Managing conflicts of interest when delegating investment management

The widely acknowledged principal-agent problem highlights how an agent's self-motivation is often at the principal's expense. Potential conflicts can arise between investors and their chosen investment managers.

The potential problem arises because the agent has superior information that makes it difficult for the principal to monitor the agent's actions and assess its motivations. The problem may be exacerbated if the interests of the principal and agent differ. For example, the principal, a pension fund, is investing to meet its long-term liabilities, while the agent, an investment manager, is remunerated based on short-term performance.

Pension plans operate in an environment that has multiple layers of principal-agent problems. Plan beneficiaries entrust the stewardship of their pensions to the plan sponsor, which delegates investment, safekeeping and other activities to various service providers, from plan administrators, custodians and investment consultants, to investment managers.

Conflicts of interest can exist among any of the links in the chain outlined in *Figure 1.* While these issues are not new to the pension industry, increasing investment complexity and fallout from the global financial crisis have focused more attention on managing conflicts and improving the alignment between investors and their delegated agents

Potential conflicts

Among the numerous asset management activities that create potential conflicts are situations where a manager or consultant:

- Could make a gain or avoid a loss to the firm at a client's expense
- Has an interest in the outcome of a decision or service that is not the same as the client's
- Has an incentive to favor one client over another
- Has an incentive to favor a service provider that is not the best solution for the client
- Purchases research and trade execution services for clients, and allocates costs among clients
- Is offered gifts or entertainment that may compromise objectivity

We expect asset managers to have clear policies outlining how they manage conflicts of interest, so the same should be expected of delegated managers. Potential conflicts exist in both traditional advisory roles and delegated relationships as well as between the two, as providers that offer both services may be able to increase their fees by advising plan sponsors to switch to a delegated model.

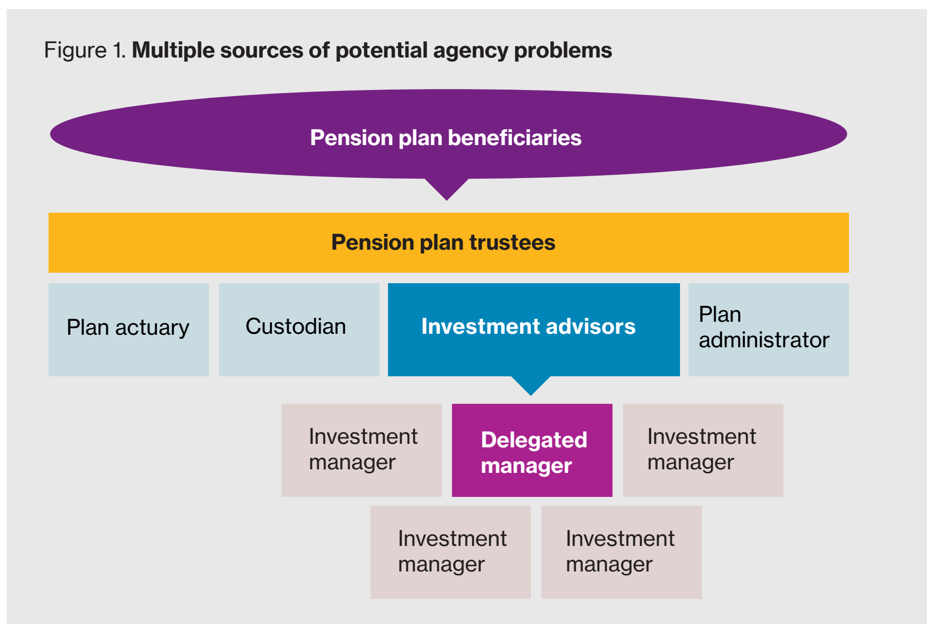

Figure 2 shows the principles that we think are needed to effectively manage some potential conflicts.

Figure 2. **Examples of potential conflicts**

Utilizing internal funds

- How does a provider ensure that internal funds are the most appropriate products to use in an overall structure?
- This varies depending on whether the underlying funds are responsible for stock selection or are a fund of fund solution of external managers. However, ensuring fee structures do not result in any double layering of fees is vital as a minimum.

Communication of changes in views on investment managers and/or products

- How does a provider ensure that all its clients have access to changes in its view at the same time to ensure one group of clients is not favored over another?
- One solution would be to notify all clients (fiduciary and advisory) receiving advice in the relevant asset class or strategy type at the same time so that they have equal opportunity to react to the changes.

Allocations to capacity constrained funds/strategies

- How does a provider ensure that any capacity-constrained investment ideas are available and fairly allocated across its client base?
- One solution would be for allocations to be managed in a systematic manner so that all clients that are employing a provider in the asset class or strategy concerned receive fair and equitable treatment.

The role of fees in managing conflicts

Fees have received a lot of attention. Delegated management is often offered as a bundled service, so it is important to understand the level of complexity in the underlying investment strategy and the range of activities that the service covers. We feel the complete transparency of all costs incurred in managing the portfolio under a delegated arrangement is vital as is a comparison on a like-for-like basis across providers. It is very difficult to monitor and compare underlying transaction costs consistently, but a delegated manager can help control the following:

- Delegated manager's base and performance fees
- Fee for any additional advice provided by the delegated manager
- Base and performance fees for the underlying investment managers
- When used, the fund of fund provider's fees and underlying manager fees
- Embedded expenses
- Custody and administration charges
- Performance monitoring
- Fees for other services, such as legal advice

Delegated managers are typically paid a fixed fee or a fee related to the portfolio's size rather than project or time-cost fees typically charged in an investment advisory arrangement. It is important to understand not only why different fee structures make sense for different service providers but also the incentives that different fee structures create.

- All-inclusive or bundled fee structures, where the pension fund pays the delegated manager a fee that covers all underlying costs, are easy to understand. Full transparency, however, may be difficult, and it may create an incentive to invest in low-cost (and potentially suboptimal) underlying mandates if the delegated manager's remuneration is based just on the difference between fees charged and fees paid. And when delegated managers use their scale to negotiate fee reductions with the underlying managers, these may not be passed on to the pension fund.
- Asset-based fees can create the incentive for asset gathering, which may have a negative impact if the manager doesn't have the resources and investment opportunities to manage a larger asset base. When a consultant is appointed to advise on some asset classes and act as a delegated manager on others, there is the potential for the delegated manager to structure its advice in a way that favors the delegated asset classes, as these attract a higher fee for the manager.
- Performance fees can encourage unnecessary risk taking, as the delegated manager is rewarded on the upside but does not suffer proportionately on the downside. In addition, delegated managers may be paid a performance fee based on short-term performance, and incentivized to add short-term value rather than to take longer-term positions in line with the plan sponsor's objectives. Performance fees may also make managers less incentivized to advise on de-risking opportunities that improve funding levels and reduce portfolio risks, and consequently managers' fees.

Most important, any advice or service should be based entirely on the plan's specific investment needs, and fees for different service offerings should be easily comparable.

Conflict-mitigation principles

Delegated investment managers should be engaged as long-term partners; a relationship of mutual trust is beneficial. The following principles can help mitigate conflicts when appointing a delegated manager:

- Agree to full transparency at the outset.
- Define clear roles and responsibilities for all parties at the outset.
- Include the responsibilities of the delegated manager, the plan sponsor and any third parties.
- Measure the manager against defined, appropriate goals and targets, and a suitable time frame for performance assessment.
- Define the evaluation metrics that will be used and the frequency of assessments.
- Structure the delegated manager's compensation to align the interests of the manager and plan sponsor.
- Ensure the manager has an appropriate policy for managing conflicts and treating all clients fairly.
- Appreciate that managing conflicts is not a one-time process — the procedure to identify, manage and monitor conflicts needs to evolve over time as circumstances change.

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