CHAPTER 1

The Pendulum Swings Back in Asset Management

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Fiduciary Management is a way of organizing the management of sizable investment portfolios. The growing interest in this phenomenon reflects the beginnings of an historic shift in the approach many institutions are taking to investment management. After several decades of expanding the range of actors involved in managing an institutional portfolio, there is increasing recognition of the problems created by the involvement of this large cast of characters. When many are involved, it turns out, no one is fully responsible.

Fiduciary Management can be viewed in Hegelian terms: thesis, antithesis, synthesis. In the context of investment management, the thesis was the balanced manager: As institutional investment was growing more than a century ago, the initial response was to turn money over to a single manager who would select all investments, manage the portfolio, and take full responsibility for all investment issues and decisions. Antithesis came about half a century later in the form of Modern Portfolio Theory. It encouraged the view that specialized managers could achieve better results than generalists, and this led institutions to put together armadas of managers under the guidance of investment consultants. But this has created problems in achieving comprehensive risk management, strategic decision making, and effective organizational governance.

The Fiduciary Manager is the synthesis: This Fiduciary Manager oversees a decentralized, outsourced array of investment managers, but the Fiduciary Manager also centralizes responsibility in one person or organization.

THE FORCES OF HISTORY

In order to understand the need for the Fiduciary Manager approach that is being advocated here, it is important to understand the evolution of

investment management in the advanced industrial countries. Much of the appeal for the concepts underpinning the idea of a Fiduciary Manager is a response to the shortcomings that many investors see in the current approach to managing institutional portfolios, especially pension funds. Thus, it is valuable to understand the course of events that has led to the current model.

As pension funds began to be created in the developed nations more than a century ago, employers had to decide what to do about funding these plans. Should they simply pay pension benefits out of current revenues, or should they put aside money on an ongoing basis to reflect the growing future pension obligations that they were incurring?

In the United States, tax policy accorded with accounting principles and led to the development of funded plans. Accountants said that since liabilities were accruing each day an employee worked, then assets should be set aside to match those liabilities. Because tax law permitted deducting the funds that were set aside as a business expense, thereby lowering a company's tax burden, employers were prepared to embrace the advice of the accounting profession and put aside funds for their pension plans. The Netherlands took a similar approach, as did Japan, the UK, and several Commonwealth countries, including Canada, Australia, and South Africa. In certain European countries, meanwhile, some plan sponsors chose to fund their plans but others operated them on a pay-as-you-go basis or on a book reserves basis.

Among those plan sponsors who decided to fund their pension plans, a few decided they could and would manage their pension assets in house. However, most companies concluded that they were not specialists in managing investments, so they sought outside expertise for their pension monies. Some companies turned the money over to an insurance company. This permitted them to make actuarially determined contributions that would be invested by the insurance companies. The insurance company would take the risk of underfunding; if investment results did not yield enough to pay the promised benefits, the insurance company would make up the difference, and, conversely, if investment results created a surplus in the pension account, the insurance company would get to keep this money.

Others turned the monies over to a bank, typically the trust department or investment management department of the company's lead bank in the case of a large national company, or the main local bank or house bank of a smaller company. Public employee pension funds did precisely the same thing: some hired insurance companies, and others hired one of the banks in their locality to manage the growing pool of pension assets.

In almost all of these cases, when banks received money from corporate or public employee pension funds, they invested the money using a *balanced*

fund approach. This meant that all of the pension assets were invested in a single account, and these monies were invested in securities. Originally, most of the money was invested in bonds, but a number of pension funds began to add shares of stock to portfolios, particularly since the early 1950s.

In this balanced approach, the investment managers would occasionally shift the allocations between stocks and bonds based on their outlook for the respective markets. The principal investment objective was preservation of capital with some modest incremental returns. The portfolio was viewed as having two parts: the original principal and the returns on that principal, which were measured in terms of the interest received on the large proportion of bonds in the portfolio and the dividends earned by the equities that were owned.

General Mills, the cereal and foods company based in Minneapolis, Minnesota, provides an example of this early approach. In 1940, General Mills established its first Employee Retirement System Pension Fund. The fund, which was managed by Bankers Trust Co. of New York, was originally invested almost entirely in fixed income securities. In the mid-1950s, however, with the encouragement of the plan sponsor, Bankers Trust began moving into equities. And by the beginning of the 1960s, the fund would be 70 percent invested in stocks.[1]

While there were certainly many exceptions to this pattern, the General Mills story was typical of pension plans in several countries: They were invested in a balanced fund that emphasized fixed income securities until the 1960s, when important developments in investment theory began to work their way through the investment community.

THE RISE OF MODERN PORTFOLIO THEORY

In the early 1950s, Professor Harry Markowitz and other academics, principally in the United States., had begun to systematically analyze investment patterns and returns. The growing availability of computers would soon mean that for the first time, it was possible to analyze massive amounts of data about the movement of prices of investment instruments as well as the returns that were, or could be, generated by large numbers of alternative portfolios.

This academic work generated a series of important ideas, which would take hold in the investment community in two ways. First of all, investors read and noted the work of academics. Perhaps more importantly, the Master of Business Administration (MBA) degree was becoming an increasingly important credential among those entering the professional investment world, and those who studied for that degree

took finance courses in which the new ideas, called Modern Portfolio Theory, were taught to them. There were several elements of Modern Portfolio Theory, or MPT, that significantly altered the investment landscape.

One was the idea that asset allocation was the principal source of a portfolio's returns. Being in the right markets, it was said, was far more important than being in the right securities. In a landmark article published in the *Financial Analysts Journal* in 1986, Gary P. Brinson, Randolph Hood, and Gilbert Beebower argued that asset allocation was responsible for 90 percent of the variability of returns achieved by a portfolio, while securities selection and the timing of transactions accounted for less than 10 percent of the returns that were earned.[2]

A second important finding had to do with the management of risk. Until the middle of the twentieth century, investors were advised to avoid risky assets. The "prudent man rule" in the United States, and similar concepts in other countries, took the view that each investment had to be "prudent." But Modern Portfolio Theory argued that the risk and return associated with a single investment was essentially immaterial. As long as risky investments had a low correlation coefficient with each other, it was possible for investors to modulate the risks by creating a diversified portfolio. This meant it was safe for investors to hold riskier individual investments in the hopes of generating incremental returns.

This mode of analysis sharply altered perceptions of what was appropriate for an institutional portfolio.[3] As these ideas took hold, "the prudent man rule" would be refocused to examine an entire portfolio rather than individual investments. The prudent man rule in the United States, and similar standards developed by the courts in other countries, essentially said that an investment manager could not be held responsible for an investment that performed badly if the investment was something that a prudent investor could have purchased in good faith. In this realm, too, MPT shifted the focus to the entire portfolio; within reason, risky investments were acceptable as long as the portfolio in the aggregate reflected a prudent approach to risk.

In 1974, the U.S. Congress enacted The Employees' Retirement Income Security Act (ERISA) which established standards for the fiduciaries of retirement plans. The Act stipulated that fiduciaries act with the "care and skill of a prudent person familiar with such matters. . . ."

SUPPORT FOR SHARES

A third important theme of MPT was that stocks consistently outperformed bonds. The emergence of new levels of computing power in the 1960s made

it possible to demonstrate what many observers had always believed: that over the long run, and on average, stocks significantly outperform bonds, and bonds outperform cash. Nowadays this is simply seen as proof of the iron law of the financial markets. On average in the longer run, an asset delivers a higher return because the risks associated with that asset are greater in terms of periodic volatility.

The Center for Research in Securities Prices at the University of Chicago amassed monthly securities prices going back to 1926, and a variety of academics used this data to provide rigorous analyses of the returns that could have been generated by various combinations of securities and various investment strategies. These showed that over the long run, despite the 1929 Stock Market Crash and the Great Depression, for almost every extended period of time, stocks outperformed bonds. This research spelled out the extent of the differences and made a convincing case that prudent long-term investors could safely increase their holdings of equities.

There would be a series of further refinements of this idea. A University of Chicago graduate student named Ralf Banz would use the CRSP data as the basis for a doctoral dissertation in which he would demonstrate that the shares of smaller listed companies outperformed the shares of larger companies. Banz, who would return to his native Switzerland and become an investment manager at a private bank in Geneva, essentially created the concept of small cap stocks as well as the view that these were highly attractive investments.

Going forward, other scholars would demonstrate that using different time frames, small cap stocks did not always outperform large cap stocks. But the importance of Banz's work was not so much that he discovered the characteristics of small stocks, but that he essentially framed a debate in which different segments of the equities market were identified and compared with others.

Concepts like small, medium, and large cap stocks, or growth stocks versus value stocks would become standard tools in examining the market. Academia provided fodder for the old Wall Street adage that there was not a stock market, there was a market of stocks. Moreover, this marketplace was a highly variegated and differentiated forum for trading investments that fell into a wide range of categories.

Another important step in the evolution of investment management was the promulgation of the total return approach. History and legal principles had led many institutions to think in terms of principal and interest. The principal was to be left untouched while the interests could be spent. But several landmark reports published by the Ford Foundation in 1969 altered that view. The first was a report by a blue ribbon panel of investment

experts, which concluded that educational endowments ought to take a "total return" approach to their investments.[4]

At any point in time, these institutions had a single pool of capital, the reports said, and there was no need to make a dichotomy between principal and interest. Similarly, there was no reason to treat returns that came in the form of dividends or interest differently from returns that came in the form of capital appreciation. The report argued that institutions should take a total return approach: A portfolio was essentially marked to market at various points in time; its value was then compared against previous points in time; and its total return was the most accurate and meaningful measure of how well it was faring.

In essence, this approach said that a dollar's worth of income was equal to a dollar's worth of growth. These two sources of value were completely fungible, and the only thing that mattered was that the portfolio be worth more at the end of a period than it was at the beginning. The Ford Foundation helped institutions understand and implement the total return approach by publishing another report, called *The Law and the Lore of Endowment Funds*.[5]

In 1972, in the United States, the National Conference of Commissioners on Uniform State Laws recommended the adoption of the Uniform Management of Institutional Funds Act, which sought to codify the findings of the two Ford Foundation reports. If an institution needed cash to meet certain liabilities, that did not mean that it had to invest in fixed income securities that would generate interest to meet those obligations. It was appropriate to invest in equities and then to sell some of those equities to generate the required cash.

Yet another theme that began percolating up at this point was that investment managers who specialized in specific, narrowly defined segments of the market did better in those segments than generalist managers who placed some portion of their portfolio in those segments. Specialization was a major theme in many endeavors throughout the twentieth century, and research was indicating that it was important for investing as well. Large cap growth stock managers typically did better in large cap growth stocks than balanced fund managers; small cap specialists did better at small cap investing than generalists; and so on.

THE NEW PARADIGM

The results of this theoretical revolution created a new paradigm for investors. Once investing seemed to be defined by a bottom-up approach: Astute investors watched the market, and one by one they perceived opportunities. Did Daimler-Benz shares appear to be undervalued? Then buy a

little of that. Did Kellogg have a popular new cereal? Then buy some shares of that company. Suddenly, theory said that was wrong; investors needed to take a top-down approach. They needed to specify their expectations for various markets going forward, then determine an asset allocation, and then invest money within the various asset classes. Moreover, the investments within those asset classes should be made by managers who specialized in those asset classes. Their job was not to decide how much to put in those areas or, indeed, whether to be in the market at any point in time. That was for some central decision-making authority. Instead, these managers were given money that was to be invested in their specialty.

These changes worked their way through both the supply and demand side of the market for investment services. In terms of the demand side, institutional investors became increasingly likely to conclude that the balanced fund approach was not good enough. How could a single manager decide how much to put into equities versus fixed income? And how could that manager then choose among the thousands of stocks and bonds that were available in the U.S. market, never mind foreign markets that were just coming into the consciousness of U.S. institutional investors? The new approaches that were emerging said that a balanced manager would inevitably produce less than optimal results because that manager did not have skills equal to those of the various specialists.

As discontent was rising among institutions, on the supply side, as the 1960s unfolded, substantial numbers of American investment professionals would leave the trust departments and the investment departments of insurance companies in the United States, and they would set up investment management firms. These firms would not propose to be all things to all men, like their previous employers. Rather, they would specialize. Fisher Francis Trees & Watts managed only bonds, for example, and, at a later stage, specialist bond houses would specialize further in government bonds, higher yield corporate bonds, and other specific types of fixed income investments. Many other new firms invested only in growth stocks, or value stocks, or they focused on small versus large caps, and so on.

As these firms were created during the heady days of the 1960s, they developed track records based on a total return approach, and their results were frequently vastly superior to the returns being generated by highly cautious banks running balanced accounts.

Pension funds took note of the differences in returns, and they began hiring groups of managers, giving each a portion of the pension fund portfolio to invest in a specific asset class. The new paradigm said the pension fund's management should determine the asset allocation, along

with a range of sub-allocations, and then the plan sponsor should hire specialized managers to invest in each of these asset classes.

But how was a plan sponsor to make these important decisions? Remember, the reason plan sponsors had hired outsiders to manage pension investments in the first place was because the sponsors felt that they did not have the investment expertise to do the job themselves. How then were they to make decisions on asset allocation and on the selection of managers?

The answer was that they would use investment consultants. A vast army of consultants would arise to provide the expertise plan sponsors needed to oversee their portfolios in the new paradigm. Originally, these consultants gathered and analyzed data about the returns achieved by investment managers. But the consulting services that were being created in the 1960s would soon go on to offer plan sponsors advice on asset allocation. They would then help the plan sponsor select investment managers. And they would also help monitor and oversee the managers that had been selected, assisting in the termination of those who were not meeting expectations and the selecting and hiring of managers to replace them. The consultants would also help the plan sponsor determine whether there were new asset classes that could and should be added to the asset allocation.

Again, the General Mills pension fund demonstrates the changes that were taking place. After several decades of having Bankers Trust manage its entire pension fund, in the mid-1960s, it replaced this bank with four independent investment management firms.[6]

As the new paradigm played out, institutions would be moving to large numbers of managers. By the 1980s, it was not at all unusual for a pension plan to have two dozen managers. The finest expression of this view was the AT&T pension plan. By 1974, it had 75 fund managers. AT&T (which then consisted of the parent company, which provided long distance telephone service, and a group of local operating telephone companies that would later be separated from AT&T in an antitrust case) had initially used only large U.S. banks as managers. But in 1971, it hired T. Rowe Price, an independent investment management firm, and in the ensuing two years it added 16 more investment advisory firms and two insurance companies to its ranks of managers.[7]

A few years later, however, AT&T and others began to call into question some aspects of the specialized manager approach. A pension plan that had a large number of managers would inevitably find that some managers were buying what others were selling, and surely the above-average performance being achieved in some segments of the market had to be offset by the below-average performance being achieved elsewhere.

THE RISE OF INDEXING

There was also growing concern about *closet indexing*. One of the most controversial academic ideas that grew out of the 1960s was the efficient market hypothesis. This said that the stock market was an efficient market. Efficiency in this context did not mean that a market operated effectively in terms of completing transactions and handling the record keeping associated with these transactions. Rather in the academic context, *efficiency* meant that the stock market quickly incorporated information, so that at any point in time the prices of securities rather accurately reflected all that was known and knowable about the issuer's prospects. In the nineteenth century, perhaps, a company might discover oil in Texas or in Indonesia, and the news would not arrive in New York or London for days. Or a company's main factory might have a serious fire in Cleveland or Düsseldorf, and the market would not hear about it. But by the mid-twentieth century, advances in telecommunications and disclosure regulations meant that news quickly arrived at the stock market and was immediately factored into the share prices. If British Petroleum found a major oil field Tuesday morning, the market would quickly know that, and the price of BP shares would quickly change that same morning to reflect the company's enhanced prospects.

As information flows were accelerating, in the same period regulations with respect to the use of nonpublic information were imposed in many markets, so that those who were privy to inside information were not allowed to use it in buying and selling investments.

To be sure, not all segments of all markets were efficient all the time. The market for small cap stocks, for example, was less efficient because there were fewer analysts and others watching smaller companies. And sometimes major markets would act irrationally as investors were caught up in emotional responses to events. But the theorists argued that most major securities markets in the United States and Western Europe, for example, were generally very efficient.

The efficient market hypothesis said two things to investors. On the one hand, there was substantial evidence that the stock market did better than the bond market over the long run, which was a consequence of the existence of a risk premium as a reward for taking on higher risks. On the other hand, efforts to pick the best-performing individual stocks were essentially doomed; the average investment manager could not outperform an efficient market, and once a manager's fees and transaction costs were deducted, their performance was often below that of the market as a whole. Managers who had extraordinary skills could beat the market, but the average investor could expect to do about average.

How could investors gain exposure to the broad market without incurring the costs of management? Again, the rise of computing power made it possible to achieve this objective. It was possible to develop and maintain a portfolio that would contain all of the stocks comprising a major index. A little later, computer programs would indicate that it was possible to shadow the index using fewer stocks than the universe, making these portfolios even more cost-effective. In the U.S. market, the Dow-Jones Industrial Average had only 30 stocks and was not regarded as reflective of the broader market, but the Standard & Poor's 500 Stock Index was considered representative of the U.S. equity market. And beginning in 1971,[8] several investment management firms, with Wells Fargo taking the lead, began to offer index funds.

Indexing was a very controversial approach. Indeed it was decried in some U.S. investment circles as "un-American," perhaps even unpatriotic. Choosing to index essentially said that the plan sponsor agreed that it couldn't beat the market, so it would settle for matching the market, giving up the opportunity to outperform in return for the guarantee that it would not underperform. This form of "passive" management was attacked by "active" managers who insisted that there were plenty of examples of managers who had, in fact, beaten the market, not only in any given year, but often year after year. The theoreticians of indexing agreed that outperformance was possible, just as gamblers sometimes beat the house, but beating the market was a zero sum game; those who outperformed had to be matched by others who underperformed. And they argued that mathematically, those who outperformed, even for an extended period of time, did not necessarily have any more skill than a gambler who kept winning at the roulette wheel. Institutional investors were being told that there might be exceptional managers who might be able to find managers who could outperform the markets in which they were investing, but it would be exceedingly difficult to find those managers and achieve exceptional results consistently over the long term.

DISCONTENT WITH THE PARADIGM

While some turned to indexing, by the 1990s, others were seeking ways to revise the MPT-driven investment paradigm in a fashion that corrected what they saw as weaknesses in it.

One major concern was that the fleet of managers used by pension funds had often grown too large and unwieldy. The response at some institutions was a decrease in the number of managers. In some cases mandates were defined more broadly. In others, plan sponsors simply hired fewer managers in each of the categories that they had established.

A more basic concern was that the MPT paradigm meant that nobody really had broad responsibility. The division of labor among plan sponsors, consultants, and investment managers meant that everybody had a narrow range of interests. In a legal sense, the plan sponsor was a fiduciary, responsible for advancing the interests of the plan participants. However, the various investment managers and service providers were not necessarily fiduciaries in the legal sense, and in a practical sense they were simply hired hands who had a specific job to do with little reason to concern themselves with the overall status of the plan. Those who had expertise had little overall responsibility for the plan, and those who had responsibility sometimes had little expertise.

The plan sponsor was an amateur. At many corporations, the pension plan was overseen by an assistant treasurer, one of two or three people holding that title within the company's treasury department. Individuals would be rotated through the job of overseeing the pension fund and then moved on to other treasury functions in order to groom them for broader financial responsibilities at the company.

In the case of public employee pension funds, there would be a small staff that worked for a pension board that was typically composed of representatives of the government agency. In the case of U.S. teachers' retirement funds, for example, the board would consist of a number of teachers. In the case of police and firefighters' funds, the board would contain representatives of the various categories, including police patrolmen and uniformed firefighters as well as senior officers from these two corps. The board members were typically chosen because they had been active in their labor union or other employee associations, and there was no test of their financial knowledge or acumen.

These people depended heavily on their consultants and their investment managers, but the managers had limited purviews, as did the consultants.

There was one brief attempt to rectify this in the United States during the late 1980s. Several corporate pension plans, including that of GTE, which was then a major telecommunications company, sought to develop a "strategic partnership" with their investment managers. In the case of GTE, the company singled out four major investment management firms and placed the bulk of the pension assets with these firms. They were to have rights and responsibilities that were far broader than what was contained in typical investment management mandates. These managers could, for example, allocate funds under their control among various asset classes and categories of investments. This approach was an attempt to enhance the plan sponsor's relationship with its investment managers. From the point of view of the manager, meanwhile, this was a welcome way to strengthen the commercial ties with a large customer.

It was seen by some as a return to balanced management. But this time around it was being done with managers who had teams of specialists within their own organization. Thus, it seemed to offer the benefits of specialization along with the benefits of a single manager who would exercise broad responsibility for the pension plan.

This approach did not catch on in the United States or elsewhere, however. One concern was that it was unlikely that a single asset-management firm could, in fact, effectively shift assets from one asset class or strategy to another. While it might have the requisite expertise under one roof, there would be institutional constraints that could prevent the manager from taking money from one department and giving it to another.

Despite a brief flurry of interest during which GTE officials and others discussed their approach at assorted conferences, little would be heard about this approach after the initial flurries of discussion. There were simply too many flaws in this approach. How could plan sponsors decide who would be the best strategic partners? And could these partners be equally good at managing equities, bonds, and other assets, or would some partner have more expertise in a certain area? Would partners shift between assets for the benefit of the fund, even if that would mean their overall level of fees would decline? Would assets be shifted for the benefit of the plan sponsor or to meet the needs of the manager?

THE NEED FOR FIDUCIARY MANAGERS

Thus, as the twenty-first century began to unfold, there was substantial discontent among plan sponsors and other institutions regarding the prevailing investment management structure. Too many people had a role while no one had overall responsibility. The fund managers were not allowed to share their expertise; their job was simply to manage funds according to the style that had led to their selection; to do otherwise was evidence of *style drift* and grounds for termination. The consultants were paid a per diem and gave their advice accordingly. Cynics postulated that some consultants might seek to increase their own returns and recoup the costs of their research by doling out the same data, and, perhaps the same advice as well, to their roster of clients.

Meanwhile, having outsourced much of the work of running a pension plan, the plan sponsor was likely to be a small organization with limited expertise. It was deeply dependent on both its consultants and managers, just as it was dependent on its actuaries and other experts for specialized counsel.

Fiduciary Management came into being in response to these problems. Fiduciary Management seeks to reunite expertise and responsibility. It seeks

to ensure that those who oversee managers and consultants have both the expertise to do this job and also to have close enough ties to the plan sponsor to do this job effectively.

The Fiduciary Manager cannot be an individual: it has to be a firm, and a rather large one. It can be a firm that does nothing other than serve as a Fiduciary Manager, or it can be a department of a firm with other activities and businesses, such as investment management. The only requirement is that the Fiduciary Manager be responsible to the plan sponsor—and only the plan sponsor—and that it have the expertise to oversee the funds' advisors and investment managers.

Turning to a Fiduciary Manager does not mean reducing reliance on specialized investment managers. In fact, the Fiduciary Manager is supposed to provide the expertise that a plan sponsor requires to manage a large fleet of specialized managers effectively. Similarly, having a Fiduciary Manager does not mean reducing reliance on the classic pension fund investment consultants. Again, interposing a Fiduciary Manager means that the expertise of these consulting firms could be tapped more effectively because the plan sponsor would have a better understanding of what a pensions consultant could and could not do. Indeed, the traditional pension fund consultant can stay on board, although his or her responsibilities will be more focused and redirected (for instance, in the direction of reporting on the fiduciary).

As the first decade of this century continued to unfold, a number of pension plans around the world began to examine and adopt the principle of Fiduciary Management. And their experiences suggest that there is much that other institutions could learn from their experiences.