Using Passive Strategies for Investment Consulting

Brian Schroeder
Founder
OCIOmonitor.com
Founding Partner
Investment Change Evaluations, LLC
Salt Lake City, Utah
Session Thesis

- Institutional investors can improve their outcomes by applying passive, or rules-based, strategies to their investment consultant functions. Those functions are:
  - Asset Allocation (Strategic and Tactical)
  - Manager Hiring and Firing
  - Rebalancing
Passive or “Rules-Based” Strategies are Everywhere

- Algorithmic, Quant and High Frequency Trading
- Target-Date, Index Funds, Robo, Smart Beta
- Transportation and Safety Systems
- Manufacturing Processes
- Recipes at New Orleans Restaurants
Figure 2. Glide path for Vanguard target-date funds

Notes: Figure assumes that a particular fund was selected based on a projected target retirement age of 65. TIPS = Treasury Inflation Protected Securities (see discussion of TIPS later in the text).
Source: Vanguard.
Active Portfolio Management

- As of the end of 2018, for the 15-year period, the percentage of active mutual funds that lagged their respective passive indices:
  - Large Cap: 91.62%  
  - Small Cap: 96.73%  
  - Emerging Markets: 96.15%  
  - IG Long Bond: 98.41%  
  - Emerging Market Bond: 85.71%  
  - Mid Cap: 92.71%  
  - International: 89.83%  
  - High Yield: 99.15%
Manager Selection by Plan Sponsors

• Professors Goyal and Wahal published in 2004 *The Selection and Termination of Investment Managers by Plan Sponsors*. They studied $830 billion of hires and fires by 3,700 plan sponsors over a 10-year period and concluded, “We find that if plan sponsors had stayed with fired investment managers, there excess returns would be larger than those actually delivered by the newly hired managers.”
Asset Allocation by Plan Sponsors

- Authors Stewart, Neumann, Knittel and Heisler in 2009 published *Absence of Value: An Analysis of Investment Allocation Decisions by Institutional Plan Sponsors* in the *Financial Analysts Journal*. Analyzing 80,000 yearly observations from 1984 to 2007, concerning rebalancing and reallocation decisions, the authors concluded, “Institutional investors do not appear to create value from their investment decisions.”
Why So Difficult to Succeed?

- Behavioral Finance
  - Performance-driven decisions, i.e. chasing hot and cold
  - Defendable decision making
- Delayed decision making
- Conflicts of interest
- Efficient markets
- Transaction costs and fees
Why So Difficult to Succeed?

Declining Marginal Returns of Investment Decisions
Why So Difficult to Succeed?

“Money Flows…

“...to the Patient Investor.”
Warren Buffett
Is Our Consultant Too Active?

- Too many meetings and calls ( > 4 )
- Frequent asset allocation changes ( > 1x / 5yrs )
- Frequent manager changes ( > 1x / year )
- Watch list monitoring ( every meeting )
"I was spreading some risk around, and apparently it all wound up in your portfolio."
Does Our Consultant Add Value?

- 5 Areas where value can be created/destroyed:
  - Strategic asset allocation
  - Tactical asset allocation
  - Manager hiring
  - Manager firing
  - Rebalancing

- Performance reports camouflage the results
- Demand consultant document their value-add
Does Our Consultant Add Value?

- Strategic asset allocation
  - “Benchmark Linking” means having the policy index or plan benchmark mimic the strategic asset allocation
    - Hides value-add
    - Enables frequent changes
    - No permanent reference
  - Track old and new plan benchmarks simultaneously
Does Our Consultant Add Value?

- **Tactical asset allocation**
  - The difference between strategic asset allocation and the actual asset allocation
    - Deviation due to market movements or intentional over/under weighting of asset classes
  - Track return of strategic asset allocation versus the actual asset allocation. Some consultants call this the “shadow index.”
  - Beware of “strawman” plan benchmarks
Does Our Consultant Add Value?

- Manager hiring
  - Do the money managers, hired by the investment consultant, beat their index net of fees?
    - Determine hiring batting average and net alpha of each manager—“micro comparison”
    - Compare total plan return versus shadow index return—“macro comparison”
      - (Comparing to plan benchmark includes tactical allocation)
Does Our Consultant Add Value?

- Manager firing
  - How do the money managers perform after termination, net of fees?
    - Track performance of fired managers versus benchmark
    - Determine firing batting average and net of fees, negative alpha avoidance
    - Compare to performance of replacement manager
Does Our Consultant Add Value?

- **Rebalancing**
  - Managing asset allocation effectively means rebalancing is occasionally needed
    - Manages risk and captures incremental returns
  - Demand reporting on rebalances made AND MISSED
Does Our Consultant Add Value?

• Rebalancing—Aug 1, 2015-Oct 31, 2015
"If we’re being honest, it was your decision to follow my recommendations that cost you money."
Benefits of Adopting a Rules—Based Approach

- Add methodical and objective discipline
- Reduce conflicts of interest
- Remove emotional decision making
- Remove behavioral finance traps
- Lower fees
- Shorter and fewer meetings
3 Passive Structures to Implement

• Maintain current structure
  – Internal CIO, Non-discretionary or OCIO
• Unbundle investment consultant duties
• Multiple, multi-asset class managers
Maintain Current Structure

Passive Rules Here
Strategic Asset Allocation
Tactical Asset Allocation
Manager Hiring
Manager Firing
Rebalancing
Maintain Current Structure

- **Strategic Asset Allocation**
  - Truly act as a “long-term investor”
  - Perform asset allocation study infrequently
    - Every 5, 6 or 7 years
    - Add thought diversification by including investment managers on study committee
  - Short-to-intermediate changes addressed by tactical asset allocation and rebalancing
Maintain Current Structure

• Tactical Asset Allocation
  – Tactical opportunities are few and far between
  – Limit to objective frequency and amount
    • Ex: Once every 5 years (roundtrip) and up to 5% of assets
Maintain Current Structure

- Manager Hiring
  - Use passive strategies when possible, i.e. indexing
    - Remove performance chasing
    - Remove emotions
    - Remove conflicts of interest
    - Lower fees
  - Not all asset classes can be indexed
    - Analyze previous hires and learn from the past
    - Has our manager search process been successful?
Maintain Current Structure

- Manager Firing
  - Adopt minimum tenure, ex. 7 years
    - What is a “market cycle?” When does it start and end? This can only be known ex-post facto.
    - Did we hire them after their strategy was fully valued?
    - Has our manager firing process been successful?
  - Can fire for non-performance reasons before tenure:
    - Personnel or ownership change
    - Strategy change
    - Fee change
    - Asset allocation change at plan sponsor level
Maintain Current Structure

• Rebalancing
  – Adopt objective triggers
    • Time or ranges
  – Back-test based on strategic asset allocation
    • Consider with and without illiquid assets and adjust triggers that optimize expected outcome
  – May hire overlay manager to implement
A Powerfully Simple Example

Does your pension plan beat the 60/40?

As of December 31, 2018, a 60% allocation to the S&P 500 and 40% allocation to the Barclays Aggregate Bond Index (rebalanced quarterly) had the following average annual returns (AAR) and standard deviations (SD):

- 3-Year: +7.76% AAR 6.83% SD
- 5-Year: +6.22% AAR 6.79% SD
- 10-Year: +9.48% AAR 6.76% SD
- 15-Year: +6.51% AAR 9.42% SD
- 20-Year: +5.59% AAR 9.80% SD

If not, what steps are being taken to improve?
Unbundle Investment Consultant

- Incorporate rules-based disciplines using part-time and project-based investment consultants
  - Diversify strategic thought with different consultants
  - Lower fees
- Hire pure performance monitor
  - Remove conflicts by separating strategy and reporting
- Hire rebalance professional
  - Custodian, performance monitor, overlay manager
Is There a Better Solution?

“Personnel Risk”

“Bottleneck”

“Lone Source of Advice and Reflection”

“Performance Attribution Confusion”

“Not Strategically Diversified”

“Delayed”

“Conflicts of Interest”

“Expensive”
Multiple, Multi-Asset Class Managers

- Multi-asset Class (MAC) manager:
  - Invests in all asset classes—“one-stop-shop”
  - Real-time execution of strategy
  - Economies of scale = Lower fees

- Delegate and Diversify
  - Greatly reduce INVESTMENT CONSULTANT and BOARD LEVEL decisions—eliminate conflicts and delays
  - All 5 investment consultant duties now diversified
There is a Better Solution

Plan Sponsor

Investment Policy Statement

MAC Manager A
MAC Manager B
MAC Manager C
MAC Manager D

"No Personnel Risk"
"No Bottleneck"
"Diversified Source of Advice and Reflection"
"Performance Attribution Clarity"

"Yes, Strategically Diversified"
"Not Delayed"
"No Conflicts of Interest"
"Inexpensive"
Multiple, Multi-Asset Class Managers

- Implementing the 5 Consultant Duties
  - Strategic Asset Allocation
    - Broad Investment Guidelines—“A wide berth”
      - Rarely need to be changed, if so, consult MAC managers
      - MAC managers execute independently
      - MAC managers execute in real time
  - Tactical Asset Allocation
    - MAC managers decide independently
## Multiple, Multi-Asset Class Managers

- Implementing the 5 Consultant Duties *(continued)*
  - Manager Hiring
    - One-time, then infrequently and carefully
  - Manager Firing
    - Minimum tenure rules apply
  - Rebalancing
    - Automatically within MAC managers
    - Objectively among MAC managers by plan sponsor
      - Time or %
Multiple, Multi-Asset Class Managers

• Other Benefits
  – Performance monitoring
    • Independent performance monitor is optional
    • Add performance returns, then divide by number of MACs
    • Creates apples-to-apples comparison
  – Lower fees
    • Savings up to 60%
  – Active vs. Passive question solved (diversified)
    • MAC managers determine which assets are indexed
Additional Resources

- Benefits Magazine—IFEBP.org
  - 3 Simple Strategies for Adopting a Passive Investment Consulting Approach—May 2019
  - Multi-Balanced Model: The Missing Link in Investment Approaches?—July 2014
Key Takeaways

• Institutional investors tend to lose value when making changes to asset allocation and managers
  – Make fewer decisions with a rules-based approach
• If your investment consultant is too active or loses value, a passive or rules-based approach will improve future outcomes
  – Ask consultant to quantitatively prove value-add
• 3 simple ways to implement
  – Adopt Rules, Unbundle, Multiple Multi-asset Class