THE PRICE OF SHORT-TERM ADVICE: PERFORMANCE ATTRIBUTION OF INVESTMENT ADVISORY MODELS USING LGPS DATA

The Hidden Cost of Poor Advice: LGPS Review - Part 4

"In years to come, we'll regard independent measuring of consultants as even more important than the independent measurement of managers that we take for granted today" – **David Morgan -2005**[1]

Introduction:

In this report CLERUS makes use of Local Government Pension Scheme (LGPS) performance data to attribute annualised return and benchmark relative performance to the different investment advisory models used by LGPS over 10 years to 31st March 2013. This enables us to quantify the **economic benefits** of the various alternatives available to schemes and can help provide a guide to best practise. We ask:

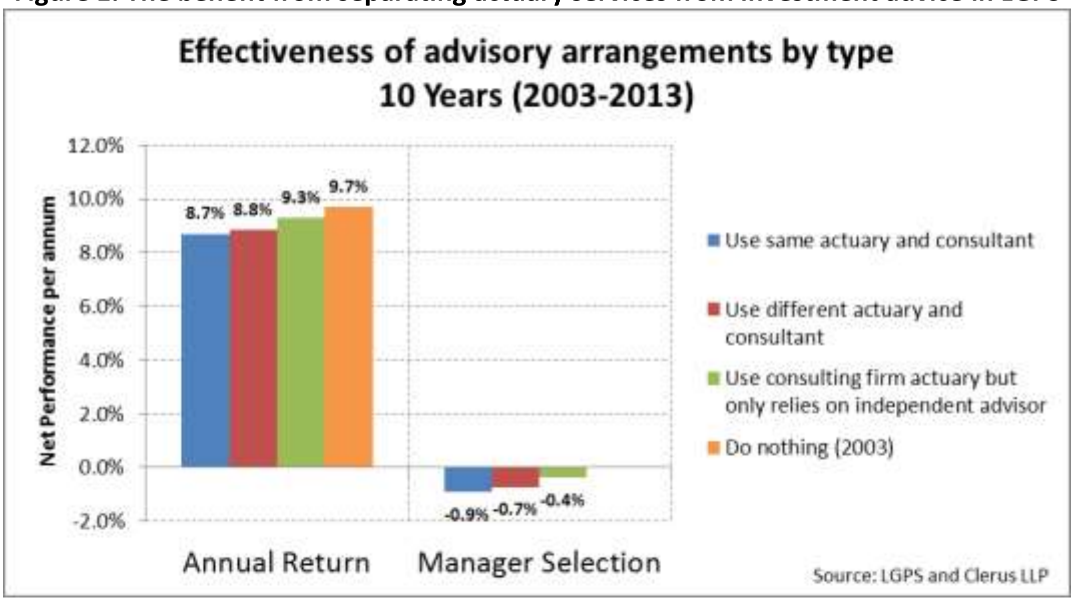
1. Was it better to have separated the providers of actuarial services and investment advice?
2. What was the value of employing independent advice (with, or without, investment consultants)?
3. What was the full cost to schemes from the investment consultant generating fees from the asset manager selection process?
4. Did some investment consultants generate better investment performance than others?

The data help to highlight some unintended consequences of the regulatory requirement of LGPS to take advice but which does not require advisors to demonstrate investment skill, or be held accountable. The report suggests that legislation could be improved in this area, promoting clarity and transparency as better regulatory principles. This will enable informed and sensible choices to be made by decision-makers.

1. Impact of separating providers of actuarial services and investment advice

The Myners report recommended in 2001 that actuarial services and investment advice should be opened to competition separately. However as at 31st March 2013, more than 35% of LGPS still use the same investment consulting firm for both of these services. In Figure 1 we evaluate the impact that compliance with this recommendation has had on investment performance.

Figure 1. The benefit from separating actuary services from investment advice in LGPS



[1] David Morgan was Chief Executive of Coal Pension Trustees Services, Vice Chairman of NAPF, member of the NAPF Investment Council. He was also Chairman of Blacket Research from 2005-6. Source Blacket Research June 2005.

Do nothing (2003): For comparison we also include the average hypothetical performance of the LGPS universe if portfolios had been left unchanged since 31st March 2003[2]. This is a relevant proxy for the would-be performance of a true long-term investment approach. It provides us with the ultimate benchmark to evaluate the value added from various investment advisory arrangements. If these had been effective we would expect them to deliver better performance than the 'do nothing' alternative.

The benefits of separating actuarial services and investment advice across different consulting firms have been limited over the past decade. It has provided 0.1% average performance improvement and 0.2% impact on performance relative to benchmark. In monetary terms, this amounts to an estimated annual benefit to LGPS of £104 million (£877 million over 10 years) on the £68 billion of assets under joint advice.

The result would indicate that actuaries do not have significant impact on investment performance. This is consistent with our observations that portfolio change in LGPS is mainly driven by so-called asset-liability studies provided by investment consultants[3]. A comparison with the LGPS, who use consulting firm actuaries but only rely on independent advisors, makes us conclude that the type of investment advisor selected is much more important to investment performance than the choice of actuary.

2. Impact of independent advisors

In this section we analyse the performance impact of independent investment advisors in more detail. The introduction of independent advisors in LGPS to complement existing investment consultants followed on from the recommendation of the Myners Report in 2001 and was seen as a way to improve best practise[4]. According to 2013 annual reports, 52% of LGPS employed one or more independent advisors.

Figure 2. The benefit of employing independent advisors in LGPS

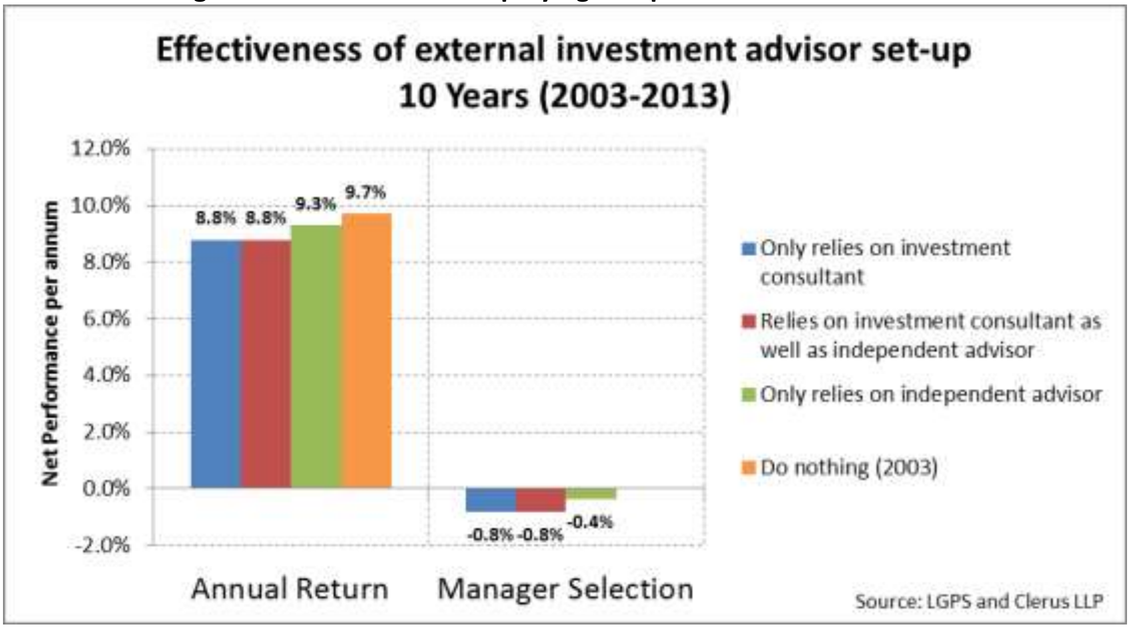


Figure 2 compares the average annual return and performance of manager selection for the three types of investment advisor set-ups used by LGPS. Perhaps surprisingly, **the data suggests that adding independent advisors alongside investment consultants did not have any impact on either annual returns or manager selection performance over ten years**. This result is only intuitive if we consider a reality where the independent advisors do not have any real influence or impact on investment decision-making, and where

[2] As estimated by Clerus LLP: See "The Hidden Cost of Poor Advice – Part 1"
[3] "The Hidden Cost of Poor Advice – Part 3"
[4] See for example: Dickson Reid (IPE 25 April 2002). "LPFA takes on independent investment advisor"

their de-facto role has been to rubber stamp the recommendations of the established investment consultant. This apparent lack of performance impact could be attributable to a number of factors:

1) Insufficient mandate or influence to challenge the consultant
2) Insufficient skill or knowledge to propose better alternatives
3) Not provided with specific measurable objectives as to how they were expected to add value

3. The true cost of consultant induced short-termism into investment decision-making

Importantly, figure 2 does suggest that **when independent advisors are employed without investment consultants present, then performance is significantly better**. This is mainly due to a reduced negative impact from manager selection activities. However we find no evidence that those LGPS using independent advisors are better at selecting managers (this loss-making service is provided by the main consulting firms). The main reason that they lose less money on this activity is because they tend to do less of it.

In a recent report from the Institute of Business Ethics[5], the author explains that investment consultants are generally well-meaning but face conflicts of interest because they generate fees from the asset manager selection process, which could encourage them to promote a short-term view of investment.

Everything else being equal, the main difference between the two advisor set-ups is that independent advisors typically do not have the same conflict of interest (because they do not benefit directly from manager selection activities) and they are therefore less likely to promote change.

We are therefore able to infer the true cost to LGPS of this conflict of interest. The difference in average performance between LGPS advised by consultants generating fees from manager selection activities and those whose advisors did not provide this service was 0.5% per annum, mainly via reduced losses on manager selection! This effective cost is around 50 times the headline investment consulting cost of just below 0.01% per annum. **In monetary terms the total cost of this short-termism can be valued at £740 million per annum or £6.2 billion net present value over 10 years across all LGPS.**

However despite reduced conflict of interest in the fully independent advisor set-up, there is still a shortfall in performance relative to the 'do nothing' alternative. It suggests that even where decision-makers are not exposed to a direct push for change, they are still indirectly exposed to short-termism from contacts with financial intermediaries who might benefit from churn. Feeling the need 'to do something' is also consistent with normal cultural and behavioural biases that favour activity[6]. However as we can see it is the performance impact of this activity itself that really matters to investment outcomes.

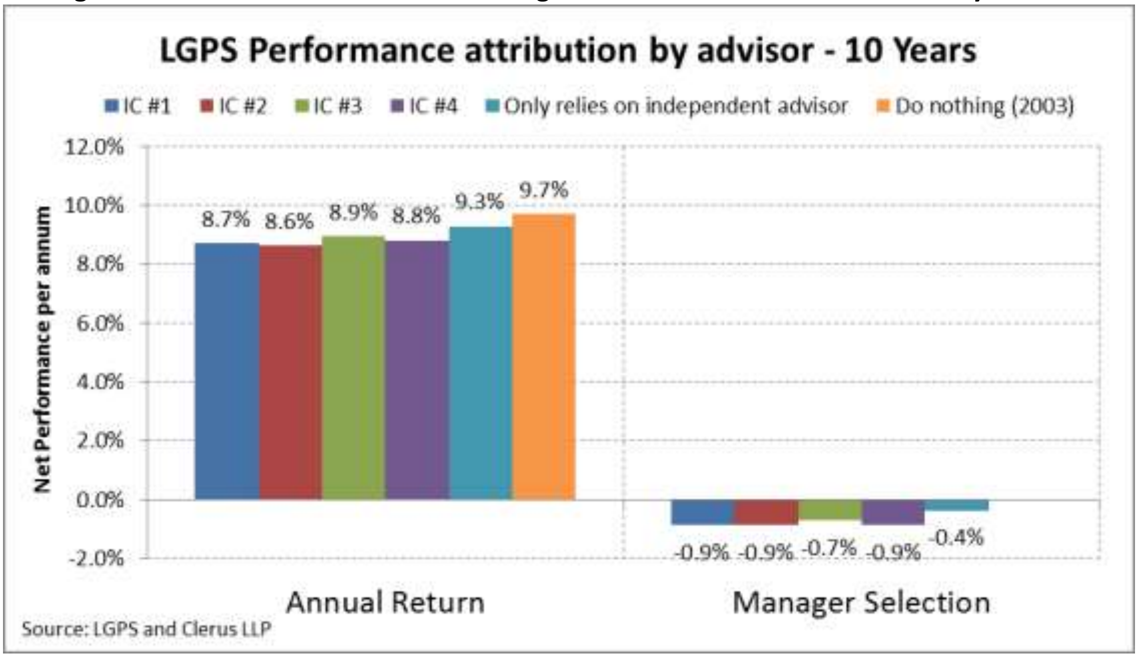
4. Performance attribution by Investment Consultant

Using the performance data we are also able to evaluate whether some consultants have been better than others in adding value for their LGPS clients. As at 31st March 2013, approximately 86% of LGPS employ investment consultants. However four main investment consultants dominated the LGPS space with an 88% market share amongst schemes making contractual use of these firms. The remaining market share was split between five smaller firms.

[5] Peter Montagnon, Institute of Business Ethics: "Ethical Challenges Facing Pension Fund Trustees: 12 key questions." – October 2014.
[6] A good summary of the behavioural biases that favours activity in investment decision-making is provided in: Bird R, Gray J and Scotti M: "Why Do Investors Favour Active Management …To the Extent They Do?" – Rothman Journal of Pension Management, Volume 6 – Issue 2 – Fall 2013.

In Figure 3 we compare annual return and manager selection performance by the four major consultants who have enough clients for the results to be statistically significant. **The results indicate that there is not much difference in the performance of the different advisors.** No consultant beat the average scheme performance of those who only rely on independent advisor, or the 'do nothing' alternative.

Figure 3: Investment Return from Manager Selection and Asset Allocation by Advisor



These results do not come as a major surprise. Despite assertions of bespoke approaches, the LGPS data suggests that each consultant ends up recommending a similar list of managers who are 'popular' at any given point in time. Alliance Bernstein, Record Currency and Fauchier Partners are just some examples of managers recommended, and employed, almost universally during this period.

The results also raise questions with regards to the benefit of so-called **framework agreements** where councils can save some money from the consultant hiring process by selecting from a limited number of incumbent consultants whose performances are included in the above analysis. This can act as a barrier to entry for more skilful advisors and we suggest these frameworks be improved to include past performance assessments in order to enable councils to better assess the full cost of this business proposition.

No place to hide

The CLERUS analysis has highlighted some significant value detraction caused by the inherent short-termism in the investment consulting model. The review covers a 10 year period with two equity market rallies and the financial crisis making it a suitable long-term period over which to evaluate the impact of investment advice on performance. It covers the full spectrum of investments across a wide range of traditional as well as alternative assets in a well-defined universe of pension funds with similar objectives.

This data removes the remaining arguments by the investment consultants against the conclusions of Saïd Business School in Oxford[7] who found evidence of value destruction in the selection of US equity managers (supposedly an efficient market). The CLERUS analysis shows that underperformance is driven by additional, but unnecessary costs incurred by pension funds to suit the revenue models of consultants, combined with a lack of demonstrable skill in selecting managers or providing asset allocation advice suitable for the long term. These activities make short-termism a self-fulfilling prophecy.

[7] Jenkinson T, Jones H and Martinez JV: "Picking Winners? Investment Consultants' Recommendations of Fund Managers" – June 2014. Original version dated September 2013.

Better governance required

As the LGPS data demonstrate, whatever measurement processes are being employed today, they have not been effective in offsetting well-established conflicts of interest inherent in investment consulting. This is probably because most assessment methods used today are based on soft qualitative service measures. Moreover these criteria have often been designed by consultants themselves. The data suggest that there is significant scope for trustees to improve governance by reducing their reliance on single providers of investment advisory services and to start requesting more transparency.

Decision-making under uncertainty requires input from several sources and deliberate scrutiny of any new ideas, whilst keeping long-term objectives in mind. This would suggest decision-makers start looking outside the established firms for different kinds of advice and to bring on more real investment expertise to work alongside trustees. This would help them to counter short-termism and to get a better deal from financial intermediaries. **With the money saved from the subsequent reduction in manager selection fees, they should be able to attract experienced investment talent to assist them in this task**.

Such an improved governance set-up will deal effectively with the poor practice of the current 'one shop advisory approach' where the same consultants: i) recommend managers; ii) set benchmarks; iii) monitor performance; and iv) manage relations which investment managers. This is poor governance because it reduces transparency and increases conflict of interest. It also disassociates decision makers from control and impact over essential parts of the investment process, to agents not being held properly to account.

Introducing more of a business approach to investment decision-making might also help. For example a car manufacturer is unlikely to outsource the responsibilities for production of vital engine components, even if the headline costs were small, without doing rigorous performance and quality testing, before, during and after, as otherwise the car might not be able to drive. Such a view of investing would also support the promotion of clarity and transparency via better regulatory principles which enable better informed and more sensible investment decisions as a contrast to the more prescriptive regulations we have today.

Low hanging regulatory fruit?

The data in this report indicate that the 'advisor requirement' has not benefitted pension funds as originally intended by the regulator. Instead, it seems to have led to a short-term view of investments and a windfall for vested interests. This highlights a major problem with prescriptive regulation because it encourages box-ticking over common sense decision-making. In this case it has also helped create a cartel-like industry structure with a limited number of proxy decision-makers not accountable to stakeholders.

Given the scale of the problems identified, we suggest that better results could be achieved by simply regulating to require clarity and transparency. This would enable better informed and more sensible decision-making. Myners identified the requirement for transparency, but unfortunately it was left as a voluntary principle, with the result that few LGPS truly comply with the spirit and objectives of Myners. For example, if providers of manager selection services were required to make track-records available, it would have been more difficult for trustees to continue to engage in this loss-making activity.

These conclusions are aligned with most academic research, summarised eloquently in a recent Ambachtsheer Letter[8]. It cites similar conclusions with regards to prioritising box-ticking over value creation, and identifies governance challenges in three main areas: agency/context issues, board effectiveness issues and investment/risk management issues. Amongst a number of recommendations it is suggested that (investment) board effectiveness is made a regulatory requirement.

[8] Keith Ambachtsheer. "Fixing the Pension Governance Deficit: Taking the Next Step" – July 2014.

Conclusion:

In this report CLERUS analysed LGPS performance data to quantify the economic benefits of the various investment advisory alternatives used by Schemes. This is the first time it has been possible to provide transparency in this important area, across a well-defined pool of capital with similar long-term objectives. The analysis demonstrates how simple performance measurement and attribution can provide valuable insights which can lead to straightforward improvements to investment governance and performance.

The main conclusions of the report are:

1. Actuaries have not had a significant impact on investment strategy and performance
2. Independent advisors did not have any impact when alongside existing investment consultants
3. The real cost of investment consulting advice has been at least 0.5% per annum or 50 times headline fees due to the inherent and unmanaged conflicts of interest in their business models
4. Negative impact on LGPS performance was similar across the main investment consulting firms

This analysis reveals systematic value detraction across portfolios from what are well-flagged conflicts of interest inherent in investment consultants' business models that are not being effectively managed. This is an unintended consequence of current regulation which helps sustain these high costs to pension funds, because the 'requirement to take advice' has taken precedence over the optimisation of performance via a sensible and long-term investment strategy.

The CLERUS research demonstrates that hiring a consultant to advise or manage investments is not a substitute for good investment governance or for the practical and applied investment expertise required to deliver desired outcomes. Investment recommendations are obviously made with an objective to improve results, but the key to justifying short-term investment activity must come with the requirement to demonstrate positive value, when compared to a more stable and long-term investment approach.

The recommendation of this report is that regulations are modified to promote clarity and transparency as better regulatory principles. This would allow trustees and investment boards to make informed decisions and focus on what they are best at. In addition, we suggest that trustees find ways to improve measurement of consultants' impact on decision-making and take urgent steps to offset the cost of the conflict of interest - either by adding investment professionals who are able to challenge advice effectively (to reduce short-termism) - or by starting to unbundle the investment advisory services they receive.

Universe and data summary:

- 99 Local Government Pension Schemes in England, Scotland and Wales
- £208 billion in LGPS assets as at 31st March 2013
- Data sources: public data (annual reports, council committee minutes, etc.) going back 10 years
- Performance Data: 10 years (58 funds / 70% of Assets) and 5 years (73 funds / 84% of Assets)

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