



Building strong foundations: Effective manager line-ups

How to ensure your investment managers are fit for purpose

Building strong foundations: Effective manager line-ups

Going from good to great

We have long argued that **good governance** is a key factor that distinguishes the very successful asset owner funds of the world.

In 2007, Roger Urwin (Willis Towers Watson's Global Head of Investment Content) and Professor Gordon Clark (Oxford University) conducted a landmark study of investment governance*. The study was carried out by examining ten exemplar funds which were selected on the basis of their reputations for strong decision-making accompanied by performance success. The key conclusion of the study was that **strong governance is a critical requirement to allow organisations to achieve above average investment outcomes on a sustainable basis**.

The study identified 12 traits that are shared by the most successfully governed institutions. These are briefly summarised below:

'Core' business traits	'Exceptional' business traits
Mission clarity	Highly competent investment executive
Effective focusing of time	High level Board competencies
Leadership	Supportive compensation
Strong investment beliefs	Competitive positioning
Risk budget framework	Real-time decision making
Fit-for-purpose manager line-up	Learning organisation

* Best-practice investment management: lessons for asset owners from the Oxford-Watson Wyatt project on governance, Gordon L. Clark and Roger Urwin, September 2007.

This note is part of our **Building Strong Foundations** series which addresses these 12 factors in turn. Here our focus is on creating a fit-for-purpose manager line up. We start with making the decision of whether to insource or outsource investment management and then discuss how to develop a framework for manager evaluation. We then look at how to create alignment with managers and the potential to develop deeper relationships through strategic partnerships. Finally we summarise our approach to manager evaluation.



Deciding whether to insource or outsource

Many investors outsource all their investment activities to one or more third parties. They typically do this because they don't have the scale to develop internal resources, or because investment activity is a distraction from their core business, or perhaps they recognise that they do not have, and are unlikely to be able to build, the core competencies required to manage investments.

Few, if any, investors insource all investment activities. There is however a trend amongst the largest investors to undertake more and more investment activity in-house. The more obvious motivations for doing so include having greater control of the investments and investment outcomes, exploiting a competitive advantage and improved net of fee investment outcomes:

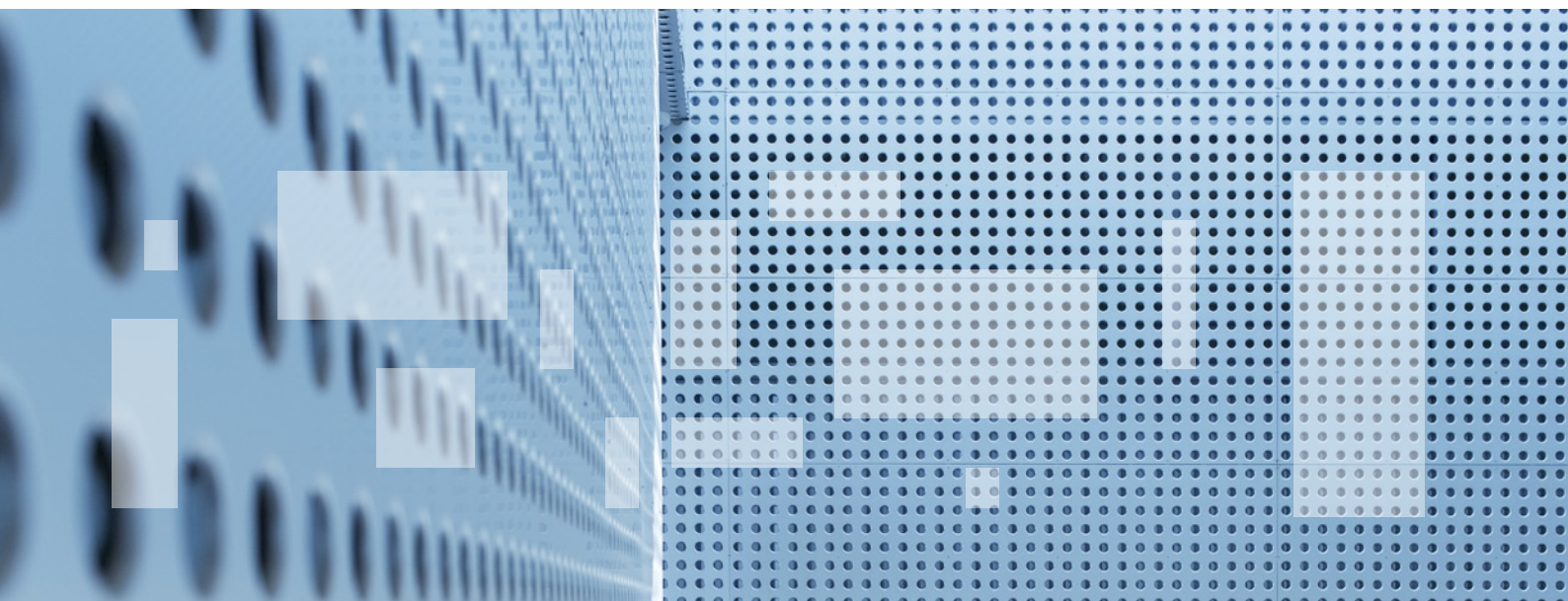
Academics Clark and Monk¹ identified five key factors pushing institutional investors to move asset management in-house.

- 1. Access:** There are instances where the third party vehicles are not attractive, and access to a given asset or market can be more effectively achieved on a direct basis.
- 2. Alignment:** Principal-agent problems are pervasive in the asset management industry, and some institutional investors view in-sourcing as a useful mechanism to minimise agency costs and issues.
- 3. Capabilities:** By developing an investor's internal resources, all aspects of the organisation's capabilities are improved, as internal teams can identify 'unknown unknowns' about the business.
- 4. Performance:** Perhaps the most cited reason for in-sourcing by institutional investors is the desire to maximise net-of-fee investment returns.
- 5. Cohesiveness²:** Managing assets in-house offers an investor the ability to think critically about how to tailor a portfolio to meet its needs (as opposed to trying to cobble together a series of external mandates).

A growing number of investors, too, are opting for what is sometimes referred to as an outsourced CIO model whereby they delegate all activities that would be undertaken by an in-house investment team to a specialist third party who then manages or contracts out all further investment arrangements.

¹ Clark and Monk: Principles and Policies for In-House Asset Management.

² Clark and Monk use the term 'Sustainability' but we have replaced this given the overlap with other uses of that term in the investing context.





Developing a framework to assess managers

Sound decision-making frameworks are a relatively easy win for most investors. They guard against the behavioural biases to which we are all subject and they provide a platform that enables consistent decision-making, even on uncomfortable decisions.

Just as many investors outsource all investment management, many others outsource the tasks of identifying, evaluating and then negotiating with external managers. This is a commonly used model as an organisation must play to its competitive strengths, and manager research and evaluation is a time and resource intensive activity³.

Other investors will choose to undertake all or part of the manager research process themselves. Where that is the case they should have in place a framework that will allow them to be consistent in their approach and not be swayed either by the salesmanship of the manager or by some factor which, when put into proper context, is not that material. Such a framework might address (amongst other things):

- Where will manager names be sourced from?
- How will managers be researched? (e.g. will we do it ourselves or hire a consultant?)
- What are the key characteristics (e.g. people, process, performance) that will be used for evaluation?
- What evaluation hurdle must a manager pass to be on the hire list?
- What events would trigger review / termination of a manager?

Best practice investors have very well developed frameworks in place. They apply principles (rather than hard and fast rules) that allow them to adapt through time and to be consistent across different asset classes (e.g. to account for both the similarities and differences between say bond and private equity managers). Their manager selection frameworks are integrated with their other investment decision making frameworks, particularly their investment beliefs and how they approach sustainability and ESG (Environmental, Social and Governance) integration.

³ By way of example, Willis Towers Watson has a team of over 100 manager researchers who conduct some 3000 research meetings or calls every year.

Creating alignment with external managers

In economic terms the owner of the asset portfolio is known as a principal. Anyone appointed to manage money on their behalf is known as an “agent”. A principal will typically delegate to their agent the ability to make decisions or take actions on the principal’s behalf. The principal would expect the agent to act in the best interests of the principal, however there may be instances where the agent does not do this. These may include activities that are costly to the agent (but useful to the principal) or where the agent partakes in activities that are beneficial to itself but come at some expense to the principal. This tension is known as the principal-agent problem, and the difference between the interests of the principal and agent is called the “agency cost”.

For most asset owners, the principal-agent problem is all but unavoidable. It doesn’t start or end with external managers. Agency issues exist between staff (even the Board) and the principal and extend all the way down to the companies in which the asset owner ultimately invests. In this note though, we are particularly interested in how to manage this problem with external investment managers.

The first step is to recognise that the problem exists and to look for ways that it can be remedied. Partly this is contractual, through the investment management agreement. This should have clearly specified constraints, key performance indicators (which should extend further than just investment performance) and time horizons (the period over which both parties believe performance can be meaningfully judged).

Agency issues are also partly managed through economic incentives. Asset owners should look at financial terms that will encourage the external manager to act in the asset owner’s interests. Performance based fees are one way of doing this, although they need to be very carefully structured to ensure they do not create their own set of incentives for the external manager to act in undesirable ways. For example, in the case of active, ‘alpha seeking’ managers, an agreed cap on their total assets under management would be a way of ensuring they are concentrating on delivering alpha rather than chasing assets under management (and the fees that come with that).

Asset owners should also care about the incentives that exist within the asset managers’ organisations, e.g. How are their staff rewarded? Do they have ‘skin in the game’? Will they feel their clients’ losses as much as reap some benefit from their gains?



Going deeper with manager partnerships

For most asset owners the relationship with their external managers is a purely transactional one: the asset owner pays the manager a fee in exchange for selecting assets for the portfolio. A more advanced approach is to build deeper partnerships with managers – ones that benefit both parties.

Where resources allow, a number of asset owners are now actively engaging with their managers in a two-way flow of ideas beyond the narrow brief of the investment mandate. Some managers have very deep organisational capabilities and are able to offer access to this to clients who meet a certain threshold. This might come in the form of access to various subject matter experts or the use of risk or portfolio management systems. In private markets, some managers have extensive industry networks and can make connections for their clients in areas where the asset owner client might not otherwise have any connections.

Asset managers generally welcome the opportunity to build deeper, more trusting relationships. By getting to know their client very well they can tailor bespoke solutions for them including structuring fee arrangements that help mitigate some of the agency issues described earlier.

In these arrangements both parties win. The asset owner is able to effectively leverage off the depth and breadth of the manager's internal resources and external networks. This helps the asset owner to identify new investment opportunities or smarter ways of managing their portfolio. The asset manager strengthens their client relationship and might also find new insights from the way their client thinks about their portfolio or investing in general.

Partnership arrangements are not for everyone and not every manager relationship should be turned into a broader partnership relationship. Generally an asset owner will need to be of a certain scale in assets under management to make it economic for the manager to provide the additional services. To work effectively the asset owner needs to have an internal team who can commit time and effort to work with the asset manager. On the flip side, not all asset managers have the necessary scale or breadth to be able to add real value over and above their core portfolio management services.

Like any partnership arrangement, long term success requires commitment, time and effort from both parties. Where they can be made to work, the benefits for both parties are worth the effort expended.



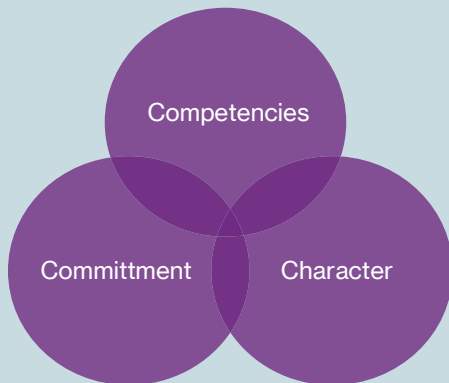
Willis Towers Watson's approach to manager evaluation

Through our manager research, we have identified six core factors which we believe enable managers to outperform by building a competitive advantage (1 to 3) and sustaining that advantage over time (4 to 6).

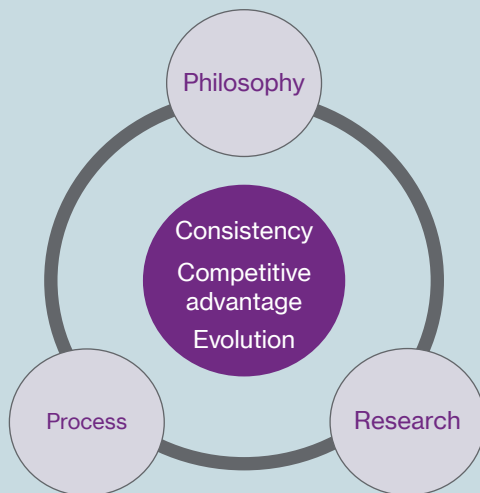
Competitive advantages

Sustainability of competitive advantages

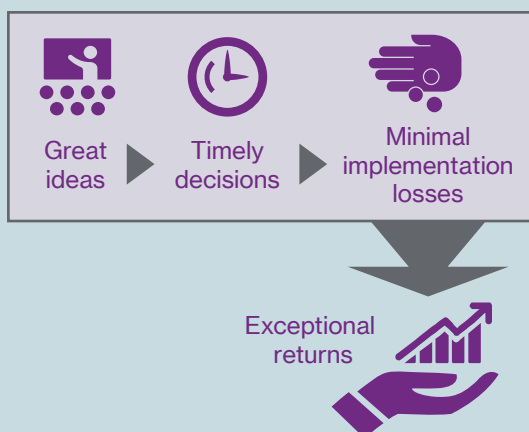
1. Investment professionals



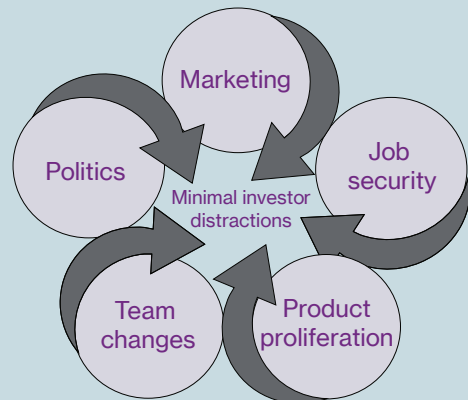
2. Approach/insight generation



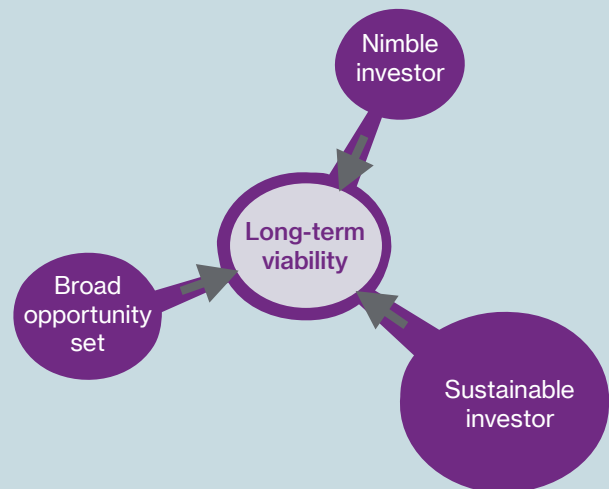
3. Portfolio management



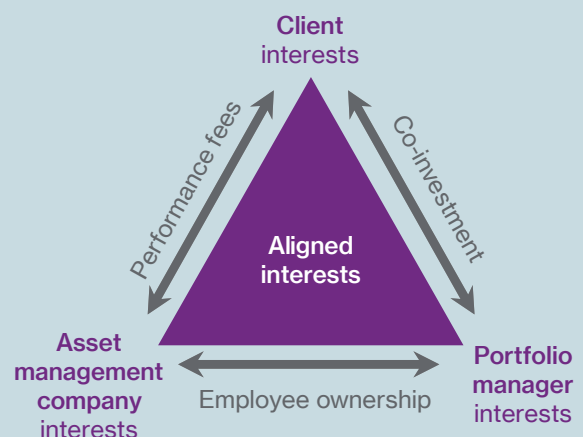
4. Firm and team stability



5. Opportunity set



6. Alignment



Further information

To discuss how we can partner with and help your organisation with similar projects, please contact:

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