The Ambachtsheer Letter

Research and Commentary on Pension Governance, Finance and Investments

Letter # 289 February 2010

DOES INSTITUTIONAL INVESTING HAVE A FUTURE?

"How can we allow people of varying abilities and financial sophistication to express preferences for investments without making them vulnerable to salespeople selling 'snake oil'?"

From the book "Animal Spirits" by
George Akerlof and Robert Shiller

A Keynote Speech in Tokyo

We just delivered a keynote speech in Tokyo that addresses the question posed above: "does institutional investing have a future?" Not to keep you in suspense, our answer was "Of course it has". But there was an important caveat. A significant proportion of institutional investment services on offer today cannot not meet the 'value for clients/ beneficiaries' test. Below, we set out the argument for this view, provide evidence supporting its validity, use logic and empirical evidence to lay out a 'better way', and ask how that 'better way' could be realized.

The argument for the 'no value for most of the customers' reality follows logically from the two key facts:

1. Markets for investment management services are 'asymmetrical'. Most sellers know more about what they are selling than most buyers know about what they are buying.
2. Sellers take advantage of this situation by not competing on price, but on less tangible factors such as 'hope', 'quality', and building strong distribution channels.

Nobel Prize-wining economist George Akerlof pointed out many years ago that in markets with these characteristics, customers will pay too much for too little. Conversely, sellers will be paid too much relative to the economic value of the product or service they provide.

The Cost of Active Investing

How much do the customers in fact pay for institutional investment services? Prof. Ken French answered this question in his 2008 Presidential Address to the American Finance Association. Focusing specifically on the US stock market, he estimated the annual investment costs (management fees and trading costs) paid by investors over the 1991-2006 period. As a specific example, the total cost of investing in US stocks in 2006 amounted to 77 basis points, or $115 billion dollars. Of that $115 billion, French estimated that the total cost would have been about $15 billion (10 bps) if the entire pool had been passively managed, leaving the remaining $100 billion (67 bps) as the incremental cost of active management to investors in that year.

The question Prof. French's work allows us to pose is this: 'what *value* did that incremental $100 billion in active fees and trading costs create for participants in pension, mutual, and hedge funds in 2006?' The correct economic answer is 'price discovery'. In other words, with zero active management, stock prices would have no economic basis. Thus the economics-based question becomes: how much money should be spent on active fees and trading costs in order to maintain 'fair value' pricing in the US stock market? The economics-based answer of course is: 'up to the point where an incremental dollar spent does not

have a sufficient incremental expected economic payoff.'

In this context, is Prof. French's $100 billion estimate for 2006 likely to be the 'right' amount to be spending if the goal is 'price discovery' in the US stock market as we define it above? In our view, not very likely. We show below that the 'price discovery' job could likely get done at 1/10th that cost. In short, recognizing the likelihood that similar 'too high cost' processes are at work in other asset class markets in the USA as well as around the world, we conclude that hundreds of billions of dollars are likely drained out of the pockets of retail investors and workers each year for which there is no economic 'quid pro quo'.

New Evidence from the Pension Fund Sector

Most of the hundreds of $billions in annual 'value losses' likely hit mutual fund investors. That is where the 'informational asymmetry' between buyers and sellers is the greatest. However, two recent studies indicate pension fund beneficiaries are not immune from them either:

1. "Investment Horizons: Do Managers Do What They Say?" (published by the *Investor Responsibility Research Center Institute and Mercer Consulting*, February 2010) finds that most active managers investing pension assets have higher turnover rates than anticipated. When asked why they seemed to be engaged in self-defeating 'short-termism', the managers cited volatile markets, adversarial hedge fund trading, mixed signals from clients, and short-term incentive systems. Interestingly, many seemed to recognize the negative consequences of what they were doing, but felt they were locked into these value-destroying behavior patterns.
2. "Absence of Value: an Analysis of Investment Allocation Decisions by Institutional Plan Sponsors" (*Financial Analysts Journal*, Nov-Dec 2009) finds that "plan sponsors are not acting in their stakeholders' best interests when they make rebalancing or reallocation decisions concerning plan assets". Investment strategies that plan sponsors allocate new money to tend to underperform after the money is allocated. Strategies that they withdraw money from tend to outperform after the money is withdrawn. The measured cost of these faulty rebalancing decisions ran into the hundreds of $billions over five-year periods for the funds they examined.

In short, there seems to be measurable decision-making dysfunction in the pension fund sector too.

How Should Institutions Invest?

All this begs the question: 'How should institutions such as pension funds invest? In a 2005 article in the *Financial Analysts Journal* ("Beyond Portfolio Theory: the Next Frontier") we noted that traditional investment theory had sidestepped this question. To derive elegant solutions, the messy 'real world' with its 'animal spirits', informational asymmetry, agents willing to take advantage of it, and complex organizational structure challenges was simply assumed away. As a result, 'rational' investment decisions could be derived solely from a universe of investment opportunities, their return distributions and co-variances, and the degree of investor risk aversion.

Our article introduced 'real world' considerations such as 'animal spirits', agents, and organizational behavior into the equation. Thus we transformed traditional investment theory into Integrative Investment Theory:

Client/Beneficiary Value=F{A, G, IB, R, IMPL}

Where:

- A = Agency considerations such as potential misalignment of interests between client/ beneficiaries and the organizations providing investment services.
- G = Governance quality considerations that recognize that bad fund governance is likely to lead to bad investment outcomes.
- IB = Investment Beliefs go beyond just specifying return distributions and their co-variances. IB also asks what predictive power those specifications are likely to have, and how behavioral issues such as 'short-termism' should be addressed.
- R = Risk management should go well beyond specifying return distributions and understanding investor risk aversion (although that is no mean task!). It should also delve deeply into what risk really means, how it is being borne, and how it is best measured.
- IMPL = Implementation is a 'real world' issue that cannot be ignored. To outsource or not? To use derivatives or not? To pay performance-based compensation or not? All critically important questions.

Empirical research confirms that all five of these considerations can materially impact client/ beneficiary value creation for better…or for worse.

For example, research using mutual fund databases and the CEM Benchmarking pension fund database confirms that mutual fund investors endure significantly higher agency costs that pension fund beneficiaries. Good governance in pension funds has been shown to be a source of return value-added, as have investment beliefs that incorporate realities such as the 10-20 year 'animal spirit' mood swings in investor mindsets (i.e., from pessimism to optimism and back again). On the implementation side, funds with low cost structures generally outperform funds with high cost structures (adjusted for differences in investment policies). Internal management generally outperforms external management (for similar mandates, on a net excess return basis).

Implicit in the latter two IMPL findings is the fact that scale matters. Fund management and pension administration are both activities that can greatly benefit from economies of scale. Take, for example, the finding from the CEM database that internal management generally outperforms external management. Cost differentials are a major driver here, especially in private markets areas such as real estate, infrastructure, and private equity. However, avoiding the heavy external '2 and 20' haircut by going in-house is only an option for pension funds that can staff up to place tens of $billions in these market segments themselves. Scale really does matter.

From Theory to Practice: The Case of Ontario Teachers' Pension Plan

It is one thing to design the ideal investment institution on paper, it is another to actually create and manage one. Has it been done in the real world, and do the actual 'value creation' results match expectations? The question would be best answered by pitting a large sample of 'ideal' funds against a large sample of 'non-ideal' funds over a multi-decade evaluation period. Unfortunately, we are decades away from being able to perform such a test. Funds that have the 'ideal' design set out above are few, and those with multi-decade performance records are fewer still. However, we can usefully examine the case of Ontario Teachers' Pension Plan (OTPP), as we were involved in its early design phase in the 1980s, and have watched OTPP achieve significant scale since its inception in 1990 to this day.

The 1987 Ontario Government Task Force study "In Whose Interest?" set out the ideal design for OTPP. CEO Claude Lamoureux recounted the actual startup of the organization, and its evolution through to his retirement in 2007, in the *Rotman International Journal of Pension Management (RIJPM, Fall 2008).* Lamoureux writes that OTPP's golden rules have been:

- Get the best Board members you can.
- Do not engage in politics: the organization's only goal is to deliver good pensions at an affordable price.
- Hire the best people possible and agree on clear goals.
- Reward them so that incentives and goals are aligned.
- Ensure the organization has the right resources to get the job done.
- Run the investment program as a team effort.
- Treat plan members and employees the way you would want to be treated.
- Give people real responsibilities and don't be afraid to take risks.
- Listen to plan members, employees, and the Board.
- Communicate constantly and clearly.
- Never give in to the temptation, as Keynes put it, "to fail conventionally rather than succeed unconventionally".

A sequel article by colleagues Bob Bertram and Barbara Zvan explains how OTPP's incentive compensation scheme evolved over time *(RIJPM, Spring 2009).* A subsequent Power Point presentation by Zvan sets out the evolution of OTPP's risk management system (http://www. rotman.utoronto. ca/ICPM/details.aspx?ContentID=232).

And what about performance? On the investment side, OTPP has outperformed its policy benchmark portfolio by a highly material 2.2 % per annum over its 20 year history. On the pension administration side, its initial Quality Service Index score in 1993 was 8.1. The score rose steadily through the 1990s, broke through 9.0 in 2002, and has remained above 9.0 since.

'Ideal' Investment Organizations and the Cost of Investing

What impact would a world filled with 'ideal' investment organizations have? Let's conduct a thought-experiment, starting with Prof. French's finding that the cost of managing the aggregate $15T US equity portfolio was 77bps or $115B in 2006. Let's create 150 'ideal' investment institutions of $100B each to manage that aggregate portfolio. They all start with a passive strategy, each holding 1/150th of the market portfolio. This only requires a small staff and very little transaction costs. Assume each spends 2.5bps, or $25M per annum. Thus together the 150 institutions spend $375M per annum.

Now institution X notices that there is no 'price discovery' in the market (i.e., no active management). It hires some security analysts who have a field day selling overvalued stocks and buying undervalued ones. X starts to outperform the other 149 institutions, which now also begin to hire analysts. When should this hiring process stop? When the marginal cost of an additional analyst has no expected net payoff. With how many analysts might that point be reached? We don't know. But let's assume that each of the 150 institutions hires 100 analysts and pays each of these analysts a base of $250,000 per annum. That adds $25M to the operating cost of each institution. Total cost goes from $25M to $50M per annum. Let's add an additional $25M for trading, travel, administration, and other expenses, pushing the annual cost for each institution to $75M, or 7.5bps.

Should 15,000 motivated, professional security analysts with $trillions of capital behind them be able to establish 'fair value' pricing in the US equity market? We would think so. If we are right, and if the optimal $75M annual cost per institution is in the ball park, we can calculate to optimal cost to society of 'price discovery' in the US equity market. If the 150 institutions spend $75M each, that optimal cost works out to about $11B per annum, or 7.5bps in relation to the $15T market portfolio. That is 1/10th of the actual 77bps or $115B spent in 2006. If that same ratio holds in other securities markets, the potential reductions in unnecessary costs by 'ideal' institutions rise to the hundreds of $billions per annum.

And that is not all. These 'ideal' institutions have already discovered that some of their investee corporations have their own unnecessary agency and governance costs. Collaborative strategies between 'ideal' institutions to drive these corporate agency and governance costs down are clearly in the interest of their clients/beneficiaries so the societal benefits form this 'ideal' institutional investment structure rise even further (see our prior two *Letters* for more on this).

Getting from Here to There

Market forces did not create OTPP, and will not create the 150 'ideal' investing institutions described our thought-experiment. Only 'public interest' entities can create such organizations. Democratically elected governments are an obvious, but not sole example. Industry associations could also do it, as could organized labor. Even better, they could do it together. With so much to be gained, why are 'public interest' entities doing so little to capture these benefits?

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