INVESTMENT MANAGER SELECTION

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Can retail investors exploit techniques used by investment consultants to financial institutions in the selection of investment managers?

" A Mission to Educate"

Introduction

The Working Party was formed at the 1999 Investment Conference and decided to try to pick up the gauntlet thrown down by Fraser Low, President of The Faculty of Actuaries, in an appeal to Conference to make some of its work more accessible and practically useful.

The profession's Vision and Value document identifies an area for improvement to be "Serving the public interest" which includes playing a part in improving the education of present and future financial consumers. As a practical measure in furthering this goal the profession launched, in February of this year, an inquiry into "The Provision of Financial Information and Advice". This inquiry is concerned with the provision of information and advice to individual (i.e. retail) customers of financial services in the U.K. and has identified a key issue to be availability and quality of information and advice.

The Financial Services Authority has financial education of consumers as part of its remit and will, presumably, be looking to the industry and the profession for assistance in this task.

It is against this background that this paper is presented.

It is, in essence, a proposal to Conference that it is possible and desirable for the profession to take a lead in improving the financial education of consumers by providing a framework within which investors can determine the factors appropriate to their purposes in selecting an investment manager. As an aid to this process, we also propose the development of a Code of Practice for product providers engaged in the marketing of Investment Products.

The Current Situation

An examination of the personal finance pages of the tabloid and quality newspapers and other marketing media shows advertising of retail investment products that focuses on some or all of four factors:-

- Past Performance
- Guarantees
- Low price
- Brand

The first three of these are objective measures albeit sometimes selective and not necessarily transparent. The fourth, Brand, is used to convey an impression of more subjective factors such as financial strength, good people, quality service, expertise and acumen.

The role of the investment consultant, inter-alia, is to examine the objective measures in a deeper and wider context than that chosen by the product provider and to apply appraisal techniques to the subjective factors for the purpose of assessing the relative strengths and weaknesses of different investment houses.

We believe it is possible to develop a framework that will explain the role that these various appraisals play in the investment manager selection process. This will allow investors, should they so choose, to make informed enquiry and encourage product providers to be more open in their explanation of their total product offering.

An Outline Framework

In order to stimulate debate we set out under seven headings some of the factors that could form a basis for the proposed framework. The seven headings are:-

1. Past Performance
2. Risk
3. Cost
4. Financial Strength
5. People
6. Process
7. Service

1. Performance

- At least five years of performance should be shown or since inception if less than five years is available.
- Annual returns for each year on a calendar year basis.
- Composite returns to be shown with all similar portfolios included.
- The number of portfolios and the amount of assets in the composite and the amount of the firms total assets represented by the composite at the end of each period.
- A measure of the dispersion of returns around the aggregate composite return.
- The composite retention date.
- Performance for less than one year should not be annualised.
- Performance of a past firm should only be included if the investment decision-making process remains substantially unchanged.
- If a composite includes carve-outs from multiple asset class composites the presentation must include the percentage of each composite the carve-out represents.
- The total return for the benchmark must be presented for the same periods for which the composite return is presented. If no benchmark is presented the presentation must explain why no benchmark is disclosed.
- Returns should be shown gross of fees and taxes.
- Equal-weighted means and median returns for each composite should be shown.

2. Risk

- Risk measures should be presented for both benchmarks and composites.
- The risk and performance statistics should be prepared in a consistent manner using consistent data sources.

- Risk measures should involve both ex-post and ex-ante measures. The risk profile should be estimated at least quarterly over the relevant period and significant changes explained.
- There should be a commentary on the models/methodology used including when they are likely to break down.
- A statement on the sources of data and whether any assets have been omitted and the extent to which this might alter the results.
- Composite risk statistics should be prepared in a way consistent with the construction of composite risk statistics eg a risk measure for each component of the composite should be calculated separately and, for example, a house median calculated.

3. Fees

In order for an individual to make a suitable comparison of fees it is necessary for that individual to first understand the different types of fees in operation. It is very easy for an unsophisticated investor to be misled, not necessarily purposely, by the wording of fees in product literature. It is also important for the individual to realise the difference that fees can make.

The first item to discuss is those fees that are disclosed, or are relatively easy to ascertain. These include:

- Initial fees when money is invested
- Ongoing fees for managing the money
- Exit charges

Initial fees

Initial fees come in two main forms, an explicitly stated charge applied to new investments and/ or the operation of a bid/ offer spread. They are usually expressed as a proportion of the money invested, although in some cases a flat amount may apply.

For example, Investment 1 may have an upfront charge of 2% and a bid/ offer spread of 2%. Investment 2 may have no upfront charge but a bid/ offer spread of 4%. In both cases, the value of any new investment falls by around 4% before it has had any time to grow.

Another complication is the allocation rate that is applied to new investments. This may vary and is not always equal to 100%. If the allocation rate is 98% then this is equivalent to an initial charge of 2%, and needs to be considered alongside the bid/ offer spread. However, allocation rates may also be greater than 100%, but the same principle applies. For example, if an allocation rate is 102%, then this effectively reduces the effect of the bid/ offer spread by 2%.

The best way to allow for the effect of these charges and to apply a rough rule of thumb as follows:

Total initial charge = Explicit initial charge plus bid/ offer spread plus (one minus allocation rate)

A further complication, which cannot be easily allowed for, is single priced funds. Whilst these initially appear to have no bid/ offer spread, they tend to switch from offer to bid at a time when a manager is losing money, which usually corresponds to a period of poor performance and may be the time when the individual is wanting to disinvest.

Ongoing fees

These are usually more easily understood. They tend to be expressed as a percentage per annum, although they may include a fixed amount. It is important to make it clear what the ongoing fees are as some may be more explicit than others. For example, one manager may deduct fees from the unit price, whereas another may deduct fees by cancelling units. What is important in each case is the size of the ongoing fees, not the method by which they are recovered.

Exit Charges

This is another area in which the individual investor may not understand the possible impact. Investment funds can sometimes quote a fund value that is not the realisable value. This is the case not just for with-profit funds. It may or may not be clear what the realisable value is as exit penaltyies may take the following forms:

An adjustment if the stock market has fallen or at some extreme level
An adjustment if a certain amount of money is withdrawn
An adjustment if the investment has not been held for some minimum period

All of these penalties effect the accessibility of the money and so it should be clear to the individual the circumstances in which less than the full face value of the contract is payable.

Other Fees

Even for relatively transparent vehicles, that state ongoing charges, initial charges and exit charges, they do not always quote other expenses incurred in running the money. These may include administration charges, staff charges, custody charges, sub-custody charges etc. The importance of these can vary between different types of contract and different investment regions.

What the individual should be concerned about is as follows:

If I invest £1,000 in a basket of investments, and that basket of investments, excluding costs (i.e. if held throughout and not managed), rose by x%, and my return was y%, what is the difference between x and y?

It is not an easy task to determine the difference, as the life insurance industry has found out when producing key features documents, however these costs can be hidden by advertising stating a certain annual charge.

Fees Summary

- Initial fees should be viewed as a package
- Ongoing fees should be ascertained irregardless of the method by which they are deducted and should also be viewed in totallity, not just by looking at the headline annual charge
- Exit penalties should be made explicit.

4. Financial strength

The important item to stress here is that the financial strength of an organisation is only relevant to an individual investor to the extent that it can alter returns. There is a small risk of default, but this is not the main area with which an investor should be concerned as most investments are ring-fenced, i.e. the organisation cannot use them in the event of insolvency.

When considering financial strength you should consider why a sound financial base is important.

- It allows the organisation to offer attractive salaries to attract the best people;

- There are more resources for maintaining the necessary systems, particularly important in today's world of new technology;

- There is hopefully stability of the process that is being used to generate returns for the investor;

- On the other hand, if the company is not succeeding then a strong financial base and/ or access to the resources of a parent, may make it easier to make the necessary improvements.

When a company is not in this position, then there is an increased risk of them being taken over and/ or sold. This may result in the continuation of the process that the investor originally bought into, but more likely will see a change in process, such that the product that the investor has is different to that they originally bought.

Items to consider may therefore include:

- The size of the organisation;
- The market share of a particular market that the company has;
- The number of regions in which the company operates;
- The nature of the companies owners;
- Whether any sister companies operate within the same business.

The size of an organisation may also affect its ability to bargain in the market place. This may mean a larger unit cost for a small organisation.

It is probably fair to say that of all the items that an individual should consider, because of the ring-fencing of assets, the financial strength of the organisation is not the main issue to consider when choosing an investment manager to run a unitised investment. Although, this may not hold true for some overseas markets where there is a very real default risk.

5. People

- The people in an organisation play a key role in its success in providing investment products.
- The person actually managing the fund can change with a significant effect if they are directly the reason for the performance.

- Some funds are sold on the individual running it ("Manek Growth Fund" is a good example) and big names (such as Nicola Horlick) have a key role in the marketing success of their organisation.
- However, the personnel involved are often not advertised. It is something that institutional investors, usually through their consultants, monitor very closely.
- People move on, retire, move into management, have their mind and time diverted to running other funds etc etc.
- Institutions suffer quite high costs in changing manager – for individuals it is much worse with high spreads (5% charge + market spread in a lot of cases) and slow transfers resulting in high opportunity costs. Most individuals do not have the time or interest to follow the personnel in the organisations that run their money. Stability in personnel is therefore likely to be a good thing.
- Fund management organisations can use individuals performance records – they poach a manager with a good track record and want to brag about it or lose a good manager but keep the performance!
- Even if people are not actually picking the stocks, they will still be involved in the design of the process (eg in index-tracking) and experience is likely to important.
- Institutions are looking to get beyond the star individual or manager to actually see the process or team involved.
- Team approaches and committees appear less dependent on individual(s) but unless you know them very well (or have read all their notes) it is not possible to be certain how significant particular individuals are or how they interact – is the committee approach just slowing down the best ideas!
- The way that the people involved changes over time can also be a good indicator. A company with very high turnover of staff relative to the peer group may be a sign that all is not well. A very low turnover suggests good stability, but may not mean that fresh ideas are entering the organisation.
- The changes in an organisation and their personnel as their business grows may be important for service as well as performance. Many retail investors do not closely monitor performance but would notice and tend to stop using an organisation if their calls are not returned etc.
- It would not be difficult for investment managers to disclose who is running the fund, how long they have been running the fund, what other funds they run and have run, how long they have been with the organisation.
- It is a difficult thing to get sufficiently close to an organisation to fully rate them on personnel - only the largest consultancies can do this. However, it is very easy to get an indication from who is running the fund and how long they have been doing it!

6. Process

- It is widely held to take between 11 and 16 years to prove skill through performance. There are very few investment products or houses that have run a similar process over this time with the same personnel – of those that have, I do not know if there are any that have outperformed and so could prove skill in this way. A much closer look at their processes and the actual positions they have take, why and how they have added to or detracted from performance is more likely to find a manager with skill.
- Process can be closely linked to people. If the process relies less on individual judgement, people are less important.
- Institutions often select investment managers where the process (or style) fits their requirements and beliefs. So for example they will combine managers in a way that maximises diversification – using a combination of passive, active,

balanced, specialist, alternative asset classes (hedge funds, private equity, property). For individuals a process that they believe in and understand may be important – alternatively they may be just looking for good performance.

- Process has several aspects:

  - What research do you do?
  - How do you find stocks you think will do well?
  - How do you find stocks that you think will do badly?
  - What is the decision making structure?
  - How do you construct portfolios?
  - What buy and sell disciplines do you have?
  - What limits do you have on investment in any stock/sector/market/capitalisation band?
  - How do you trade?
  - Do you have analysis of the trading costs of your strategy?
  - What is the predicted risk of your portfolio in absolute terms?
  - What is the risk relative to your peers or benchmark? Institutions generally set the benchmarks for their managers and then look at risk and performance relative to benchmark.
- Investment process is arguably the most important determinant in future performance. Past performance is at best a very weak predictor, personnel are important but change - they also have off days.
- It is difficult to describe the philosophy or process in a sufficiently complete manner that will allow individuals to compare – but a short paragraph on the areas that managers think important and differentiating in their process would not be too much to ask!

7. Service

- Access to Product
- Accuracy and Timeliness
- Documentation
- Ease of effecting changes
- Access to fund managers
- Quality of Commentaries
- Quality of Service Staff

Summary

We are well aware that the technical content of this paper is incomplete and in need of significant development. However, from our perspective this is not the primary issue that we wish to consider at this Conference. Instead, we seek first the views of Conference as to whether this is an avenue worth pursuing and, second, we are looking for guidance and help in the practical process of gaining a wider acceptance for the concept.

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