HEALTH WEALTH CAREER

ALIGN BY DESIGN

STEPS FOR SUCCESS IN FUND MANAGER ENGAGEMENT

MAY 2016

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MERCER

OVERVIEW

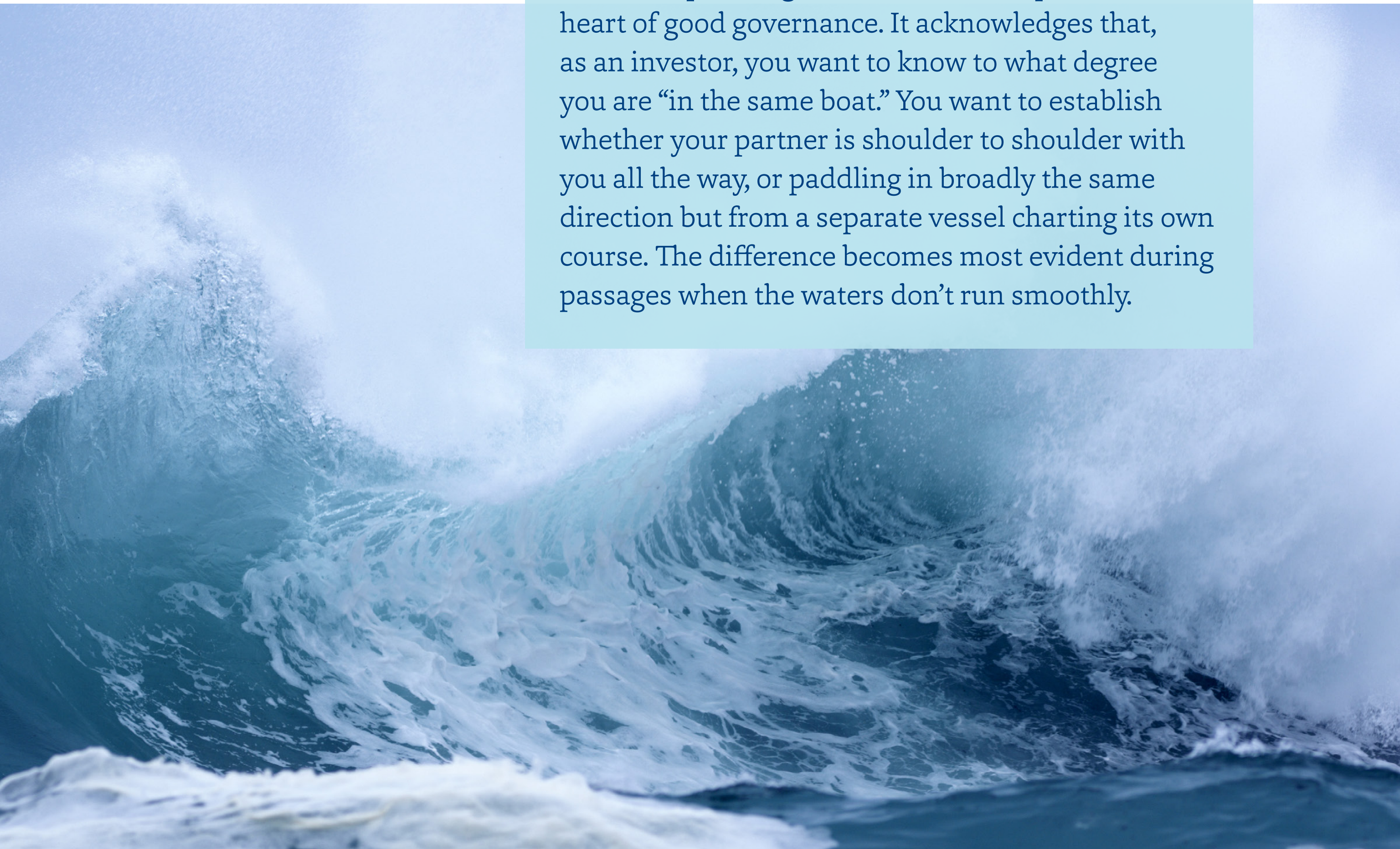
> "It is one thing to travel down the river with me; it is another to also share my boat."

The saying to the left is one that can be suitably applied to the investment industry. In this article, we explain how this is so and discuss what tools you can employ as part of the investor/fund manager relationship to enhance the prospect of mutual success.

In assessing whether to engage or retain a fund manager, investors can tend to focus on the firm's investment capability and operational strength. These are important factors, but you should also consider the often overlooked aspect of alignment — the extent to which a business model directs a fund manager, acting in its own interest, to act also in the best interests of investors.

In covering this topic, we first touch on who the main players are, then outline the benefits of strong alignment, before discussing some of the ways to promote alignment, particularly with respect to listed securities, such as equities. We recommend clients give due attention to these factors as a relevant part of fund manager selection and ongoing assessment.

The concept of alignment is one that speaks to the heart of good governance. It acknowledges that, as an investor, you want to know to what degree you are "in the same boat." You want to establish whether your partner is shoulder to shoulder with you all the way, or paddling in broadly the same direction but from a separate vessel charting its own course. The difference becomes most evident during passages when the waters don't run smoothly.



THE MAIN PLAYERS

We can identify three key relevant parties: the funds management firm (including the owners), the portfolio managers and investment staff, and the investors (clients and advisors). In the case of boutiques, the first two groups are possibly one and the same, but generally we have:

An organization seeking to maximize profits and build a sustainable business

Individuals making day-to-day investment decisions who are seeking reward for their skills and to establish themselves as professionals

Trustees and fund executives who are accountable to their members or boards for achieving investment returns (risk-adjusted, we would suggest) that are as high as possible

To jog the memory of those who studied science at one time or other, biologists would call this scenario "obligate disjunctive symbiosis" — a clever way of describing an association between two or more species that live separately but depend on each other for survival. Each party does not necessarily benefit equally, although that is surely a worthy goal for a successful long-term relationship.

BENEFITS OF GETTING ALIGNMENT RIGHT

To quote Charlie Munger of Berkshire Hathaway fame:

> “Show me the incentives and I’ll show you the outcome.”

This observation strongly implies that incentives drive human behavior, and that we under-estimate them at our peril. We’re not saying that the majority of fund managers don’t fundamentally want to “do the right thing” for clients and deliver good outcomes; rather, the statement highlights the importance of embedding a natural proclivity for that to happen.

With the right alignment structure:

The investment team is motivated to “go the extra mile” in terms of trying to generate superior performance, to the benefit of all parties.

A platform is created for the relationship whereby there is less need to second-guess what the other party is doing and what its motives are. The reduced scepticism means that, in many cases, the requirement for intense monitoring is moderated.

If there is more of a partnership approach, this should result in less switching of fund managers over time. Changing managers is typically costly, time-consuming, and subject to transition risk — in short, it is best avoided where possible.

STEPS TO IMPROVE ALIGNMENT

So can we improve alignment? As with many things in life, the bigger you are, the more influence you are going to have. But more individual paddlers can also make for forceful collective progress. Below we outline a range of aspects that, regardless of investor size, can be discussed around the board table and raised with fund managers.

1. CO-INVEST FOR SUCCESS

Assume you have a sizeable amount of money to place with an investment firm. Would you rather that your portfolio manager invested a significant amount of his or her own money in the product (at standard fees), or did not have that sort of skin in the game?

Why would the portfolio manager not invest in the same product? Is the investment style not truly what he or she believes in? Are the fees simply too high?

Expecting a portfolio manager to have all of his or her life savings in the product is probably unreasonable — the product may have some characteristics less desirable for that purpose and everyone has a requirement for diversification. However, a significant co-investment supports the notion that the manager is going to fully "keep his or her eyes on the ball" and manage risks as well as pursue upside.

It's more the exception than the norm to see disclosure details on co-investment, but it does happen. To quote an actual factsheet of an equity manager, "The portfolio manager has $100,000 invested in the fund, and staff have $1.5m invested in the fund, as at quarter-end." We can make a judgement call as to how meaningful such amounts are to the staff concerned, but they are likely to be amounts of consequence, and indicate that there is some "eating of own cooking" going on, which has to be regarded as a positive feature. An absence of meaningful co-investment is particularly open to question when the portfolio manager is well-established in his or her career and hence likely (in most cases) to have significant investable funds.

2. SHARE A MUTUAL TIME FRAME

As an investor, are you in reality adopting a long-term mentality, and have you discussed that stance with your fund manager? A lot tends to be assumed.

The reality is that, over one or two years, a very good or bad return may well have been generated more by luck than skill. Market conditions will favor or penalize different investment styles at different times, and performance data deliver a lot of statistical noise.

If a portfolio manager detects that the client base is likely to react based on short-term outcomes, he or she is not encouraged to make longer-term strategic decisions — decisions that may well be in the best interest of clients. The opportunities for investment outperformance often require patience — even great ideas can't be timed perfectly — and a side-benefit is lower trading costs from lower portfolio turnover.

3. DEFER A PORTION OF REWARDS

Remuneration structures for investment staff, driven by key performance indicators (KPIs), are a central element of running an organization. If your portfolio manager performs well and gets a bonus — preferably reflecting a multi-year outcome in line with the above point — then, great! But what should happen to that bonus? Would you rather it was released straight away as cash, or instead that half of it was invested in the product for a minimum of, say, three years?

Most of us would take some comfort if the manager had that sum locked away for a little while. That way, the portfolio manager has no inducement to take risks in the portfolio that may pay-off in the short-term but "come home to roost" at a later date, when the manager may not still be in situ. To use our boating analogy, better that your paddling partner had a vested interest in building a vessel to last the full day, not just till noon, especially if he or she had plans to be elsewhere after lunch.

With regard to the relative weights given to the base component and variable component of pay, to encourage alignment with clients, unsurprisingly you want the latter to represent a significant enough proportion of the total so that it is meaningful — something worth striving for.

Specifically, in terms of the KPIs, relating the bonus component primarily to fund performance outcomes is highly desirable. Often you will come across KPIs relating to client growth or revenue growth, but if strong portfolio returns can be generated, in most instances those outcomes represent a natural follow-on.

4. SUPPORT BOARD INDEPENDENCE

Would you rather the board of the investment firm had independent directors or instead consisted entirely of internal management?

The advantage of some independence on the board is to help balance the interests of the three parties referred to earlier — shareholders, staff, and stakeholders, such as clients. Independent directors are typically charged with being the guardians of the longer-term health of the business, making sure attention is paid to such elements as succession planning, audit, and risk management. Although their presence is no guarantee that investor interests will be at the fore, diversity offers an increased chance of broad representation at the board table.

It's fair to say that, for a new fund manager setting up shop, having independent directors is something of a "stretch target" given it will compound initial business costs. However, once the firm is clearly established, the defence for not having such a presence increasingly dwindles.

5. THINK STRATEGICALLY ABOUT FEES

We cannot ignore the topic dear to all our hearts — fees, which is a sizeable issue in itself and not one that this paper can do full justice to.[1] That said, establishing some principles is useful:

- We can likely all agree that a fund management firm is entitled to rewards that reflect true value added from bringing its skills to the table.
- As an investor, you want to reward skill, because if you don't, someone else will, and that someone will obtain the benefits. The question is how much reward is too much.
- When it comes to performance-based fees (PBFs), the best advice is to explore while at the same time exercising caution. If I give my nine-year-old son $10 for every goal he scores on Saturday, and other parents do the same, the practical effect is to incentivize chaos (albeit entertaining chaos!). But in the investment world, a well-designed structure helps create alignment of interests because benchmark-like performance will see a low fee being paid, and stellar performance will see a higher fee being paid for a share of those excess returns. That said, the devil is very much in the detail, and thought needs to be applied to such issues as the correct benchmark, high-water marks being in place, a cap on total fee, and so on.[2]

A partial attraction of PBFs relates to appropriate management of capacity. It is well established that, beyond a certain point, a manager's size of funds under management eats away at the scope to generate excess returns — the best ideas get diluted or sacrificed because of an inability to execute at a reasonable price or within a reasonable time frame.[3] In that regard, PBFs can provide a self-correction mechanism because excessive growth in assets will, via a lower excess return, be felt in the manager's pocket through lower fee revenue.[4]

[1] Mercer. "Investment Manager Fees: A Critical Look," July 2015, available at www.mercer.com/insights/point/2015/investment-manager-fees-a- critical-look-mercer-2015.html.

[2] Mercer. "Effectively Aligning Definitions of Success with Proper Benchmark Selection," September 2015, available at www.mercer.us/insights/point/2015/effectively-aligning-definitions-of-success-with-proper-benchmark-selection.html.

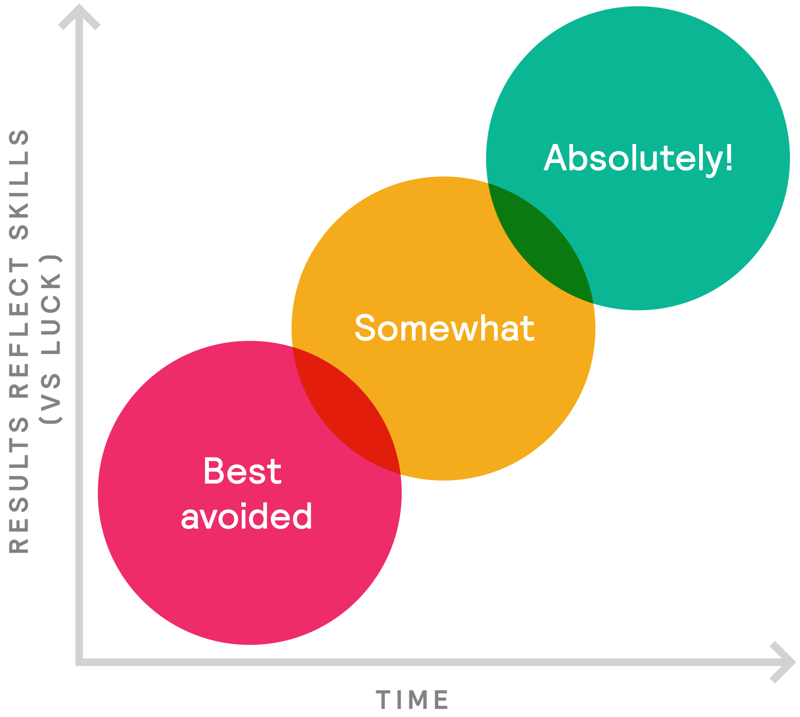
[3] Mercer. `Keep Your Eyes on the Size: Fund Manager Capacity and Why It Matters," March 2013, available at http://www.mercer.com/content/dam/mercer/attachments/global/investments/keep-your-eyes-on-the-size-fund-manager-capacity-and-why-it-matters-mercer-2013.

[4] Managers should, in theory, aim to maximize a total alpha in dollar terms and be paid a share of that. A desirable outcome is when, for instance, a 4% excess return on $10 billion of assets is preferred over a 1% excess return on $40 billion of assets, by both investor and manager.

With reference to earlier comments about luck and skill, fund managers generally wish their performance to be judged over a period of years rather than months, as that is the time frame over which skill can crystallize.

This is fair enough, though by the same logic, it makes most sense for PBFs to accrue based on a similar time period, as depicted in the area toward the top right in the chart below. The longer the period, the higher the confidence that skill rather than noise is being rewarded.

Exhibit 1: What Performance Period Should Be Rewarded?



Source: Mercer

We note in respect of remuneration mechanisms that, when firms predominantly use PBFs, linking investment staff bonus payments to the magnitude of such fees earned has merit.

6. DISCOURAGE PERSONAL TRADING

Earlier, we discussed the merit of your portfolio manager co-investing in the product. Taking this a step further, would you prefer that he or she was able to trade in the same asset class separately on a personal account, or was not able to do so?

In part, this represents a compliance issue (prohibiting or making transparent certain trade activity), but is any such personal trading something to be condoned? Conceivably, there could be upside to the individual in pursuing some short-term trading opportunities, for instance, but perhaps you want him or her focused on the securities in your portfolio. Even if personal trades are cleared through internal compliance teams, the scope for conflict of interest is hard to eliminate. And why open up the risk when, as a general statement, portfolio managers are fairly well compensated for their "day jobs."

7. CONSIDER THE OWNERSHIP STRUCTURE

One situation not discussed so far is when investment staff have an ownership stake in the firm. Does that promote alignment?

On the positive side, ownership of the firm by key individuals can help with staff retention, amplify incentives for the business to be a success, and help foster a longer-term mindset.

On the other hand, ownership ties individuals more directly to the interests of the business — i.e., the total revenue picture — rather than the outperformance of a certain product, per se. This is particularly relevant if the product you are invested in does not represent a large part of the overall business; i.e., the success of the firm may not be closely tied to how well that product performs. And there is an issue of what to do if a staff member is a shareholder but starts to under-deliver. Arrangements can be a bit hard to unwind, even though parting company may be the best outcome for the business and for clients.

Hence, we can regard the self-ownership model as positive in many respects for alignment purposes, but not purely so.

IMPLEMENTATION

Some challenges do present themselves when trying to execute material change to alignment structures. Many investors are not big enough in dollar terms, relative to the size of a manager's total client base, to be able to have meaningful influence. Existing fee structures may be so ingrained that effecting change is near impossible. In some cases, managers have experienced a level of success that means they do not feel obliged to be flexible on arrangements ("There is plenty of demand; if you want to invest with us, these are the terms!").

The reality is that the scope for negotiation is mostly evident when, (a) the investor is large and/or prestigious; and (b) the manager or strategy is in its relatively early stages — as the saying goes, he who is most hungry is most flexible. In some cases, smaller and/or boutique-type firms are well placed to apply flexibility given relatively smoother pathways to implementing internal policy changes.

Notwithstanding some implementation challenges, fund managers have little defense for not being open to discussions aimed at improving mechanisms for strong alignment.

CONCLUSION

At Mercer, we look at a variety of alignment factors as part of the manager research process. Although expecting every fund manager to tick all the boxes is not realistic, evidence of investor interests being strongly accounted for warrants attention as part of a manager selection exercise, and adds weight to an overall assessment of manager capability. We also consider alignment factors as part of the engagement process once a preferred manager has been selected, advising on the terms and conditions of a mandate on behalf of clients or for Mercer's own funds.

TO SUM UP, WE HAVE ARGUED THAT WELL-STRUCTURED ALIGNMENT ARRANGEMENTS:

- Help underpin a sense of partnership between investors and fund managers.
- Promote strong performance and risk management.
- Help minimize the costs incurred from intensive monitoring and changing of managers.

"Align by design" and maximize your opportunity for investment success.

For further information, please contact your local Mercer office or visit our website at www.mercer.com.

BIOGRAPHY

David is a principal in Mercer's Investments business. As well as having a senior client consulting role, he is involved in evaluating domestic fund managers and links in with Mercer's research capability in Australia and globally. David is actively involved in assisting clients with their investment structures and selection of fund managers. He is based in Auckland.

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Principal
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Prior to joining Mercer in 2003, David gained six years of experience at the Reserve Bank of New Zealand where he was a portfolio manager with responsibility for trading US and European bond portfolios. David also worked in the asset and liability management branch of the NZ Treasury as a senior analyst. He monitored the performance of crown financial institutions and companies, and provided strategic advice on a variety of commercial investments.

David holds a Bachelor of Commerce and Administration (economics) from Victoria University, New Zealand.

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