adair Turner's review of the United Kingdom retirement system recommends the introduction of an individual account system with a maximum annual charge of 0.3% of assets. Turner acknowledges that this approach would most likely result in a significant proportion of the assets being invested in passive strategies, but does not regard this as potentially detrimental to market liquidity, despite the considerable asset volumes involved (UK Pension Commission).

⁸ Potgieter suggests that an example of a company in the former category is one that engages in sustained job creation activities. Activities that investors may seek to avoid are those that might be harmful socially or to the environment.

⁹ This category of assets does not necessarily require direct investment in risky asset classes such as venture finance, as some asset managers have developed portfolios that include these types of

Freshfields Bruckhaus Deringer (2005) distinguishes between a number of types of SRI activities. In the area of investment selection they identify the following approaches:

- **passive screening** makes decisions by following one of many international indices with ESG benchmarks like the Dow Jones Sustainability Index and the FTSE4 Good,
- **positive screening** establishes a set of criteria that must be met before an investment is included in a portfolio, for example, a record of strong relations with employees, good corporate governance or outstanding safety standards,¹⁰ and
- **negative screening** excludes companies on the basis of ESG performance.

Negative screens may be applied to exclude, for example, organisations that manufacture alcohol, weapons, tobacco, GM foods or nuclear energy; are engaged in gaming or animal testing; have poor labour standards; or are guilty of breaching human rights (Freshfields Bruckhaus Deringer, 2005:25; to this list could be added companies that engage in questionable lobbying activity).

To this they add the practice of shareholder engagement, under which the investor seeks to “understand and attempt to influence the ESG performance of an organisation through engagement with management... and through the exercise of voting rights.” (Freshfields Bruckhaus Deringer, 2005:25-26) They mention that a number of investors have combined screening and shareholder engagement for maximum impact.

Some commentators have suggested that engagement should be seen not as an alternative to screening but as an essential mechanism for obtaining information about corporate performance – information that may not be known to the market but that may influence investment decisions. In this way, the results of engagement feed back into and inform the investment process. (Freshfields Bruckhaus Deringer, 2005:27)

The Seventh Swedish National Pension Fund (AP7) implemented a set of ESG standards in 2000 by requiring of companies in which it holds a stake that they follow what is referred to as the UN Global Compact. This seeks corporate compliance with

- declarations on human rights,
- ILO conventions,
- international conventions on the environment, and
- conventions against bribery and corruption.

By ensuring that the approximately 2,500 companies the fund invests in globally follow UN agreements the fund has succeeded in achieving a good return, while at the same time

investment. But neither should direct investment be ruled out by trustees when it could result in a clear financial commitment to, for example, social or environmental development.

¹⁰ Within this approach are variations, for example, selecting only best-in-class companies, those that lead each industry grouping on SRI considerations, and thematic investment approaches, leaning towards firms that have made a commitment to responsible products and services (Freshfields Bruckhaus Deringer, 2005:25).

following ESG considerations. About 30 companies have been excluded from our portfolio on the basis of failing to meet the conventions. All exclusions have been based on court decisions, official investigations by governments (or government agencies) or international organisations like the United Nations, and even confessions by companies themselves. (Ragnartz, 2007)

This is a form of negative screening.

These descriptions represent a useful start but they do not explain exactly how trustees might be able to implement such strategies. How difficult is it for the trustees of a pension fund to see that good corporate governance principles are applied at companies in which it invests and how might it distinguish between companies with a positive contribution to society and their peers? Small and medium funds may not have the resources to undertake screening and shareholder engagement themselves.

Asset managers can help. The practical challenges around SRI strategies are sometimes raised by trustees who express the view that SRI is too difficult to implement. This is not true. There are a number of simple and effective strategies available to trustees.

The arguments against SRI

The first argument often cited against SRI is that the **trustees' only responsibility is to maximize investment returns.**

Any deviation from that single-minded pursuit of profit-maximisation by the admission of some other social responsibility is 'fundamentally subversive', 'pure and unadulterated socialism', something which could 'thoroughly undermine the very foundations of our free society.' Businessmen subjected to 'a social responsibility other than making maximum profits for stockholders' cannot know what interests to serve. (Freshfields Bruckhaus Deringer, 2005:27, quoting Friedman and An Economist's Protest)¹¹

The authors of the Freshfields paper note that there are many economic arguments against this line of reasoning,¹² but that the primary purpose of their paper is to debunk the oft-cited legal argument that trustees cannot consider any basis for their decisions other than profit maximization, by implication short-term profit.

Despite the growing body of evidence that ESG issues can have a material impact on the financial performance of securities and an increased recognition of the importance of assessing

¹¹ References provided by the authors are: M Friedman, *Capitalism and Freedom* (1962:133) and *An Economist's Protest* (1972:177).

¹² "For a critique of this argument see e.g. C Joly, 'Ethical Demands and Requirements in Investment Management' *Business Ethics: A European Review* (Vol. 2 No 4 October 1999) at 201: 'The essence of business is the sustainable evolutionary adaptation of its activities to emerging opportunities and risks in its markets. Making profits means making sure the conditions for future profits are being put into place and this is rarely coincident with maximising short-term profits. A business builder builds an edifice for coming generations.' (Freshfields Bruckhaus Deringer, 2005:27, footnote 55)

ESG-related risks, those seeking a greater regard for ESG issues in investment decision-making often encounter resistance on the basis of a belief that institutional principals and their agents are legally prevented from taking account of such issues. (Freshfields Bruckhaus Deringer, 2005: 6)

This comprehensive work, commissioned by the Asset Management Working Group of the United Nations Environment Program, undertakes a detailed survey of the legal structure underlying pension fund investment across a number of countries.¹³

The authors refer to the celebrated case of *Cowan v Scargill*¹⁴ in which it appears that the judge ruled that it is unlawful (in the United Kingdom), for pension fund trustees to do anything but seek to maximize profits for the beneficiaries of the fund.

In fact, the judge did not rule in this way. The decision has been distorted by commentators seeking to build support for this view. The judge, one Megarry, took the unusual step of revisiting his judgment in print in 1989 to make it clear that “... *his decision stands for an uncontroversial position that trustees must act for the proper purpose of the trust, and not for extraneous purposes.*” He explained that “... *Cowan v Scargill did not support the thesis that profit maximization alone was consistent with the fiduciary duties of a pension fund trustee.*”¹⁵

The authors take great care to investigate the legal arguments for and against SRI in different jurisdictions, broadly concluding that it has a substantial role to play in the decision-making of trustees.

A second argument cited against SRI is that it is **not consistent with the principles of modern portfolio theory**, in which investments should be diversified across uncorrelated asset classes to improve the risk-adjusted return.

Two responses to this follow. One, the marginal benefits of diversification fall rapidly with each security added to the portfolio and are insignificant above a relatively small number of companies. Two, companies attractive for their SRI initiatives can add to diversification rather than taking away from it, because they swim against the current to achieve a different set of objectives, or to reach the same goals in different ways.¹⁶

¹³ The countries included are Australia, Canada, France, Germany, Italy, Japan, Spain, the United Kingdom and the United States, as well as the European Union as a whole.

¹⁴ Cowan and other trustees were appointed to the Mineworkers' Pension Scheme by the National Coal Board and Arthur Scargill and his co-trustees were from the National Mineworkers' Union.

¹⁵ Both quotes are from Freshfields Bruckhaus Deringer (2005: 9).

¹⁶ This applies more to positive screening methods of security selection, or to those entities falling into the suggested unlisted firms mentioned by Potgieter (see discussion earlier in the section), than to negative screening methods intended to remove certain firms from a portfolio.

A third argument, related in some ways to the first, is that **businesses should engage in business** and stick only to that.

Institutional investors should indeed invest only in firms with the focus and determination to meet their business objectives, but this should not rule out a responsible approach to achieving business goals.

Trustees should ask themselves a question. Is it right to invest member assets in firms that fail to take responsibly their commitment to society and the environment, that do not report on their activities transparently or that engage in market deception or fraudulent activity? Even from a purely economic point of view, this is not a sensible approach because it is highly likely to result in reduced performance at some time in the future.

The fourth argument is that **SRI is unavoidably subjective in nature**. This has an element of truth to it. Are their ethical justifications to a refusal to invest in wine manufacturers, for example, or in retailers who sell wine? Difficulty of decision, however, does not provide to trustees the justification to ignore SRI considerations in the policy and practice of investing fund assets.¹⁷ The fact remains that trustees who ignore SRI in their strategy ought to make it clear to members why they have chosen to do so.

The consequence of the concept that "the market is always right" is a cynical and irresponsible approach that belongs to a past when we did not have global common guidelines, or democracies for that matter. The seriousness of global warming is one example where the market has proved flawed. Climate change is the biggest market failure ever. Relying on market forces has so far led us into a dangerous situation where it is hard to see how investors could argue they had taken their fiduciary responsibility seriously. (Ragnartz, 2007)

The fifth reason for not investing in line with SRI principles is that **it is too difficult to do**. Trustees cite an absence of SRI funds in sufficient numbers.¹⁸

This is a cop-out. Trustees have an explicit duty to ensure that assets are responsibly invested and managed. At the very least this suggests that trustees should be requiring their managers to report on what they do to ensure that companies comply with corporate governance guidelines. And if trustees feel that it is inappropriate to extend this to considering other investments with a social and environmental slant to them, they should be prepared to explain to members why they feel that this omission is in the interest of the members and their beneficiaries.

¹⁷ Difficulty of decision can never be used by trustees as a reason for failing to apply their minds to any issue affecting the fund and its members.

¹⁸ Managers in turn suggest that there is insufficient demand for them to launch new funds with an SRI focus. As a result, we see our listed companies ignoring requests to report on the environmental impact of their businesses, because they do not experience the consequences of their irresponsible behaviour.

Trustees should remind one another, as frequently as may be necessary, that they represent the owners of capital and that asset managers and company managers are stewards of this capital that manage it in the best interests of the owners.

How widespread is SRI?

SRI and ESG are growing in significance in many parts of the world.

Australia has more funds under management committed to the UN Principles for Responsible Investment (UNPRI) as a percentage of total assets than any other country. ... For the last couple of years Australians have had the ability to choose their own superannuation fund. This has resulted in a battle for consumer loyalty between not-for-profit industry superannuation funds and retail funds. The battle has mainly focused on the traditional areas of fees, charges and investment performance, but some super funds are realizing that they will need to differentiate themselves in other areas. The impact of climate change in Australia, which is suffering its worst ever drought, has meant that responsible investment issues have come to the fore in the community mind and may in the future influence purchasing decisions. (Gordon Noble, Responsible Investor, 19 November 2007)¹⁹

Australian providers are paying significant attention to SRI issues, perhaps because consumers have the power to choose between pension providers and because competition is intense, but SRI is growing in importance in other parts of the world where this dynamic of individual choice is not as strong.

Hugh Wheelan reports for Responsible Investor²⁰ on the more than 40% year-on-year growth in the assets invested in SRI mutual funds in Europe. The number of funds involved has increased by 13% over the last 12 months to a figure of 437. Earlier in 2007,²¹ he cited research house EIRIS estimates that responsible investment now accounts for about \$4 trillion of all global assets, comparing reasonably well to the total value of investment industry assets of a little over \$42 trillion.²²

While actual SRI-orientated funds might be more attractive to individual investors, pension funds – particularly the larger entities – take a somewhat different approach, preferring either (Freshfields Bruckhaus Deringer, 2005:25) to

¹⁹ "Australia takes the lead on responsible investment", downloaded from www.responsible-investor.com on 27 November 2007, available at www.responsible-investor.com/home/article/australia_takes_a_lead_on_responsible_investment/.

²⁰ "European SRI mutual fund assets jump 43%", 1 November 2007, downloaded 23 November 2007 from www.responsible-investor.com/article/european_sri_mutual_fund_assets_jump_43.

²¹ "Report says SRI assets reach \$4 trillion", 13 September 2007, downloaded 19 September 2007 from www.responsible-investor.com/article/report_says_ri_assets_reach_4_trillion/.

²² Freshfields Bruckhaus Deringer (2005:6) figures apply to the end of 2003 and are likely to have increased somewhat.

- instruct managers to take SRI issues into account,²³ or
- to engage actively with the firms in which they invest.²⁴

Not all funds in the United Kingdom are actively considering SRI in their strategies,²⁵ but the incidence is growing.

French institutional investors are growing more aware of SRI considerations:

French institutional investors are increasingly focusing on socially-responsible investment (SRI) and most institutions now expect it to play a role in their business strategy, suggests a study of investors. Details of the sixth annual Socially Responsible Investment survey, conducted by investment consultancy Amadeis, SRI research centre Novethic and asset manager BNP Paribas, reveals 61% of the 50 institutional investors questioned now invest in SRI, compared with 48% in 2006. (Investment & Pensions Europe)²⁶

Denmark looks set to follow a similar route:

An official report in Denmark has concluded pensions institutions can take an ethical stance on investments while still fulfilling their legal duty to get the highest possible return. The report conducted by Denmark's outgoing Pension Market Council also forecasts the Danish pensions industry was likely to become more involved in the process of investing on environmental and social governance (ESG) grounds, than it is at present. "An examination of the foundation of law shows it is possible for pensions institutions to apply an ethical profile to their investment choice," the report concluded. (Investment & Pensions Europe)²⁷

There is growing evidence that ownership is being taken more seriously by pension fund members, who are requiring trustees to take a responsible approach to the investment of fund assets:

Trade union officials have warned Merseyside pension fund could face a legal challenge over a recent decision by local authorities to continue the fund's investment in companies selling armaments. Councillors from eight boroughs representing employer sponsors to the £4.2bn... pension fund rejected a proposal ... to divest pension fund assets from assets linked to the arms trade, on environment and social governance (ESG) grounds. ... as a result of the pension fund committee's decision, a legal team has been created to give guidance to Merseyside and Wirral [trade union] branches on whether it has a case to challenge the legal premis (sic) on

²³ Examples of these are the British Post Office pension fund and the BBC pension fund.

²⁴ The Lothian Pension Funds in the United Kingdom and, in the United States, TIAA-CREF, fall into this category.

²⁵ Responsible Investor reports that half of the UK's twenty largest funds do not appear to have a policy regarding climate change or human rights (8 December 2007, citing a report by FairPensions). Investment & Pensions Europe reports that only one UK-based local authority currently shows a best practice approach – the highest rating on a 4-point scale – to responsible investment (30 November 2007, citing the UK Social Investment Forum).

²⁶ "France steps up the pace on SRI", www.ipe.com, 3 December 2007.

²⁷ "Danish pensions body deems ESG safe", www.ipe.com. 30 November 2007.

which many local authority pension funds believe they cannot legally opt for divestment. (Investment & Pensions Europe)²⁸

The UK National Association of Pension Funds has issued a corporate governance guide, demonstrating its commitment to responsible investments.

The National Association of Pensions Funds has suggested an independent non-executive director of a company may not be able to continue to be considered 'independent' the longer they hold their position. Details of a corporate governance guide issued yesterday by the UK pensions association suggest deciding how long a non-executive individual can still be considered 'independent' has triggered a great deal of discussion among its membership, when trying to revise its corporate governance guidelines for pension funds and trustees. (Investment & Pensions Europe)²⁹

There is also a strong expectation that SRI will continue to grow in impact. Mercer Investment Consulting surveyed 195 managers from around the world in 2005, establishing widespread acceptance of growing screening and activism approaches.³⁰

What are the factors that are driving the increased use of SRI strategies? Freshfields Bruckhaus Deringer (2005) list a number of possibilities (quoted below from page 24 with modification of formatting)

Commentary suggests that this movement toward mainstream consideration of ESG issues in investment decision-making is a response to a variety of different factors, including...

- *increasing evidence of the nexus between performance on ESG issues and financial performance,*
- *stakeholder activism,*
- *reputational concerns,*
- *consumer pressure/public opinion,*
- *pressure from research bodies, investor initiatives and non-governmental organisations,*
- *pressure from the insurance industry,³¹*
- *introduction of corporate environmental reporting obligations,*
- *the rise of the global company,*
- *adoption of investment guidelines by the World Bank, IFC and other intergovernmental lenders,*
- *growing corporate transparency,*
- *the information technology revolution, and*

²⁸ "Legal threat to pensions arms trade decision", www.ipe.com, 6 December 2007.

²⁹ "NAPF questions non-execs independence", www.ipe.com, 28 November 2007.

³⁰ Some 70 per cent of fund managers interviewed believe that SRI will be fully integrated into investment analysis within three to ten years and half believe that active ownership will be mainstream within a period of two years. (Freshfields Bruckhaus Deringer, 2005:23)

³¹ The insurance industry is affected by irresponsible corporate activities, through their impact on, for example, climate change.

- *regulation mandating disclosure of ESG investment policies.*

For a large variety of reasons, owners of capital are increasingly requiring greater responsibility of their stewards.

What is the picture in South Africa?

How many of these factors play a significant part in investment decision-making in South Africa? While pressure is being brought to bear in a number of ways its impacts appear to be rather slow in bearing fruit.

SA is one of the world's worst when it comes to carbon emissions ... Unfortunately, according to a report presented at the JSE by the Carbon Disclosure Project, SA is not about to change its behaviour any time soon. The project, an initiative launched in 2000 which aims to improve communications between investors and the companies they give their money to, surveyed three quarters of the JSE's Top 40 companies. It found that although 89% of them thought there were business opportunities linked to climate change, there was "a disconnection between awareness of climate change and action on the issue". Some companies did not respond to the project. (Renee Bonorchis, Business Day, 28 November 2007, formatting edited)³²

This suggests that there is little activity in the area of corporate governance. The view is supported by the paucity of public comment by asset managers on company controversies. Though more discussion probably takes place behind closed doors, it would be helpful for asset managers to make clearer their views on issues that emerge into the public domain, demonstrating their commitment to their clients, the pension funds, and to the beneficiaries of the funds whose assets they manage.³³

Progress on improving the transparency of corporate reporting in South Africa has been painfully slow.

Financial communications should be revolutionised so that people can actually understand them. 'Intelligibility' is a requirement of the King code [of corporate governance standards in South Africa] that's too often ignored but can be simply remedied. Judge Dennis Davis doesn't mince words. "In a society where few people can understand complex English," he rhetorically asked a recent conference of the Pension Lawyers Association, "can't highly formalistic communication enable their exploitation?" (Allan Greenblo, Today's Trustee, June/July 2007, page 26, originally published in Business Report, 29 March 2007)

³² "South Africa: Businesses in Country Lukewarm On Climate Change Issue", article downloaded on 29 November 2007 from [www.allafrica.com](http://allafrica.com/stories/200711280228.html) at <http://allafrica.com/stories/200711280228.html>.

³³ Refer to Ann Crotty's comments quoted in the opening paragraphs of this section.

Greenblo, editor of Today's Trustee, goes on to call for the introduction of narrative reporting requirements to corporate financial disclosure, which is essentially about expressing all of the facts clearly and in the appropriate context.³⁴

Perhaps investment managers could take clearer steps to demonstrate their commitment to clear reporting of their own businesses. The same could be said of other providers of service to the occupational pension fund industry.³⁵

Davis said large institutions and fund managers needed not only to become more active, but to take more of their own medicine by applying rigorous standards of transparency and accountability to themselves. (Renée Bonorchis, Business Day, 4 July 2007)³⁶

It would nevertheless appear that encouraging changes are afoot.

[The] Public Investment Corporation Limited's ... Corporate Governance and Proxy Voting Policy specifies a framework of principle and action for its stakeholders, primarily the companies in which it invests and fund managers that invest on behalf of PIC. The framework reflects the conviction that in South Africa socially responsible governance and sound management practice are inseparable. (Public Investment Corporation, undated:2)³⁶

The Public Investment Corporation, by far the largest asset manager in the country, looking after most of the assets of the Government Employees Pension Fund, among others, recently released a policy paper to make clear its approach to corporate governance and proxy voting. It sets out what it requires of the companies in which it invests:

- discipline,
- transparency,
- independence,
- accountability,
- appropriate behaviour,³⁷
- fairness,

³⁴ Similar requirements should surely apply to all communication by trustees to members and by service providers to all of their customers.

³⁵ If all providers of services to retirement funds had been transparent to their shareholders about their sources of revenue would we have had a bulking scandal in this country? How many pension fund trustees asked their asset managers about their attitude to investing in those companies implicated in the bulking scandal as it emerged? Would we be concerned about asset managers and consultants who enjoy undisclosed revenue from transition management if such revenue were transparently disclosed?

³⁶ Stephen Davis was speaking at a conference in Johannesburg. He is a specialist in international corporate governance and co-author of the book "New Capitalists: How Citizen Investors are Reshaping the Corporate Agenda."

³⁷ This concerns specifically the willingness to take corrective actions where required.

- social responsibility,³⁸ and
- good stakeholder relations.

This follows similar initiatives by private sector providers. Frater Asset Management launched in 2001 the first South African investment vehicle with an activist mandate and was the first asset manager to publish a complete voting record and a voting proxy policy. It is well-known for the set of investment principles that it applies to its investment decisions (Frater Asset Management, 2004),³⁹ expecting from the companies in which it invests:

- communication and disclosure,
- financial and economic performance
- effective leadership,
- respect for shareholders' rights,
- meeting stakeholder obligations, and
- embracing the challenges of their business environment in which they operate.

Futuregrowth is another manager with a long track record in SRI. Futuregrowth publishes its proxy voting guidelines and corporate governance philosophy and has for some time been involved in promoting community development through active investment in South Africa's underprivileged areas.⁴⁰

These three cases – one very large fund and two service providers – hint at widespread interest in SRI in South Africa. Sadly, this appears not to be the case. Perhaps for the reasons discussed earlier, perhaps for others, on closer examination socially responsible investing occupies a very small space in the investing actions of South African retirement funds. There are still few funds dedicated to socially responsible investment and it would seem that hoping for change to come, in significant scale, from the supplier side could result in a long wait.

Sobering evidence of a dire situation

The views of trustees give yet greater cause for concern. Helen Wildsmith's MPhil research into the potential for South Africa's largest public sector pension funds to play a collective

³⁸ This is defined by the PIC as ensuring good corporate citizenship involving non-discriminatory, non-exploitative and responsible action in relation to environment and human rights issues. (Public Investment Corporation, undated:2)

³⁹ The document and further information on the Frater approach is available at www.fraters.co.za.

⁴⁰ More information is available at www.futuregrowth.co.za.

development role (Wildsmith, 2006)⁴¹ suggests that a wait and see attitude predominates, even among the trustees and managers of these very large pension arrangements.

Her writing raises very serious concerns that go to the heart of this study and clarify some of the reasons that trustees fail to take the longer-term view that SRI requires of them:

Although most interviewees believed that pension funds should take a longer-term investment perspective and play a collective development role, it was widely recognised that pension funds face considerable capacity problems in doing this. (Wildsmith, 2006:39)

Clearly, this industry must overcome a number of significant challenges if it is to be more effective in its operation:

Pension funds are governed by trustees who are typically part-time and from outside the investment industry. Their responsibilities are wider than their funds' investment policies, and they are often faced with a full agenda of short-term pressing issues at trustee meetings. They therefore often rely on external investment advisers and fund managers ... for input, advice and training, and often delegate significant investment authority to these external advisers and fund managers. This makes it difficult for trustees to hold their advisers and fund managers to account, particularly in less tangible areas like shareholder activism. Some interviewees also noted that some advisers and fund managers form 'cosy' and potentially corrupting relationships with some trustees, through corporate hospitality and other mechanisms. One interviewee even asked to what extent trustee boards exist as separate independent entities. (Wildsmith, 2006:39)

Wildsmith comments on the prospects for the supply-side to take a longer-term view of investment requirements, again, with interviews painting a pessimistic viewpoint:

Nearly all the interviewees mentioned that the investment industry has a predominantly short-term focus. Long-term investment success is typically seen as the sum of a series of short-term wins. Index-based performance benchmarks tend to result in a focus on relative rather than absolute performance. The incentives within the industry reinforce this, with career prospects, bonuses and mandate renewal all being adversely affected by short-term relative underperformance. Investment analysis is predominantly short-term in nature, and portfolios tend to turn over quickly. The Warren Buffet approach of buy and hold is atypical, as is the use of longer-term analytical tools like scenarios, and longer-term ownership practices like shareholder activism. (Wildsmith, 2006:41)

The theme running through this research paper – the reality of serious market conduct issues undermining the soul of this industry – is reflected also in Wildsmith's reporting of the trustee point of view:

⁴¹ The thesis is due for publication in the journal *Corporate Ownership and Control* in largely unchanged form (Wildsmith, forthcoming). All references in this paper are to the thesis rather than the journal submission.

Several interviewees mentioned recent ethical scandals within the financial services sector, and questioned whether it could change itself from within. It was noted that those who profit from the status quo have a vested interest in maintaining it, and that protection for 'whistleblowers' is inadequate. As the predominant providers of trustee training and advice, fund managers and investment advisers have a powerful influence over the beliefs of the trustees who award them mandates and pay their fees. The fact that advisers own fund management operations was also seen as a cause for concern. The need for a strong regulator to protect weaker clients was mentioned, as was education from alternative sources. (Wildsmith, 2006: 41)

Concluding comments

Wildsmith's summary of the issues in South Africa's occupational pension funds environment make for depressing reading, but they echo quite clearly the concerns raised in this paper. They also make it clear that, if socially responsible investing is to gain traction in this country and provide the impetus for development that this country so badly needs, then a great deal more needs to change than the attitude to SRI.

Nevertheless, we cannot wait until the raft of other problems is addressed. Trustees can start by making sure that they understand the imperative to take a longer-term view on the investment of fund assets. This alone should go a long way to developing the type of thinking that makes SRI principles a natural part of the entire investment process.

10

MULTI-MANAGERS REPLACING TRUSTEE RESPONSIBILITY?

In which the complex operations of a multi-manager are described and some of the market distortions and inappropriate incentives outlined. This section summarises some of the issues set out earlier in the paper and identifies other concerns unique to multi-managers.

The South African multi-management industry has shown startling growth in recent years and now manages hundreds of billions of rands in retirement fund assets.

This section explores the dynamics of the multi-management industry, pointing out some issues with its operation and suggesting that trustees should do more to understand what they are purchasing when mandating these firms to provide asset management services.

Summary of issues

Some concerns that trustees should be aware of are issues that multi-managers have in common with their counterparts in the actively trading single manager space

- whose products, on the one hand, they utilise, for the benefit of their clients, and
- with whom, on the other, they compete for client assets.¹

These concerns are discussed throughout this paper and this final section summarises a number of the market conduct issues from a slightly different perspective. The success of the South African multi-manager industry appears to be fuelled by, for example,

- a continued belief by the market in the active management model,
- the option of launching multiple products to maximize the possibility of having a horse in the winners enclosure, and

¹ *This feature of the game, playing tennis on both sides of the court as it were, is an important paradox in the multi-manager offering that deserves more coverage. It is discussed further on.*

- the continuation of fee models based on assets under management, along with questionable performance incentives.

Other features of the multi-management industry that trustees should take into consideration are unique to these firms.²

- conflicts of interest emerge in ways that are peculiar to the dynamics of the multi-management operation, and
- multi-managers have opportunities to generate hidden forms of revenue that are generally not available to single managers, conflicts of interest that have the potential to impact the integrity of the service offering to the retirement funds.

The multi-manager space is no longer limited to specialist multi-managers. Section 3 describes the investment consultant market, pointing out that some consultants are moving into implemented consulting, in which asset manager recommendations are not just advised they are actively implemented. Multi-management and implemented consulting are not philosophically far apart.³

This blurring has a number of implications. First, trustees should be aware that distortions affecting some parts of the multi-management market could impact on the effectiveness of the delivery of implemented consultants as well.

Second, while services may be similar, fee levels do not appear to be. It would be helpful to trustees looking for providers that co-ordinate investments across multiple asset managers to have a clearer picture of exactly what is provided by each type of provider and at what cost. This section touches on some of the issues around fee models.

Section 8 points out the significant pure cost borne by retirement funds using multiple managers that arises purely from trades executed between those managers. This ought not to be surprising, in a market with no more than thirty or forty actively traded shares and it begs the question of why the model has been so popular.

In this context, multi-managers should surely be required by trustees to do a better job of justifying the incremental value provided to their customers.

² The management-of-managers space is no longer limited to specialist multi-managers. So-called "implemented consultants", for example, are pushing into the space. Trustees should be aware that similar distortions could impact on the effectiveness of their service delivery as well.

³ It has been suggested to me that section 3 and this one should be combined, so blurred is the distinction. I prefer to treat them as separate subjects because each has a number of distinct features, but to alert trustees to this blurring and the complex revenue models that exist.

The active management argument

Multi-managers depend on continued belief in the skill of active managers and the ability of these managers to convert this skill into performance.⁴ But multi-managers depend on more than a belief that some managers will deliver performance in excess of the relevant index. After all, we know that, in every period, some managers will be in this position.⁵ They depend on customer belief that the multi-manager will be able to identify tomorrow's winners with consistency, producing a good return in the process.

But such confident assertions can be enormously difficult to implement. Consider the issue of key personnel. The oft-spoken dictum of the experts in and around the asset management industry is that some traders have skill. This is a belief essential to the success of the active management brand. Though there may indeed be some truth to this, enough conclusive evidence for or against the existence of such skill is very hard to come by.⁶

For the purposes of this argument, however, let us assume that some individuals working in asset management have identifiable skill, sustainable through a variety of market conditions. For a multi-manager to succeed in taking advantage of the movement of key personnel, it must correctly identify these individuals. Then it must anticipate changes both in the employment status of these experts and the impact that such a change will have on the performance delivered by them, under the old employer and the new.

Note the assumptions behind this claim:

- sustainable skill is identifiable, along with changes to the level of skill or the extent to which it translates into performance,
- such skill is consistent in all markets and in the face of all market events, and

⁴ Issues around the persistence of the confidence in active manager outperformance are discussed in more detail in section 1.

⁵ This is true at all times, except if every manager delivers excess performance that is lower than its fees, not an impossibility, but very unlikely.

⁶ The consequences of such a belief are difficult to swallow, however. Since actively trading institutional investors make up the bulk of JSE trades, on average their trades yield zero return in excess of the benchmark. If some of them are skilled, generating consistent positive performance, then others generate an average performance that is negative, through "an absence of skill". The majority of motor vehicle drivers believe their driving ability to be better than average, an obvious impossibility, unless what they really mean is "some of the time, better than average". Asset managers should be careful not to promote too strongly the existence of skill, unless they are happy to acknowledge that it might come and go, somewhat undermining the claim in the process.

- the movement of the individual between employers is predictable,⁷ along with an understanding of how the timing of the move would affect the performance delivered by both managers.

Performance claims by the experts can sound credible when confidently expressed and backed up by what appears to be evidence, but these claims are very difficult to test systematically.⁸ Beware of the anecdotal evidence.⁹

This is a subtle distinction. I am not suggesting that, because it could be luck, it is; equally, however, one good performer or a few examples of successful manager selection are not evidence that skill exists.

... a population entirely composed of bad managers will produce a small amount of great track records. As a matter of fact, assuming the manager shows up unsolicited at your door, it will be practically impossible to figure out whether he is good or bad. The results would not markedly change even if the population [of managers] were composed entirely of managers who are expected in the long run to lose money.¹⁰ Why? Because owing to volatility, some of them will make money. We can see here that volatility actually helps bad investment decisions. (Taleb, 2007)

Product proliferation

Multi-managers have a strong incentive to launch multiple products. The reasoning behind such an approach is simple. It allows them to take advantage of the customer tendency – and often that of the consultant too – to over-emphasise anecdotal success, since a systematic analysis of the entire portfolio of the house is nearly impossible and very rarely

⁷ This suggests that the multi-manager has better knowledge than anybody else. Alternatively, since individuals about to move from one investment house to another have a disincentive to disclose this to a multi-manager, the multi-manager must be in the position of responding to the news of a move with remarkable speed and accuracy.

⁸ A set of examples presented in marketing material does not constitute evidence because it presents successes. The potential for errors arising from survivorship bias should not be ignored. A proper study of skill includes an assessment of all instances of the application of such skill, not just a few.

⁹ Some years ago, Peter Lynch, Fidelity superhero, was the darling of the US asset management industry. His skill was surely unmistakeable: he had beaten the market 10 years running. This so-called evidence is not proof at all. With close to one thousand mutual funds active in the market during that period – probably more if closures were taken into account – even pure luck would produce, on average, one fund that outperforms the index ten years in succession. The probability of tossing ten heads in a row is 2^{-10} , one in 1024, so good fortune alone could have produced Peter Lynch's performance. This is another example of survivorship bias.

¹⁰ Taleb precedes this discussion with the mathematics showing that, even if a manager had only a 45 per cent probability of outperforming the market in a given year, in other words poorer than random, nearly 2 per cent of a starting set of managers would manage five consecutive years of market outperformance. This doesn't look like a high proportion, but many of the others would have disappeared by then. Potential clients could be convinced by a marketing campaign that proclaims five consecutive years of market outperformance. This is really a lesson on survivorship bias, but it shows how easily we could be 'fooled by randomness', the title of Taleb's book.

carried out. Put more simply, the greater the number of products, the greater the probability of a headline-grabbing winner.¹¹

The temptation to launch multiple products is not unique to multi-managers. Collective investment houses, selling mainly to retail customers, have a similar incentive to create as many potential winners as possible, highlighting in due course the performance of the attractive funds and closing or ignoring the poorer performers. How many asset managers advertise the existence of a raging bull award, omitting to make clear that the award was achieved in a particular asset class rather than based on exceptional performance for the house as a whole?¹²

Such practice is not limited to the individual product market. It is more difficult to detect this type of activity in the institutional space because segregated portfolios are often based on different mandates, increasing the sophistication of the performance selection approaches.¹³

Product proliferation appears to extend outside of the supposed skill set of the provider. Despite the claimed core offering of the multi-manager – the ability to deliver excess performance by selecting tomorrow's winners from among the available investment managers¹⁴ – some multi-managers sell products that allocate across the largest available single manager portfolios, equally weighted.

This looks very much like a triumph of marketing over asset management. Trustees should ask themselves whether this is really designed to maximize returns? Are the fees on such a product lower than the corresponding fees on its counterparts, since it does not require the science of manager selection? An equal-weighted product also adds another horse to the

¹¹ Study the marketing presentation of any multi-manager, any asset manager for that matter. Is the data quoted in the material complete, allowing correctly for the performance of closed funds and reflecting the house in aggregate, or is it selective, presenting merely a sub-set of the information? Another way to run the test: read the presentation until the first mention of investment performance. Does it accurately reflect the success of the entire stable, or does it reflect selectively the career – even the single races – of selected horses?

¹² Even if manager performance were based entirely on luck, launching multiple funds would increase the probability of awards, leaving the marketing department free to draw attention to the winners, should they choose to.

¹³ Not very long ago, for example, the in-house manager of a large pension fund and the adviser of the fund both claimed the excellent investment performance as theirs, quoting the figures in their respective material.

¹⁴ Some multi-managers claim that manager selection is not their only important offering and that the allocation of assets across the major asset classes is another key skill. Trustees should acknowledge that others also claim this skill. Asset managers, for example, run balanced portfolios and are expected to vary the weights across the asset classes to maximize return, providing tactical asset allocation. Investment consultants provide strategic asset allocation, taking into account the need of members to set broad benchmarks for spreading the assets across the main asset classes.

stable of the multi-manager, generating another string of performance history and another potential winner.

Trustees considering the appointment of a multi-manager should ask for information on the past performance of all of the portfolios of the prospective provider, not only those that are open for business or those that the manager wishes to promote.¹⁵ They should seek to understand the rationale for all products available through the house and should wonder aloud why different products might have been established to meet the needs of a variety of investment rationales.

Conflicts of interest

Name a South African multi-manager. Is it independent? Is it part of a corporate entity that includes asset or actuarial consultants, who may have an incentive to recommend the products of the multi-manager? Does the parent company have a stake in one or more single asset managers, into which there may be motivation or subtle pressure to place assets?¹⁶

Many South African multi-managers suffer a conflict of interest affecting either the distribution of their products or the mix of the underlying managers. The first of these is an issue that they have in common with single managers; the second is specific to multi-managers.

Conflicts of interest around the distribution of multi-manager products are likely to affect the integrity of the entity recommending the services of the multi-manager rather than the multi-manager itself. Inappropriate incentives or pressures, if they exist, would seriously compromise any claimed independence of the consultant. In such instances the consultant should make clear the nature of its relationship with the multi-manager. The trustees in question must satisfy themselves that the advice provided by the consultant is free of influence and, if they cannot, should seek an alternative provider of consulting services.

Multi-managers also have relationships with the underlying managers whose investment expertise they tap into. Remember that multi-managers do not purchase the underlying assets; they purchase the investment services of the underlying managers, just as any customer would. They negotiate a fee for these services and, in theory, the customer benefits from the negotiated fee – more about that in the next part of the discussion.

¹⁵ This should include products that no longer exist because they have been absorbed by others, a method for deleting poor track records.

¹⁶ Ironically, this pressure can work both ways. Multi-managers that are part of larger financial services conglomerates are sometimes so determined to show their objectivity that they find it difficult to allocate any assets to the asset manager in the conglomerate.

What happens if the prospective underlying manager wants a higher fee than the multi-manager is prepared to pay?¹⁷ Either the underlying manager is not included in the portfolio of the multi-manager, undermining the claim of the multi-manager to be doing the best for the client, or the multi-manager pays a higher fee, which may be passed on to the client.¹⁸

Trustees would be remiss not to consider these conflicts with care, requesting the multi-manager to make it clear how such conflicts are identified and how they are managed in a way that ensures that no adverse consequences are felt by client funds and their members.

Trustees should ask the multi-manager

- how underlying managers are identified for inclusion to the multi-manager portfolio, particularly with key personnel moving between managers,
- how the weights allocated to their portfolios are established,
- how many hours a year are spent on carry out due diligence of each manager,¹⁹
- how much experience the multi-manager has in portfolio management and how this experience is applied to understanding the investment processes of each manager,
- how fees are determined with each of the underlying managers, and
- what happens in the event that a favoured manager demands too much in fees.

This moves the discussion neatly to the next point.

Fee basis

A number of the issues around the fee basis for asset management are shared by multi-managers and their single manager counterparts and have been discussed at length (see section 4). Perhaps the fundamental problem with the asset-based model prevalent today is that it only indirectly encourages the pursuit of investment performance. The clear goal is increased assets under management.

Investment performance may be an important route to acquiring these assets – certainly poor performance is a good way to fail – but acquisition, ultimately, is more important

¹⁷ This negotiation could be crucial for both entities, because it is likely that a cake of fixed size – the fee charged by the multi-manager to the client – is being divided between two parties.

¹⁸ I am aware of both local and international instances in which a significant multi-manager could not include an important underlying single manager on the basis of a failed fee negotiation.

¹⁹ This paper repeatedly stresses the need to interpret the skill of a manager not on the basis of a single string of performance figures, which may include a strong random element, but on the processes that the manager uses to run its portfolios. Understanding such processes and converting this into intelligent manager selection requires considerable investment in discussion with that manager and every member of its team.

than performance, as pointed out by one of the doyens of the US asset management industry, John Bogle:

*Mutual funds, once a profession with elements of a business, gradually became a business with elements of a profession. Our traditional guiding star of **stewardship** was replaced by a new star – **salesmanship**. Largely focused on **management** when I wrote my Princeton thesis about the industry, our predominant focus today is on **marketing**. (Bogle, 2006, emphasis in the original)²⁰*

Multi-managers are not very different. They too seek assets under management. Fixed costs are a significant component of their expenses and the marginal profit associated with each additional unit of assets is significant.

But multi-managers see the world differently. Their revenue model is more complex, sometimes opaque. While we know that single managers have opportunity to make hidden profit,²¹ the layers around the multi-management operation create further opportunities for additional revenue to this type of investment house that may conflict with the performance objective of most interest to their clients.

Box 8 presents two multi-manager fee models. Which would you prefer to use? The first has the attractiveness of a known fee, but also the substantial opportunity for the manager to seek profit at the margin, creating a misalignment of the interests of the manager and the customer. The second provides a more transparent approach. The total fee may not be known in advance, but at least the retirement fund trustees have the opportunity to assess value against cost, for each level.

Box 8 Multi-manager charging options	
Option 1	Option 2
Multi-manager charges a total fee of 75bp. Fees to underlying managers are negotiated by the multi-manager, who retains the margins without disclosing them. Total fee is certain, but the split between service providers is not known.	Multi-manager charges a margin fee of 12.5bp. Fees to underlying managers are negotiated by the multi-manager, but paid by its clients. Total fee can be uncertain, but the client knows what it is paying for multi-management services.
<i>Figures are illustrative only and are annual charges based on assets under management. One basis point (bp) is 0.01%.</i>	

Some customers may prefer the first approach, despite the fact that they do not know what margins the multi-manager is making. The argument might be that the level of

²⁰ John Bogle is the founder and former chief executive of the Vanguard Group, the world's largest index-tracking asset manager.

²¹ Section 8 discusses the evidence that they occasionally seek to do so.

transparency is not the issue and that trustees might choose in favour of this manager on the basis of the known total fee and the (necessarily subjective) assessment of performance prospects. This may be acceptable, but raises the possibility of a misalignment of interest. Trustees in these circumstances should satisfy themselves that the revenue incentive – the pursuit of margins above investment performance – does not distort the decisions of the multi-manager in favour of itself and to the detriment of its customers.

Now consider the additional layer of performance fees. Box 9 illustrates the arrangement in the context of such fees. Which manager would you prefer?

Box 9	
Multi-manager charging options (with performance fees)	
Option 1	Option 2
Multi-manager charges a total fee of 75bp. Negotiation with underlying manager is the same as before. The multi-manager forces the base fee of the underlying manager as low as possible and promises the payment of performance fees in the event of performance exceeding benchmark. Performance fees, however, are paid by the client, giving the multi-manager a higher guaranteed margin, still undisclosed, no matter the performance of the portfolio.	Multi-manager charges a margin fee of 12.5bp. As before, the multi-manager negotiates a fee with the underlying manager that reflects the benefits of large asset volumes, but the client pays this fee. A base fee with performance overlays motivates the underlying manager. The multi-manager makes clear to its clients the basis for the performance arrangements, which may include an additional overall incentive bonus to the multi-manager.
<i>Figures are illustrative only and are annual charges based on assets under management. One basis point (bp) is 0.01%.</i>	

Trustees should ask hard questions of existing or potential multi-managers. When performance fees emerged as market practice, some may have taken advantage of a changing environment to force down the base fees paid to underlying managers as low as possible. These managers would not lose out, they may have claimed, because they would still have performance incentives, but the fees rewarding good performance would be paid by the client.

The result is a useful demonstration of what can happen when the interests of the provider are not in line with those of the customer.

- The multi-manager's margins are larger than they were before, since it hasn't changed its all-in base fee to the client.
- These margins are completely unaffected by the performance of the asset managers, since the arrangement insulates it from performance clauses in contracts with the client and in the corresponding contracts with the underlying managers.

- Performance fees are paid by the client to a successful manager whether or not the multi-manager portfolio as a whole delivers a return in excess of its benchmarks.²²

Under the guise of transparency, the multi-manager has delivered a manager selection and portfolio administration service at a fixed fee. The client justifies the arrangement on the basis that good returns are rewarded, but this applies only to the performance of individual managers, not to that of the portfolio as a whole, hence not to that of the multi-manager who selects the managers.²³

This thinking process might seem cynical but is precisely what trustees should be undertaking in their continued efforts to protect the interests of their members. It is correct to assume that the ultimate interest of all financial service providers is to maximize profit.²⁴ The challenge is to identify actions by the provider that may compromise the extent to which it also takes care to maximize financial value to its customers.

Trustees should make every effort to understand which providers add value to the fund. Independent analysis demonstrating the performance of all underlying asset managers and the contribution of the multi-manager would help the trustees to assess the alignment of performance fees with the objectives of the fund.

There are good multi-managers in South Africa, with strong integrity and a diligent approach to the investment questions that their clients ask them to address. They choose to use a transparent investment process and disclose clearly all fees and all other sources of revenue. Careful examination by trustees will reveal these organisations.

Layers

A multi-manager adds a layer to the investment process. How should the trustee assess the value of this additional layer? The issue is more complex than incremental performance and fees. Trustees should be aware of the potential for the multi-manager to establish other opportunities for revenue that further complicate the picture.

Multi-managers can provide pure administration service through their ability to mix the underlying managers. Under such an arrangement, the trustees of the retirement fund

²² This is because performance fees are not symmetrical – they reward on the upside without punishing to the same extent on the downside. If the portfolio, for example, has five underlying managers with the same performance incentives and only one delivers a performance that exceeds the benchmark, then the client pays a performance fee to that manager despite the performance of the portfolio as a whole failing to beat the goal.

²³ The multi-manager should be rewarded for delivering performance for the portfolio as a whole, because this aligns the interests of the retirement fund and the service provider.

²⁴ I stress that maximizing profits is not inappropriate, as long as the interests of customers are taken into consideration in the process. Customers, in this case, are retirement funds, ultimately the beneficiaries of these funds.

retain the right to select the managers and the multi-manager administers the entire arrangement. Trustees may find this attractive but should ask

- whether it is appropriate to pay a fee for this service that is based on assets under management,
- whether an administrator might not be better placed to provide the service, particularly if it is independent with no interests outside of the administration itself, and,
- where the administration service is white-labelled to an implemented consultant who selects asset managers for the retirement fund, whether there might be any conflicts of interest in the arrangement that could inhibit its effectiveness.

Multi-managers may have a financial interest in the transition of assets that is an integral part of its business. The basis for this financial interest may appear quite logical: as it is likely to need to trade substantial volumes, it approaches one or more brokerage houses to negotiate fees on trades, and it may be tempted to seek financial reward on the basis of large volumes outsourced to a particular broker operation.

If this reward influences its choice of brokerage house to the detriment of its retirement fund customer, then it is not appropriate because the service provider is using client assets to its benefit, failing to exercise its duty of care to the retirement fund and its members.²⁵

Two simple questions should be asked of multi-managers:

- How do they determine who carries out their trades for them?
- Do they stand to gain financially in any way from the allocation of trades?

Best practice investment management requires all investment managers to seek best price and best execution for all trades. Multi-managers should do the same. In addition to this, all transitions should be subject to the guidelines of the recently issued T-charter, which sets out principles of best practice for all transitions.

Questions for trustees

Trustees must ask themselves why they appoint a multi-manager to look after the assets of their members, or why they are considering doing so. This paper tries to demonstrate that

- the case for active management is tenuous,²⁶

²⁵ The existence of the arrangement should be disclosed to the customer because it is a form of revenue gained by virtue of the relationship with the retirement fund, but disclosure alone does not fulfil the duty of care.

²⁶ More precisely, the probability of picking tomorrow's winners is low, but the market depends on the continued belief that it is not only possible but likely, with the skills of the right expert to hand.

- the cost of multi-management can be high and revenue to the multi-manager opaque, and
- the alignment of interests of provider and customer is, in some cases, weak.

Trustees must make the best decisions for the fund and its members. To do so they may need to appoint professional advisers or to utilize entities that invest assets across multiple managers. But employing the services of a multi-manager may actually add to the complexity of trustee responsibilities, because it involves a number of additional parties, and requires greater vigilance and stronger attention to decision-making dynamics.

A multi-manager provides an administration platform that enables funds to spread investment risk across multiple providers, but a pension fund administrator can do this just as well. A multi-manager provides portfolio construction, which asset managers and investment consultants can also do.

What the fund that appoints a multi-manager to select managers is really purchasing – and paying for – is the power of manager selection.²⁷ This part of the paper seeks to show that this power provides an unclear benefit to the fund but opens up for the provider substantial additional opportunities for revenue, which can result in implicit cost to the fund. Trustees must be sure that their decision really is in the best interest of the members of the fund.

²⁷ Some multi-managers would suggest that portfolio construction is also a key service that they provide. To be effective in the long-term, strategic asset allocation needs to pay careful attention to the needs of the members – see section 3 – and investment consultants are in a good position to carry this out.

THE WAY FORWARD

In which the common threads of discussion are summarised into five themes and the discussion document is completed on a practical note with some thoughts for consideration by trustees of retirement funds.

This section is dominated by a set of suggestions for consideration by trustees, but before that it seeks to identify the underlying streams or philosophies that appear to support the inefficiencies in South Africa's retirement funds.

Major Themes

The five themes discussed here are perhaps a little less practical than the ten questions covered in this paper because they are one step removed from the activity of running a fund. But they may be more important, because they:

- could assist with identifying further questions for consideration,
- might usefully form the basis for ongoing regulatory reform, and
- they apply in some way to the other forms of institutional investment in existence in South Africa, for example, to mutual funds.

The five themes considered here are the:

- distinction between owners and agents
- length and complexity of the value chain
- allure of past performance
- impact of conflicts of interest
- effect of information inequity

Other themes may need to be added,¹ but in sum they cover well the issues discussed under the ten questions.

Owners and agents

While much has been written about the shortcomings of corporate America, little has been written about the failure of its owners to assert their ownership rights. ... The stockholders of

¹ Comments from readers would be very helpful in this regard.

investment America – dominated by our giant financial institutions – hold awesome power. Yet these firms all too rarely exercise that power, in essence neglecting the legitimate interests of the ultimate stock owners, the beneficiaries whom they are duty bound to represent. (Bogle, 2005a:xxi)

Might the same be said of South African investments? Perhaps we need to remind ourselves of the structure of institutional investments in this country and any other:

- retirement funds are the owners of the assets,²
- their members have a strong interest in how the funds invest their assets, particularly if the fund is a defined contribution type,³
- asset managers have the responsibility to invest the assets of the retirement fund according to the instructions given by the trustees of the fund, making them stewards over the assets, not owners, and
- company executives are ultimately answerable to the asset owners, who may delegate, through proxy voting arrangements for example, some of their ownership responsibility to the asset managers.

If each party understood its role in the process and acted in accordance with this role, we might find that a number of the issues addressed in this paper were more easily solved.

Trustees, for example, more aware of their power and duty as owners of assets, might then recognise more widely the responsibility that they have towards their members to:

- consider all types of assets and provider models without prejudice,
- obtain adequate independent training,
- ensure that advisers are skilled, independent and assessed, and
- pay fees for service that align the interests of stakeholders and adequately motivate service providers but are not inappropriately high.

The list goes on, of course. The 'Tips for Trustees' section that follows seeks to help trustees understand the areas in which asking the right questions might increase their effectiveness as representatives of the owners of capital.

Section 9 covers the issue of socially responsible investment, but asset managers must act as responsible stewards of the assets under their care at all times, reporting both policy

² There is an important exception to this case. Where a retirement fund purchases a policy of insurance, it applies all of its assets (or a significant part of them) to this policy. The fund retains ownership of the policy of insurance but cedes control of the investment of the assets to the insurer. This may or may not be in the best interest of the fund and its members. Trustees should consider this issue with care.

³ Furthermore, in the case of a defined contribution arrangement, members may have the right to choose how to invest their share of the assets, increasing yet further the distance between owners and their agents.

and practice to their clients with regularity. Owners have the right to know how their asset managers intend to respond to cases of poor corporate governance or unethical practice by companies – price fixing irregularities, for example. They have the responsibility to call on their asset managers to report on their response to any such incident, whether it has been publicly aired or not.

Too many boards [of corporations] have failed to adequately exercise their responsibility of managerial oversight. Worse, it was only the rare institutional investor that exercised its responsibilities of corporate citizenship and demanded such oversight, insisting that managers operate not in their own interest, but in the interest of the owners. (Bogle, 2005:30)

Let this not be true of South African institutional investors.

Supporting the value chain

Institutional investors, particularly boards of trustees, may not be aware of the extent to which the industry is supported by their decisions.

This paper is not suggesting that some of the services are unnecessary, but the market may be more efficient if all providers recognised the ultimate customer and trustees were more aware of the length of the chain and the potential for inefficiencies between elements.

The first part of this paper gives some sense of the depth and complexity of the so-called value chain. A number of the subsequent sections give examples of actions that may – directly or indirectly – be more concerned with sustaining this value chain than with the needs of retirement funds and their beneficiaries.

The push for active management, for example, supports nearly all parts of the supply industry, from the active asset managers through the investment consultants and intermediaries to the market traders, and all others who gain from market activity.⁴ This would be appropriate if active management were needed by retirement funds to the extent that it is used, and the relationships between players in the value chain were efficient and focused on the best outcome, but these conditions are not met with certainty.

The allure of the past

Trustees would like to do the best they can, obtaining the best investment performance for members within acceptable risk constraints. But most trustees are not experts and they are bombarded with information that is almost certainly biased⁵ and selective.⁶ Even if

⁴ Trading is a zero sum gain activity. For every buyer there is a seller, both incurring costs.

⁵ The set of information includes only surviving portfolios, for example.

they had a complete set of information, it would be much too large and detailed for even an expert to understand with confidence.

On top of that, we all suffer the tendency to infer causality where it may not exist, linking events which are unlinked. We do this because the world is complex and we need to make sense of it, giving us an information set that is more manageable.⁷ This error is not only about extending past success into the future, investing with those that have recently performed the best, but it often finds expression in this tendency or others similar to it.

As we build erroneous linkages between pieces of information, we grow in confidence in our ability to manage detail and we tend to reduce our corresponding willingness to consider the bigger picture. For example, we

- buy in to any apparent evidence that active management can work, despite the logic that, on average, active managers cannot outperform the market;
- willingly subscribe to a single string of performance data without asking for information concerning all of the other portfolios of the asset manager, including those that have closed to business or been merged with others because they have performed poorly; and
- assume consultants and other intermediaries to add value to the retirement funds that they serve, even though it is extremely difficult for them to demonstrate this skill, over a sufficiently long period of time, with consistency.

The allure of the past is very difficult to overcome, but deeper questions and a willingness to avoid premature conclusions may go some way to addressing it.

Conflicts of interest

A conflict of interest occurs when an individual in a position of trust has competing interests, professional or personal, that can make it difficult for that individual to fulfil his or her duties with impartiality.

Such conflict takes a number of forms in the institutional investment industry.⁸ Some suggest that we cannot avoid them because there are not enough market providers for

⁶ Asset managers and investment consultants have a strong incentive to focus their reporting only on certain parts of the information, the successful portfolio, for example, or the most convenient starting date for a performance history.

⁷ Professionals do not necessarily have an advantage over amateurs in this respect. They deal with more information, but their tendency to link events that ought not to be linked is at least as severe, because inference and pattern recognition is a crucial part of managing the complexity. It is the rare expert who remains open to the possibility that events show a high level of randomness and that correlation is not the same as causality.

⁸ This paper touches on some but not all of these. Comments from readers on additional sources of conflict of interest would be much appreciated.

every one of them to be a specialist. Others put forward the view that it is not appropriate to avoid conflicts of interest where a packaged arrangement is available at a lower cost than the separately purchased components, even if this might compromise the integrity of some of the services.

These arguments are acknowledged, but trustees should consider with great care the potential for conflicts of interest to undermine the integrity of the services that they receive. If the demand for wholly independent providers of service increased, the opportunity for such suppliers would improve.

Trustees are encouraged to understand more fully the nature of the relationships characterising suppliers and the extent to which this might compromise the integrity of their services.

Information inequity

The information inequity⁹ might also be referred to as a skills inequity, an availability inequity or even the professional versus the amateur. Lay trustees are very important in representing the interests of a group of people of which they are members, but they must equip themselves to do so effectively.

Retirement funds operate in an extraordinarily complex world where even the best of providers suffer the temptation to misrepresent information. Financial markets provide enormous opportunities for data mining and positioning and it is in fact very difficult to report completely and without bias.¹⁰

It is not obvious how this information inequity could be overcome. There are some extremely well run South African retirement funds in which the trustees are well versed in financial matters and provide tightly controlled mandates to their service providers, but these funds are generally large and have sufficient resources to do so. This paper is intended to provide some help to trustees of smaller funds that are not as well resourced.

Other sources of information should be considered as well. The Financial Services Board's Pension Fund circular 130 provides excellent guidance to trustees. The draft CFA Code of Conduct is another example. Conferences, publications and trustee organisations provide other opportunities for trustees to equip themselves. Training from qualified, independent

⁹ "... leading to the possibility of market breakdown..." (Cannon & Tonks, 2006: 112)

¹⁰ How many asset managers have to hand the aggregated, unbiased, performance of all of the portfolios in existence over a specified performance period, whether open or closed at the date of the request? How many investment consultants have this information available regarding the asset managers that they claim to understand? How many manager surveys provide this type of information? The point is that, in the financial markets, it can be difficult to identify and calculate scientifically unbiased information. But difficulty is not an excuse not to seek it.

sources is available. All of this requires time and effort, but fund members depend on exactly this from their trustees.

Tips for Trustees

The paper ends with some thoughts on how trustees might address some of the issues raised in the discussion of the preceding pages. It is not comprehensive, merely a set of questions that trustees could ask themselves and their service providers in an effort to understand a little better the dynamics of the market in which they participate.

This in turn will assist trustees in framing a response appropriate to the needs of the retirement fund and its beneficiaries.

Active management

- Have the trustees applied their minds to the issue of active management and its appropriateness to the fund?
- Have they understood the logic that, on average, active managers provide an investment return that is in line with the market, before fees?
- Have they understood the cost of active management and considered whether the benefits outweigh the fees?
- Have they considered the appropriate allocation of equity assets to active management and the corresponding allocation to index-linked alternatives?
- Have they requested complete information from incumbent or prospective managers covering all relevant portfolios, whether still in existence or not?

Trustee training

- Are trustees given sufficient opportunity to receive training concerning their duty as trustee and the tools available to them to exercise their responsibility in the best interest of the fund and its members?
- Are trustees given a copy of the fund rules and all other relevant documents when they join the board and are they encouraged to read these and clarify any issues not clear to them?
- Is the training that is provided to trustees adequate, delivered with sufficient clarity for all trustees to understand it and presented by an individual or organisation with sufficient expertise and independence to carry it out effectively and free of conflicts of interest?
- Does training focus appropriately on the oversight responsibilities of trustees, making clear to them the avenues available to them to delegate operational issues?

Investment consultants

- Have trustees considered whether the financial interests of their investment consultant are independent of the corresponding interests of any product providers, whether or not the retirement fund uses any of these providers? If the investment consultant is not independent of all product providers, how does it manage any conflict of interest that may arise?
- Has the investment consultant been requested to describe its approach to the management of the assets and liabilities of the fund, explaining how this differs from other approaches used in the market, and has it done so to the satisfaction of the trustees?
- Is the investment consultant remunerated appropriately, in a manner that best aligns the interests of the retirement fund and the consultant, and at a level that reflects the skill and value of the consultant and is affordable to the retirement fund?
- Is the performance of the investment consultant evaluated regularly to determine its contribution to the long-term benefit of the fund?
- Is the investment consultant best suited to the task, all other things considered, and would it be possible to establish, in addition to the incumbent consultant, a shortlist of alternatives that could be called upon from time to time to assess different issues affecting the funds or to provide high-level oversight?

Fee models

- Have trustees considered the models used by all providers of service to determine their fees?
- Is the level of fees charged by asset managers and other providers appropriate and competitive?
- Does each model produce a fee outcome that is appropriate under a range of circumstances, aligning the interests of the service provider and the retirement fund and sharing risk suitably?
- In particular, are any of the fund's asset managers or investment consultants in a position to receive fee enhancements for performance that is not attributable to their skill but to variation in the general level of the market?

Hedge funds and other alternative asset classes

- Have trustees applied their minds to the need for alternative asset classes or mandates based on absolute rather than relative performance? If they do not have the skill to carry out such an exercise, have they sought independent professional advice on the issue?

- Do trustees understand the investment products that they have purchased on behalf of the retirement fund and the role of each in meeting the needs of the fund and its members?
- Are the incentives of providers of alternative asset types appropriate to the service offered and aligned with the needs of the fund?
- Do providers have any conflicts of interest that ought to be taken into consideration in assessing their services?
- Do providers have the skill to meet the mandate that they propose? Have they demonstrated such skill to the satisfaction of the trustees?

Marketing

- Have trustees considered and physically signed up to a code of conduct to control the extent to which their decision-making might be influenced by the inappropriate behaviour of other parties?
- Do trustees share with one another potentially inappropriate offers made by suppliers or possible suppliers in order to identify such behaviour and curb the extent to which it might impact on trustee decisions?
- Does the board consider carefully the information presented to it to address issues of misrepresentation?
- Do all service providers, appointed or being considered, adhere to a code of conduct established by a credible industry body, for example, the Chartered Financial Analyst Institute, that covers the calculation and reporting of their investment performance?

Surveys

- Do the trustees depend on surveys of asset manager performance in their decision-making?
- Have the trustees considered the technical limitations of the surveys that they are using and the possibility that absolute and comparative performance may be flawed?
- Where service providers, independent intermediaries for example, are using manager surveys to support their advice, have trustees asked them to consider alternative sources of information to back up their recommendations?

Trading dynamics

- Have trustees sought to understand the issues around portfolio trading, the costs involved, for example, and the potential for conflicts of interest?

- Do trustees request trading reports of their asset managers to ensure that inappropriate activities are not taking place and that managers always execute trades in the best interest of their customers?
- Do trustees ask managers to provide a breakdown of the turnover of the portfolio and the success of their investment decisions, disclosing the cost of all trading executions and the benefit that they have produced for the retirement fund?
- Do trustees receive reports directly from their asset managers that are sufficient clear and succinct for them to understand, interpret and act upon, in the best interest of the fund and its members?
- Have the trustees of funds that use multiple managers considered the cost involved in the trade of securities between these managers, trades that bring no benefit to the retirement fund because they merely switch a security from one manager to another?

Socially responsible investment

- Have the trustees recognized and noted their responsibility to consider the investments of the retirement fund in the context of long-term objectives?
- Have they established a policy concerning their approach to socially responsible investment, even if it is limited initially to a set of principles, and have they communicated this policy to their members?
- Do the trustees ask their asset managers to report on their policies on corporate governance and socially responsible investment, citing examples to demonstrate their commitment to these policies?
- Do the trustees request a demonstration by their service providers of their own commitment to good corporate governance?

Multi-managers

- Have the trustees of funds that have appointed multi-managers, or are considering doing so, noted explicitly that putting in place such an investment manager in no way reduces their fiduciary responsibility to the fund and duty of care to its members?
- Have the trustees of retirement funds serviced by multi-managers carried out due diligence sufficient to convince themselves that the service provider has the skill to carry out its mandate with appropriate regard to the needs of its clients and does not earn undisclosed or inappropriate revenue by virtue of its relationship with the fund?
- Has the multi-manager been asked to describe, to the satisfaction of the trustees, how underlying managers are identified, how weights allocated to each manager are determined and how much time is spent carrying out due diligence on the capabilities of each manager?

- Has the multi-manager explained how fees are negotiated with managers, what it does in the event that a favoured manager demands higher fees than are appropriate and how performance incentives are split between it and the underlying managers?
- Does the multi-manager have any conflicts of interest affecting its business and, if so, how does it address these conflicts?

Trustees have an enormous responsibility to the fund and its beneficiaries. This list of questions is intended to assist them but should form only the foundation for a habit of ongoing, rigorous enquiry.

EPILOGUE

Ernest Hemingway tells the story of an old man who fishes the warm waters of the Gulf Stream from a skiff with nothing but a set of fishing lines and a harpoon.¹ At home he sleeps on newspaper on the springs of an old bedstead and eats whatever he can find.

One morning, after eighty-four days without taking a fish, he hooks a marlin longer than his boat. For two days the fish drags him and his boat out to sea. For two days, his line tight over his shoulders and his hands raw, the old man fights the beautiful giant, at the same time catching and eating what small fish he can to keep up his strength.

On the morning of the third the fish, finally showing signs of weakening, begins to circle the boat and eventually comes close enough to take the fisherman's harpoon. The old man kills the enormous marlin.

"He started to pull the fish in to have him alongside so that he could pass a line through his gills and out his mouth and make his head fast alongside the bow. I want to see him, he thought, and to touch and to feel him. He is my fortune, he thought. But that is not why I wish to feel him. I think I felt his heart, he thought." (p 89)

He lashes the fish to the boat, hoists his mast, trims the sail and begins the long journey home. "It was an hour before the first shark hit him. The shark was not an accident. He had come up from deep down in the water as the dark cloud of blood had settled and dispersed in the mile-deep sea." (p 92)

Bravely, the exhausted old man fights off shark after shark until he can do no more. "He was a fish to keep a man all winter, he thought. Don't think of that. Just rest and try to get your hands in shape to defend what is left of him." (p 103) But each takes another chunk out of the fish until "in the night sharks hit the carcass as someone might pick up crumbs from the table". (p 110)

Finally he lands.

"He unstepped the mast and furled the sail and tied it. Then he shouldered the mast and started to climb. It was then that he knew the depths of his tiredness. He stopped for a moment and looked back and saw in the reflection of the street light the great tail of the fish standing up well behind the skiff's stern. He saw the white naked line of his backbone and the dark mass of the head with the projecting bill and all the nakedness between." (p 111)

¹ Hemingway, E (1952) *The Old Man and the Sea*, quotations from the 1953 edition by The Reprint Society, **London**

REFERENCES

- AIMR (1999) *Standards or Practice Handbook*, The Codes of Ethics and The Standards of Professional Conduct, **Association for Investment Management and Research** (now the CFA Institute), Charlottesville
- Allen, G (2007) *Does Size Matter?*, **The Journal of Portfolio Management**, Spring 2007, pp 57-62
- APRA (2001) *Superannuation Circular No. III.A.4: The Sole Purpose Test*, Australian Prudential Regulation Authority, February
- APRA (2005) *Letter to all Trustees of APRA Regulated Superannuation Funds*, Ross Jones, Deputy Chairman of the Australian Prudential Regulation Authority, 14 March
- Bank for International Settlements (2007) *Institutional Investors, Global Savings and Asset Allocation*, report submitted by a Working Group established by the Committee on the Global Financial System, February
- Bashi, M (2005) *Understanding Transaction Costs*, Collective Insight, published tri-annually by FinWeek, South Africa, Summer 2005
- Bogle, J (2005a) *The Battle for the Soul of Capitalism*, **Yale University Press**, New Haven
- Bogle, J (2005b) *The Relentless Rules of Humble Arithmetic*, **Financial Analysts Journal**, November/December
- Bogle, J (2006) *The Battle for the Soul of Capitalism: Doing Your Part to Begin the World Anew*, address to the students of Immaculata University, Immaculata, Pennsylvania, 23 October 2006
- Cabot-Alletzhauser, A (2005) *The Upside Down Food Chain: Shifting the Food Chain to a Value Chain*, Collective Insight, published tri-annually by FinWeek, South Africa, Summer 2005
- Cannon, E & I Tonks (2006) *Survey of Annuity Pricing*, Department of Work and Pensions, United Kingdom, Research Report No 318
- Deloitte (2005) *Retirement Fund Governance in South Africa 2005: Plain Sailing?*
- Dence, S, W Feller & Z Hod (2007) The rise (and fall?) of hedge funds, Building an Edge, IBM, Vol 8, August
- Dias, L (2006) *Governance of Brazilian Pension Funds*, working paper hosted by The Berkeley Electronic Press
- Financial Services Board (2004) *Annual Report 2004*
- Financial Services Board (2006) *Annual Report 2006*
- Financial Services Board (2007a) *Annual Report 2007*

- Financial Services Board (2007b) *Circular PF No. 130: Good Governance of Retirement Funds*, June
- Freshfield Bruckhaus Deringer (2005) *A legal framework for the integration of environmental, social and governance issues into institutional investment*, produced for the Asset Management Working Group of the UNEP Finance Initiative, October
- Grinold, R & Kahn, R (2000) *Active Portfolio Management: A Quantitative Approach for Producing Superior Returns and Controlling Risk*, **McGraw-Hill, New York**
- Hogan, M (2005) *Peer Group Analysis and Survival: Buyer Beware*, SEI Investments Weekly Commentary, 24 August
- Hugo, D (2003) *The Manager Selection Puzzle: Does Size Matter?*, Dimensions, published by Fifth Quadrant, December
- Hugo, D (2004) *The Hidden Costs of Investing*, Dimensions, published by Fifth Quadrant Actuaries & Consultants, November
- Investment Management Association, DATA & Fitzrovia (2005) *Performance Fees for Investment Funds*, Technical Discussion Paper by the IMA and the Depository and Trustee Association, in conjunction with Fitzrovia International Ltd, February
- Irish Department of Social and Family Affairs (2007) *Green Paper on Pensions*, Stationary Office, Government of Ireland, Dublin
- James, E, J Smalhout & D Vittas (2001) *Administrative Costs and the Organization of Individual Account Systems: A Comparative Perspective*, published in *New Ideas about Old Age Security*, eds R Holtzmann and J Stiglitz, World Bank
- Levitt, S & S Dubner (2006) *Freakonomics*, **Penguin**, London, revised edition
- Marathon Club (2007) *Guidance Note for Long-term Investing*, Spring 2007, available at www.marathonclub.co.uk
- Myners, P (2001) *Institutional Investment in the UK: A Review*, HM Treasury, London
- National Treasury (2007a) *Budget 2007 at a glance*, part of the Budget 2007 material, South African Government
- National Treasury (2007b) *Social Security and Retirement Reform: Second Discussion Paper*, South African Government
- Novare (2006) *South African Hedge Fund Survey*, Novare Investments, October
- Novare (2007) *South African Hedge Fund Survey*, Novare Investments, October
- OECD (2005) *OECD Guidelines for Pension Fund Governance*, Organisation for Economic Cooperation and Development, adopted by the OECD Council, 28 April
- O'Rourke, P (2007) *On the Wealth of Nations*, **Atlantic Books**, London
- Pawley, M (2002) *A Comparative Study of Opposing Investment Strategies: Active versus Passive Investment Management*, unpublished MBA dissertation, Oxford Brookes University

- Pawley, M (undated) *The Impact of Survivorship Bias on South African Unit Trust Performance: 1972-2004*, University of Free State
- Piele, S & W van der Merwe (2004) *Hedge Funds in South Africa: The Investment Case*, presented to the Annual Convention of the Actuarial Society of South Africa, October, available from the resources section of the web site of the Actuarial Society, www.assa.org.za
- Polakow, D and M de Araújo (2005) *Active Smoke and Peer Mirrors: Reflections on Luck and Skill in South African Fund Management*, Peregrine Securities, Derivative and Quantitative Research, February
- Polakow, D, A Seymour & Y Greyling (2007) *The South African Alpha Allure – Reflections on the Myths, the Myopia and the Mystique*, Peregrine Securities Derivative and Quantitative Research, October
- Potgieter, E (2004) *Socially Responsible Investment: What does it mean?* Dimensions, published by Fifth Quadrant, November
- PriceWaterhouseCoopers (2007) *Survey on Effective Management of South African Retirement Funds*, PWC South Africa, March
- Public Investment Corporate (undated) *Corporate Governance and Proxy Voting: Principles, Policies and Practical Application*
- Ragnartz, C (2007) *Why lack of action on SRI is the biggest market failure ever*, 8 November 2007, published by Responsible Investor, downloaded from www.responsible-investor.com/home/article/sri_the_biggest_market_failure_ever/ on 27 November 2007
- Registrar of Pension Funds (2005) *Forty-sixth Annual Report 2004*, Financial Services Board, South Africa
- Rousseau, R & Tayob, I (2006) *Part 1: The New Paradigm in Asset Management: Separation of alpha from beta to change the way we invest forever*, Deutsche Securities South Africa, February
- Rousseau, R (2005) *The Winds of Change: A comprehensive overview of the latest global pension fund management trends*, Deutsche Securities South Africa, September
- Rousseau, R (2007) *Alpheta Rising: Re-thinking the asset management process*, Deutsche Securities South Africa, January
- Rusconi, R (2004) *Costs of Saving for Retirement: Options for South Africa*, presented to the annual Convention of the South African Actuarial Society, Cape Town, October
- Rusconi, R (2007) *South Africa's Mandatory Defined Contribution Retirement Saving System: Provider Accreditation*, part of a set of feasibility studies until the title *Reform of Retirement Provisions* issued by the Department of Social Development, Government of South Africa, September
- Schreuder, J (2007) *Pay for What you Get: the case for good performance fees*, Financial Services Board Bulletin Second Quarter

- Social Development (2007) *Reform of Retirement Provisions: Discussion Document*, South African Government
- South African Reserve Bank (2007) *Quarterly Bulletin December 2007*, supporting Statistic Tables, available at www.reservebank.co.za
- Symmetry (2007) *Hedge Fund Survey*, Symmetry Multi-Manager, July
- Taleb, N (2007a) *Fooled by Randomness: The Hidden Role of Chance in Life and in the Markets*, second edition, **Penguin**, London, first published in 2004 by Texere
- Taleb, N (2007b) *The Black Swan: The Impact of the Highly Improbable*, **Random House**, New York
- UK Pension Commission (2005) *A New Pension Settlement for the Twenty-First Century*, review of the UK old age system commission by HM Treasury and led by Adair Turner
- United Nations (2007) *World Economic and Social Survey 2007 – Development in an Ageing World*, Department of Economic and Social Affairs, New York
- Umbono Fund Managers (2003) *The New Capped and Shareholder Weighted Benchmarks*, July
- Umbono Fund Managers (2004) *Is There Anything New Under the Sun? Historical Performance and Asset Allocation (1925 to 2003)*, March
- Wildsmith, H (2006) *South Africa's Largest Public Sector Pension Funds: A Collective Developmental Role?*, part of an MPhil program at the Graduate School of Business of the University of Stellenbosch
- Wildsmith, H (forthcoming) *South Africa's Largest Public Sector Pension Funds: A Collective Developmental Role?*, for publication in May 2008 in the journal **Corporate Ownership and Control**