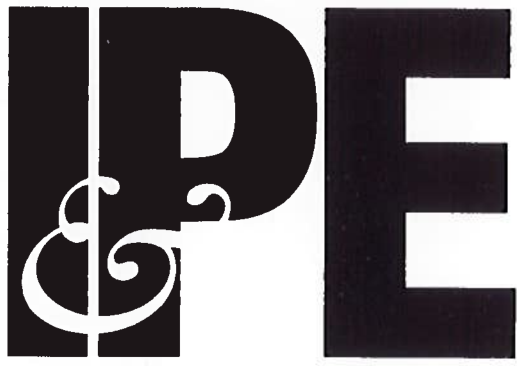

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Talking heads

IPE put some questions to pension consultants and fiduciary managers, here is a selection of their views

The questions

1 A 2013 study by Jenkinson, Jones, and Martinez of the Saïd Business School, UK, questioned the ability of US consultants to select asset managers. What can you say in defence of your firm's processes and track record in this area?

2 Institutional investors have been urged to allocate long-term capital into the real economy. What are the biggest challenges that your firm faces in this area?

Aon Hewitt, UK

1. We know that active equity management adds significant value. Our track record shows that clients that followed our recommendations have seen outperformance in their portfolio (over 2% pa ahead of benchmark over three to five years). This relies on the conviction and insight to pick, hire and fire managers, as not all of those chosen will outperform, particularly over shorter periods. The conviction and insight comes from the right combination of our capability and our clients' governance. Broad mandates are more successful, particularly with equities. The use of active management can be improved with a combination of higher-conviction, higher active risk managers and/or low-cost index funds. There is a simple truism: if active management works, constructing a mandate to buy stocks in which the manager has little conviction makes no sense. Traditional 'lower risk' benchmark-driven mandates force managers to buy stocks that they do not expect to return. As a result, any benefit to active management is diluted. Again our experience shows this. Where we are asked to select on tightly defined mandates they achieve lower outperformance. The results of the recent study reflected these narrower mandates.

2. We believe that these investments form a valuable part of a diversified portfolio of growth assets. We find these investments attractive at a time when the deleveraging of banks has reduced funding. Pension schemes can sacrifice some of their excess liquidity and harvest the premium available on these illiquid assets while benefitting from the diversification they provide from other growth assets. Successful investment in this area is based on several factors. First, recognise that the assets are not homogenous. This is less about selecting the right asset class and more about backing the right managers and teams to deliver returns. The risk and return characteristics of the different types of private assets will vary markedly. Second, diversification is key. Different strategies, managers, sectors, geographies, and vintages should be balanced. Third, understand the illiquid nature of the assets. It will take time to build the portfolio and you do not want to become a forced seller so sufficient liquidity needs to remain in the wider portfolio. This is a challenge for DC schemes likely to insure portions of their asset in the medium term.

Tim Giles, partner, Aon Hewitt

Hymans Robertson, UK

1. The US equity market is one of the most efficient capital markets and, therefore, one of the most difficult in which to consistently add alpha. The opportunities are greater in markets where there are barriers to investment such as lower liquidity, higher transaction costs, less transparency and greater complexity. Our preference is to use active management where it is necessary to access a market opportunity, or as part of the risk management process.

In most situations, asset allocation will have a greater impact on risk-adjusted returns and their ability to meet their liabilities than the impact of active management relative to indices. Hence, the focus of our research is on asset allocation and capital markets, with manager research as part of the implementation process. However, asset allocation and implementation are linked and our manager research reflects this. This is particularly the case in alternatives.

Manager selection is important, of course, and we have a proven track record of success. Our independently audited accountability report, which covers the 10 years since Q1 2004, shows that our manager picks in 17 out of 20 asset class categories have outperformed their benchmarks by an average of 2% pa over every meaningful time period.

2. Our clients have been investing in venture capital and infrastructure for years; some for decades. The illiquidity premium can be attractive for those that have the requisite long-term investment horizon and governance capabilities. Many of the recent opportunities in direct corporate lending derive from the outcome of the credit crisis and bank deleveraging. A number of these offer the prospect of attractive returns reflecting barriers to market access, an illiquidity premium and a complexity premium.

As long-term investors, many pension funds are well placed to be the providers of capital; many of our clients are doing so. The challenges they face derive mainly from the reducing scope for (private sector) mature pension funds to maintain long-term programmes investing in illiquid assets, the length of time it can take to establish allocations, the need for adequate diversification, especially by vintage, and the high fees charged by managers, including fees on undrawn assets. Managing investments in a number of close-ended vehicles is also a challenge to most schemes. Charging high fees can sometimes be justifiable; often it is not. We look for managers that are properly aligned and incentivised.

John MacDonald, head of manager research, Hymans Robertson

Coninco Explorers in Finance, Switzerland

1. The US market is efficient and specialised, with defined management styles and processes. The approach to skill selection is more complicated than in other parts of the world because it requires a consultant who will not merely apply a set of methodologies. In order to generate added value compared with indexed management, he must have his own views on the development of the financial markets and adapt the positions of each asset manager according to these views. This viewpoint corresponds to our European vision since, unfortunately, many US asset managers offering arbitration capacities for capitalisations, economic sectors and value or growth positions, thus creating added value, do not offer enough products that are available to investors outside the US. This is a specific need for us since we have clients who want to target this specific area.

2. The greatest challenge we face in the field of venture capital is the 'millésime', or vintage. The initial effect of a first investment and its ultimate rate of return will have an influence on the investors' attitude regarding the continuation or interruption of this investment opportunity, particularly if the listed shares come into correlation with the stock market. In terms of infrastructure projects, we were faced with a lack of efficient investment structures in 2003, when we started investing. Today, the offer is more extensive and our clientele is open to this type of diversification to broaden the base of opportunities in the market. Regarding loans to small businesses, our clients are not yet prepared to consider this diversification. We first tried to introduce such projects 15 years ago. The withdrawal of commercial banks from this market has led us to reconsider this opportunity. The market offer is not, however, relevant.

Olivier Ferrari, founder and CEO, Coninco Explorers in Finance

Kirstein, Denmark

As a regional, local consultant, we distinguish ourselves from the large international consultants that the Greenwich survey covers.

Thus, in general terms, we would not often bump into the same type of flows and capacity issues that international consultants face in their manager selection with their large amounts of assets under advice. The study confirms our conventional wisdom that being too big is not necessarily an advantage in independent manager selection.

In addition to this, we do not work with a preferred list of managers but tailor every search to our clients starting with a new search from scratch or look-through of the manager universe for new and interesting candidates.

Our manager selection follows a well documented proprietary methodology and process, which includes a well-balanced focus between quantitative and qualitative elements. Like our international equivalents, we do not select solely on performance, which is why we are emphasising the need to understand the so-called 'soft factors' mentioned in the study.

However, the discipline and capabilities to perform this analysis vary across different manager selectors as some tend to focus too much on peripheral areas of the management itself or simple box ticking, while others focus only on identifying the red flags. However, a good manager selector is one who knows in detail what they are looking for and who can relate to and sort through the vast amount of soft information.

In our region there is no 'natural' – or legally required – buying base of our services. We would, therefore, not exist if we could not show the value-added from our manager selection. We therefore often disclose the combined track record of our shortlist, as this is the result of an interactive dialogue and thorough analyses from our side. However, we do not disclose the individual underlying managers.

However, we can show value added in our manager selection by beating the benchmark by the best performing managers up until the selection point on almost all asset classes with the exception of a few small asset classes, which were not investigated in the study.

Nikolaj Enevold Waldhausen, head of search and selection, Kirstein

Mercer, UK

1. The Saïd Business School study focuses on US equities. Most investors are aware that the US equity large-cap market is highly efficient in a technical investment sense. Given the consequent lack of persistent added-value – or alpha – from individual investment managers, it is unsurprising that institutional funds and their advisers struggle to outperform. It never makes sense to play a losing game. For this reason, Mercer had advised clients to either look to invest globally in equities, or to manage US large-cap equities in a passive or smart beta manner, combined with actively managed mid-small cap mandate. We follow a robust manager research process which centres around identifying 'idea generation' and the efficiency with which ideas are incorporated in portfolios. We apply formal ratings to products, and measure the performance of our 'A' rated strategies. We find, to take the mid-small-cap US equities, for example, that our 'A' list has outperformed the relevant index by 1.1% pa over three years, and 1.5% pa over 10 years to end-September 2013. We have 10-year track records for 47 product categories. The average of the 10-year value-added figures for these categories is 0.8% pa.

Andrew Kirton, Mercer's EuroPac investments leader

◄ **2.** As with any investment class or theme, it is difficult to generalise as to the suitability of 'real economy' investing for European institutional investors. The retrenchment of traditional providers of long-term finance to sectors such as infrastructure, property and wider corporates creates opportunities for alternative forms of patient and flexible capital. If appropriately structured, managed and held within a well–diversified and constructed portfolio, many of these can, in turn, provide attractive investment opportunities.

Headline challenges often include illiquidity, client resourcing and governance constraints, access to high-quality managers, and risk appetite. In one form or another, many pension scheme investors in Europe are on a de-risking journey and face a limited (albeit, in many cases, indeterminate) final investment horizon. Many are also operating subject to a limited governance budget. This can make it difficult to allocate to longer-lived, often less liquid investments that do not fit the traditional financial risk asset paradigm. Against this, prudent and well-structured management arrangements and a robust approach to risk management, our experience has also been that these challenges can be overcome for the right investment.

Toby Buscombe, global head of infrastructure in Mercer's investments business

Novaster, Spain

1. Our asset manager selection is based on a thorough preliminary study of our client's goals and constraints. Regarding this, we make a selection of asset managers that suit best our client's profile and then deliver a questionnaire. We set threshold criteria that managers should meet before putting forward a manager to clients. In the end, the client should make the decision – to choose the manager – based on our assessment. The key point for us is explaining to them the strengths and weakness of each asset manager to aid the decision.

2. The main challenges are education – explaining to clients the type of investments they are facing, why we believe they are suitable, and research – finding the best vehicles in which to invest.

Diego Valero, chairman and CEO, Novaster

Redington, UK

1. We have sympathy with the conclusions of the study. In reality, few managers (and manager researchers) can deliver consistent risk-adjusted returns in liquid and developed markets. However, there are asset classes, strategies and environments in which good research is invaluable in selecting the best managers.

We have found that some managers, in some asset classes and environments, have the ability to outperform consistently.

We focus our research efforts on these areas with a seven-step framework to concentrate on the best future (risk-adjusted) return opportunities. It also puts us in control of the wider universe according to a classification system we have devised.

Not having to research every asset manager in every category gives us the freedom to offer coverage of prospects in the most important categories. We use a disciplined proprietary process for screening and selecting managers, focused on their competitive differentiation.

While it is consistently difficult to identify the best manager in every category, we believe it crucial that we help clients avoid the worst ones. Our focus on downside risk and early warning signals differentiates us. Anecdotally, we are told that we have consistently helped our clients capture opportunities in specialist, 'niche' or emerging strategies ahead of their peers.

Mitesh Sheth, director of strategy, Redington

2. We have allocated over $4bn (€3bn) to these types of investment in the last year. We believe that banking regulation changes are likely to continue to provide opportunities for institutional investors to lend into markets usually dominated by banks at more attractive margins. For example, senior secured SME lending at margins above 600bps over LIBOR or infrastructure lending at margins above 200bps over equivalent maturity Gilts, to provide risk adjusted returns as well as diversification.

When allocating to these less liquid asset classes, it is instructive to focus on a number of key factors: experience and track record of the team allocating to these opportunities; sourcing ability to originate deals that the whole market doesn't see and to commit capital in an appropriate time; longevity of the investment platform; ability of the team to effectively structure deals to allow for robust risk management; and experience of the team in managing stressed deals and deals that require restructuring or indeed enforcement by the lender

This does not provide an exhaustive list, but if an investor gets comfortable with all of these factors while also retaining ownership of loans on its own balance sheet, they should sleep easily.

Pete Drewienkiewicz, head of manager research, Redington

Sigma Consult, Belgium

1. A first key element before starting the selection process is the definition of the client's investment philosophy and objectives. This definition (as clear as possible) will result in a combination of active and passive investment styles, and the aim of the selection process is to pick up the best 'fits'. Not all selection processes have similar goals. A second key element is the definition by or with the client of non-investment related parameters (such as proximity of asset manager) to be taken into consideration. As a result, the selection process is not a 'beauty contest' (which was the scope of the study).

Jean van Caloen, partner, Sigma Consult

Trident Consulting, Ireland

1. Clearly there are markets and time periods that are more receptive to active management than others. A few years ago, it was common for active management in main markets to be dismissed as unlikely to add value, and the view that active management only adds value in peripheral markets was regularly expressed.

We are realistic about what active management can deliver and we accept that it doesn't always appear to work. But I think the debate has matured to a point where many people now accept that an active manager can be an asset even in main markets during particular periods of time – perhaps turbulence – even when it doesn't appear to be delivering. A good example was European bond markets, whereby passive managers were forced to hold upwards of 40% in Italian bonds when the 2008 crisis hit – an uncomfortable level of risk which thankfully didn't lead to losses to passive investors. Active managers could, of course, choose exposure taking into account multiple criteria.

2. The marriage of institutional funds to companies and infrastructure projects is a key ingredient for sustained economic wellbeing and growth. But I don't know of any European country doing a good job in this area. Institutional funds are drawn to larger companies where the governance is stronger while unproven smaller companies and infrastructure projects struggle to attract funding. Because of the difficulty that smaller companies have in attracting funding, the chances are that the returns from this sector would be strong overall, once allowance is made for the inevitable failure rate. The marriage problem cannot be solved by investors nor do I believe that they can be solved by any one sector. I would like to see an EU initiative to tackle barriers to investing in smaller companies or infrastructure projects. Two key areas would be the encouragement of stock exchange listings for smaller companies, and help for smaller companies in improving their governance structures to a level that makes institutional investment practical.

John O'Connell, founder, Trident Consulting

Towers Watson, UK

2. The real economy has become an area of increased focus for institutional investors as traditional funders – governments, banks or corporates – have come under increasing financial and regulatory pressure over recent years. We believe this offers a number of investment opportunities in both the direct lending and infrastructure asset classes.

In infrastructure, this has been characterised by governments incresingly looking to access institutional capital directly from pension funds, insurers as well as sovereign wealth funds. We are supportive of a growing appetite for these types of assets, where there are fundamentally sound projects or assets underlying the investments. The ability to invest in assets struggling to attract capital, often in capital intensive assets or projects, is attractive and offers the opportunity to find risk-adjusted returns. Further, the ability to do so in assets that derive a significant element of their returns from on-going yield is particularly attractive in a low-yielding environment.

In the US, direct lending strategies have long been part of the shadow-banking infrastructure. In Europe, this is still an emerging asset class for institutional investors, as it has previously been dominated by banks. While we expect banks to continue to dominate, an institutional lending market should emerge as banks look to deleverage. We are, therefore, supportive of a growing appetite for strategies such as lending to sub-investment grade and smaller companies that cannot access public markets.

There have been numerous impediments preventing groups in these asset classes from fundraising, among these being factors which makes these asset classes attractive – a scarcity of risk capital and a desire for liquidity. When looking at these, investors' first consideration is whether there is sufficient compensation for locking up capital. The answer is subjective and needs to be considered in the context of an individual investor's portfolio and desire for liquidity. Also, an issue is the cost of accessing these strategies. While recognising that a meaningful infrastructure is required to manage these strategies, investors need to fund these assets from liquid alternatives so the net-of-fee proposition must be compelling on a relative basis to justify locking up the capital.

Duncan Hale, global head of infrastructure and Gregg Disdale, direct lending specialist, Towers Watson