

The changing face of investment consultancy



Phil Irvine, director of advisory services at Liability Solutions, examines the challenges facing investment consultants and finds that despite a shifting universe there is room for all

The 2001 Myners Report characterised the investment consulting industry as “best described as a small, low-profitability market in which a handful of long-established firms offer similar products and limited expertise in some important specialist areas.” [Section 4.44]. Some six years later, it could be argued that the situation is very similar, where the top four pension consultancies have an estimated 70% of the market. The largest traditional investment consultants (typically “bundled” with more general advice) still dominate the UK pension scene. However, there are a number of developments that may threaten this status quo in the future.

In the 1990s, the services provided by investment consultants typically focused on the following:

- Definition of investment objectives and in-

vesting guidelines after review and consultation with the trustees and the employer;

- Construction of an asset allocation approach to achieve the investment objectives and formulation of a plan for implementation (which often took the form of a single investment in a balanced mandate);
- Establishment of investment performance benchmarks and targets to measure and evaluate performance (often against a peer group or WM Median);
- Identification of qualified investment managers and assistance in selecting the investment manager(s) for the mandate(s);
- Review of the investment managers’ performance against the agreed performance benchmarks (typically with little statistical analysis of the risks that were being undertaken).

The introduction of statement of investment

principles, which meant that the asset allocation of individual schemes should be aligned to their particular circumstances, and the severe equity bear market during the early part of this decade accelerated the move to creating specialist mandates rather than investing in a traditional balanced fund. One of the consequences of this was that the range of investment managers that the consultant had to follow increased substantially. This, coupled with newer areas for investigation and investment such as liability driven investment, portable alpha, private equity, hedge funds and other alternative investments has greatly added to the complexity of the advice. For many the conclusion of this is that only the very largest investment consultancies can possibly cover all these asset classes to an appropriate level and this will cement their leadership position. However, others believe there still is likely to be a significant role

for other types of consultants and approaches. Before examining the reasons behind these views, it is useful to review the industry background.

Broadly speaking, the investment consultancy providers can be split into three categories:

- The large, leading consultants who provide a one-stop shop for all aspects of actuarial and investment advice to large numbers of clients and have an international scope.
- Mid-size to small generalist consultancies that provide most services and serve a moderate number of clients.
- Specialist consultancies that provide extensive expertise in particular investment areas (e.g. asset allocation, private equity, hedge funds, swap pricing, etc).

Some of the key advantages of each type of consultancy approach regarding investment advice are given in Chart 1.

Generally, the strengths of any one group can be their biggest weaknesses. Hence for large consultancies the broad house views and the need for consistency may mean investment decisions are unwieldy and preferred asset managers may be subject to dramatic cash inflows that hinder future performance.

Whilst key man risk is less of an issue for such firms, regular staff turnover may mean the client feels service levels could be affected.

For the smaller generalists, the more personalised bespoke service may come at the risk of less wide coverage of the entire investment spectrum. Selecting a specialist external consultant will require additional time and effort from the trustees rather than going with their existing consultant. Overall the choice of consultant should be dependent upon the individual requirements of the pension scheme and the value that the trustees place upon the particular service from the individual consultant(s) within each practice.

It is clear that the largest consultancy groups have more resources to investigate the investment universe; however, does this mean that they have done a better job in selecting managers and constructing appropriate investment portfolios? Some would argue this is not proven. Whilst a number of the largest consultancies allow access to “model portfolio” performance figures, the view of many is that investment consultants have undergone far less scrutiny and measurement than the fund management community. A part of the problem lies with the fact that consultants typically do not make the final manager selection decision, as this resides with the trustees. In the UK, one specialist consultant – Blackett Research – provided an evaluation service of investment consultants based upon the consultants’ proposed manager shortlists. However, this firm closed at the end of 2006 due to lack of funding and this independent service is no longer available.

A development that should make it easier to assess the quality of consultants’ investment advice is that a number of the consultants are offering their own multi-management products or are negotiating performance fees for creating portfolios that aim to out-perform agreed benchmarks. Whilst this trend makes it far easier for clients to regularly review their investment consultant (as recommended by the 2005 Morris Review), it is seen by many as compromising the independent role that consultants have traditionally played in evaluating the effectiveness of the asset managers.

One example where a consultant has avoided this potential conflict is Aon’s sale of its UK multi-manager business to Close Brothers Group this year.

As some consultants become product providers, other financial organisations are seeking to move into the space the investment consultants traditionally occupy. Investment banks have been raiding the actuarial firms to hire staff to create liability driven investment solutions. These products aim to provide a more holistic approach to managing assets (within agreed tolerances) to more closely match the cash flow properties of the scheme’s liabilities. Whilst these products do not replace the investment consultant, they certainly change their central function within asset allocation and manager selection.

Another challenge to the role of the investment consultant is from the asset management community, with the introduction of the “new balanced” fund concept. This allows asset managers a flexible mandate across a wide range of asset classes to achieve a specified investment objective. This could be viewed as an attempt to wrest the asset allocation decisions back to the fund management industry. Both Mercer Investment Consulting and Watson Wyatt have publicly attacked the merits of this approach. One of their arguments against this is that in 1999, the managers of balanced pension funds increased their already high equity

weightings at exactly the wrong time. Hence they enquire, “why should it be different next time around?” It could be argued this is a little misleading. Fund managers of the 1980s and 90s won balanced fund mandates primarily by having better returns than their competitors (subject to giving a reasonably coherent pitch on their resources and process).

This process, overseen by the investment consultants, gave a significantly lower weighting to the risks that were being undertaken to achieve these returns. Whilst discussion centred on information ratios (a measure of relative risk), there was very little emphasis on quantitative measures of absolute risk levels. For example, few presentations during this period focused on the Sharpe or Sortino ratios of their past performance. Hence fund managers behaved in a way that they were incentivised to in order to win mandates, i.e. take more risk to get higher returns. Over the period from 1980 to the end of the 1990s, the average equity exposure of a balanced fund rose from around 50% to over 75%. There seems to be no obvious reason why fund managers should be less able than consultants in achieving a target risk adjusted return objective. Additionally, it probably

is a case of “having one’s cake and eating it too” from consultants that are moving into the asset management territory to warn asset managers that “any attempts to bypass the consultants will not be welcomed”.

Overall, in an increasingly complex world, the position of the largest investment consultancies should be ever more secure. However, investment banks, asset managers, fiduciary management offerings, fund pension buyout firms are all at the margin challenging their role. Whilst smaller, generalist consultants have always competed primarily on the level of their more personalised service, a recent trend is for complementary smaller consultants to work together.

Liability Solutions, a specialist investment consultancy focusing upon absolute return and fund of hedge funds mandates, has collaborated on a number of pitches with other mid-size, generalist consultancies where the pension scheme client required a cohesive one-stop solution. Whilst these strategic partnerships are unlikely to threaten the dominant position of the existing major consultants, they can increase the choice open to pension schemes and possibly allow more tailored and innovative solutions.

Chart 1: key advantages of each type of consultancy approach

Type of Consultant	Advantages
Large & international	<ul style="list-style-type: none"> Have substantial resources and hence are expected to have wide coverage of all investment offerings Able to express house views and hence have lower key man risk International perspective of group can assist multi-national companies One-stop shop hence clients need only deal with one institution
Medium to small generalists	<ul style="list-style-type: none"> Ability to give a more personal service to clients and clients may feel that they are “bigger fish in a smaller pond” More likelihood of dealing with senior, experienced staff Possibly keener pricing Easier to give innovative advice as less need to worry about consistency across client base
Independent specialist	<ul style="list-style-type: none"> Deep, but narrow expertise in chosen area of specialisation High likelihood of dealing with senior, experienced staff Easier to identify value added in area of specialisation

Source: Liability Solutions