

The role of the investment consultant in the trustee world

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Abstract

The current paralysis and increasing complexity in the financial services industry serve to highlight the ever increasing challenges faced by Trustees in sourcing good, consistent and independent guidance from their advisors more than ever before. The role and importance of an Investment Consultant has risen in direct relation to these challenges and whilst traditionally only Family Offices could afford the infrastructure, with today's enhanced communication and technology the services have become more widely accessible. This article seeks to build a picture of the industry as it stands today and to examine the merits and weaknesses of the industry, to provide guidance on the selection of investment consultants and to assess how the industry will look in the years ahead given the challenges that the segment faces.

Overview

The current paralysis and increasing complexity in the financial services industry serve to highlight the ever increasing challenges faced by Trustees in sourcing good, consistent and independent guidance from their advisors more than ever before. The events of the last year have highlighted the need for true, independent advice.

The role and importance of an Investment Consultant has risen in direct relation to these

challenges and whilst traditionally only Family Offices could afford the infrastructure, with today's enhanced communication and technology the services have become more widely accessible.

Whilst access has increased, so has the diversity and range of firms offering Investment Consultancy services led to confusion over the range of services and the genuine benefits offered. For the Trustee a previously inaccessible service has become available for most clients and the opportunity to strengthen client relationships has heightened the merit of a consultancy offering.

The value added offered by the industry has never been in doubt but just as there is wide disparity in the experiences provided by the investment industry, the same is now true for investment consultants and as the industry has evolved so have a range of conflicts of interest served to confuse investors.

This article seeks to build a picture of the industry as it stands today and to examine the merits and weaknesses of the industry, to provide guidance on the selection of investment consultants and to assess how the industry will look in the years ahead given the challenges that the segment faces.

Definition

Just as the hedge fund industry struggles to be easily defined, so the diversity of the investment consultancy industry presents challenges in providing a

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simple definition. A simple dictionary review summarizes an Investment Consultant as:

An individual who helps wealthy institutions or individuals find an appropriate investment manager. The investment consultant sends out a request for proposal (RFP) to investment managers and then helps the client narrow down the list of managers. The investment consultant helps the client interview the managers that most closely fit the client's needs. Investment consultants also evaluate the performance of the investment management firm after it has been chosen. During the last decade, the role of investment consultants has grown as the number and complexity of financial instruments has grown.

The essence of an Investment Consultant stems upon the provision of impartial advice in any field relevant to the firm. High-quality research on Investment Managers, Strategies and the Economic Environment is a key feature of an Investment Consultant. Independence from external influence or control and impartiality in terms of the attitude of the firm to asset classes and investment managers should also be apparent and finally, transparent consolidated communication and reporting would be seen to be a key defining feature of an Investment Consultant.

A Trustee should be able to invite an Investment Consultant to sit on their side of the table to help support any aspect of the profiling, asset allocation, selection and monitoring of their assets and investment institutions.

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The marketplace

Ten years ago, the market could be defined quite neatly between those firms supporting Family Offices and those providing services to Institutional Pension Funds and Charities.

The complex and time-consuming nature of providing good service to these two segments resulted in a simple de minimus of around £50 million being set upon which a relationship could be supported.

However, the advent of improved communications, wider personal expertise, research and technology has resulted in a raft of consultancy practices being established to support a myriad of investment segments.

Scaled down services are being offered to clients with assets of as low as £2 million and with the blending of time spent and ad valorem fees almost any asset value could be supported albeit with a reduced offering.

Today, market segmentation is driven by product offerings ranging from tailored pension or private/Family Office advice to the design of off the shelf products for individual clients.

Segmentation can be divided between:

- Pension Funds,
- Charities,
- Family Offices,
- Private Clients, and
- Trustees.

Within these groups, a further division of the market exists such that the full service offering of an Investment Consultant may be broken down into its component parts to further refine the marketplace.

For the Trustee, the use of an Investment Consultant ranges from taking advantage of the full service offering usually for more complex, demanding or litigious clients, to the purchase of the individual building blocks with a specific focus on performance monitoring.

In addition, the Investment Industry and Regulatory bodies are a distinct market segment which has presented attractive opportunities and further blurred the segmentation of the industry.

Core services

Today the range of services offered by Investment Consultants has expanded into pretty much any

area where impartial advice could be sought. However, the core services offered are usually:

- relationship profiling and objective setting;
- strategic and tactical asset allocation;
- manager selection and monitoring;
- fee and agreement review; and
- performance analysis and consolidated reporting.

Relationship profiling is an essential role played by the Consultant as despite protestations to the contrary, few parties to a client can genuinely sit on the side of the client and truly impartially guide a client through the morass of issues that must be considered when determining a client's invest profile.

Ever more sophisticated techniques including behavioural and lifestyle profiling aid the client and consultant when identifying a client's needs. However, there is no single intellectual solution to the identification and interpretation of a client's profile but a robust knowledge of the variables that make up the decision taking of a client strongly help to determine relevant and achievable series of investment objectives.

It is rare that an investment objective will be very narrowly defined and ideally because a consultant does not have a product, asset class or manager to promote, they should be unfettered in the often complex discussion about a client needs.

The result of what is often a lengthy, complex and emotive discussion is then translated into a definition of the investment objectives, policies and later investment guidelines to be set into an investment policy statement.

Strategic asset allocation stems from the foundation setting process of objective identification. It formulates a plan for asset diversification and determines which asset classes should be considered for the relationship. It also determines which investment styles are suitable and if specialized investment managers are to be included. A neutral, initial asset allocation is determined which creates the foundation upon which individual investment managers are selected.

The asset allocation methodology of the consultant is critical to the investment outcome that the client experiences. The use of optimization software following the principles of the Capital Asset Pricing Model are widely used but the subsequent variants in terms of forward looking analysis, subjective inputs and qualitative overlays can result in a wide variation in the nature of the proposals.

Furthermore, the range of asset classes and subsectors proposed will vary materially as will the attitude of the consultant to regional, sector, strategy and other asset allocation considerations.

The 'Investment Philosophy' of the Consultant is an essential feature that indicates how the asset allocation process will be addressed. For example, some firms, particularly Pension Consultants have a Philosophy that global investing adds too much risk at the currency level and have enshrined in their Philosophy that the asset allocation should have a large local currency bias.

Similarly, other consultants have taken a measured view on asset classes such as Property, Hedge Funds or Private Equity to be included or excluded as a consequence of their Investment Philosophy.

Strategy Allocations such as Commodity investing may also form part of an Investment Philosophy in that one firm may believe that exposure to commodity markets can be achieved through the stock market whilst others may feel that the behaviour of this strategy merits a distinct separate allocation.

Regionally and at the strategy level, the determination of asset allocation is also critical and hinges on the Investment Philosophy of the firm. For example, one firm may suggest specific equity country allocations whilst another may simply suggest a global equity allocation. Likewise, in determining a hedge fund allocation, the weighting will initially be risk based but afterwards the allocation may either be to one hedge fund strategy or to a range of strategies.

Tactical asset allocation involves the pro-active guidance when to alter the asset allocation at the sector, investment style or macro level. It is a contentious area within Investment Consulting as many firms believe it is not their responsibility to advise

in this area and that once the Strategic Asset Allocation has been determined and the managers selected that the long-term strategy should achieve the clients goals.

The other school of thought is that some big picture decisions should be taken by the consultant during the life of the relationship which should add value to the client. For example, it would be highly unlikely that a Global Equity manager would pro-actively call the consultant and explain that given an economic downturn that their strategy may not deliver positive returns for several years and that they should be fired or have their allocation reduced! This type of scenario can only be assessed and proposed by an impartial Investment Consultant.

The provision of tactical advice can vary from simple decisions to change the weighting to an asset class such as bond, equity, cash, hedge, property, private equity decisions to more subtle style decisions such as value or growth allocations or regional and currency decisions, depending on the area of expertise of the consultant.

Whether tactical decisions are taken, often depends on the client that is being served. For instance, clients with a Pension Scheme or Foundation focus, often

apply a very long-term time horizon whilst Private Clients expect greater pro-activity in the oversight of their assets with a shorter time frame.

Manager selection comprises the identification of qualified investment managers to meet a client's asset allocation profile and is an essential function performed by the Investment Consultant.

Through the analysis of the firm's performance platform, managers are compared against peer groups and benchmarks to see who has delivered consistent risk-adjusted returns. Usually, the results will be cross-referenced to each manager's underlying portfolio for style drift and consistency of investment process.

Once the long list of managers has been whittled down to a cross section of potential firms, the consultant will dispatch a Questionnaire. This would normally request key background information on the corporation, the team, investment philosophy, structure of the investment process, portfolio construction, risk management as well as areas such as compliance and the functioning of the middle and back office.

A typical manager selection process



In many cases, the responses within the questionnaire will send signals which suggest if the review of a manager should be continued or terminated. Following what may be many conference calls with the firm, a team of analysts would then visit the shortlisted managers.

The site visit varies enormously by consultant but usually comprises up to two days interviewing a wide cross section of essential personnel. Deeper analysis will focus on a wide array of areas not just the investment team and process to assess the quality and culture of the firm.

As investment personnel are essential to any organization, the compensation and ownership structure are examined closely as are individual's careers, personalities and general backgrounds. Exit interviews and third party reference checks are often essential in highlighting political and sensitive interpersonal issues.

After the site visit, the impartial assessment of managers takes place. Most firms have a grading tool to remove the emotional interplay that often builds in a relationship business.

Having shortlisted the managers, they are presented to the client and the relative suitability of each firm is discussed. The quantitative merit and interplay with other managers are also reviewed and then, if desired a 'beauty parade' with the shortlisted firms is arranged.

Fee and agreement reviews normally take place during the manager selection process to ensure that the full purchasing power of the consultant is brought to bare and at the same time reporting and communication conventions are agreed upon.

Whilst the agreement will usually be reviewed in-depth by lawyers, the investment content, in particular the investment policy statement would be designed by the consultant. The statement should comprehensively define the boundaries of the investment relationship with each investment manager and specify areas such as excluded asset classes and investments, credit parameters, maximum exposures and ensure that the benchmarks being used to monitor the manager are articulated.

Performance analysis and consolidated reporting is an essential ongoing service provided by the consultant. Performance Analysis comprises the internal day to day analysis that the consultant performs on each investment manager and the overall results but also delves deeper into the style and investment features of each investment manager and their interplay with other selected investment managers.

Consolidated reporting to the client provides an overview of each investment manager, their results but equally importantly the qualitative developments that may have arisen within each investment institution over the reporting period. The report should collate data from multiple custodians and should clearly show not just each investment managers results also the overall aggregate results for the client providing substance that the consultant has hopefully added value.

Although everything a consultant does is driven by the above characteristics, the key differentiation stems from service and the ability for the consultant to enhance the understanding and knowledge that the client has in the management of their assets.

Value added

Given the summary above, one could be forgiven for asking if any further explanation is needed to explain how an Investment Consultant adds value. However, this is certainly the most frequently asked question by clients and rightly so. Value added should come in many forms and the attraction will vary according to their needs.

Culture and values or the lack of them has been a frustration of Family Offices and Trustees with the Investment Industry over many years. Wealthy families and private clients alike seek to partner with firms whose values are closely aligned.

The short-term nature of Investment Managers in terms of performance profile, staff compensation and turnover often conflicts with the longer term relationship driven approach of Family Offices and Trust Clients. Small and middle-sized investment consultants often have a partnership structure or

long-term shareholder structure which more closely aligns the consultant to the client. Relationships are often very long term and the advice and depth of thought often reflects the wish for a long loyal relationship.

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Transparency is an overused term but an essential role of an Investment Consultant is to remove the opaque nature of the investment industry and provide transparency to clients so that they can make an informed decision on every aspect of their investment profile. As there should be no product to sell, a consultant should articulate every aspect of the investment process, asset allocation, manager selection and reporting in a clear and understandable fashion. The concept of sitting on the same side of the table as the client to interview the investment manager encapsulates the trust and transparency that should be seen.

Fees net of the investment consultants fees should be materially lower than if the client had not engaged a consultant as the purchasing power of the firm should secure lower fees for the client than if they had approached the investment manager directly. In addition, the overall service, communication and reporting should be substantially enhanced due to the institutional approach taken by the consultant.

However, this does assume that fees are taken in a hard dollar time spent or a percentage fee basis rather than soft dollars which the consultant might receive from the manager.

The *Investment Results* should show a marked improvement compared to a pre-consultant experience. This assumes that the consultant has invested heavily on a robust quantitative and qualitative research process. In theory, the Strategic Asset Allocation should add value by ensuring that the appropriate amount of diversification is taken amongst the correct asset classes for the client whilst ensuring the risk budget is fully utilized to maximize returns.

Tactically, the risk budget can be adjusted in extreme circumstances and the blending of investment managers should reduce the correlation and risk whilst good manager selection should enhance returns. In addition, the use of qualitative investment manager analysis combined with good quantitative analysis should provide an early warning on performance issues long before the actual performance deteriorates.

In combination, all of these ingredients should add considerable value to a Trust relationship. Of course, if the opposite occurs the use of a consultant could dilute the experience.

Conflicts

Similar to the mainstream investment industry, there is an array of weak to strong conflict of interests that exist within the investment consulting industry. The media has rightly focused upon these areas and it will be a challenge for the industry in the years ahead to maintain its attraction whilst the issue of integrity is often raised.

The *fee model* for the industry is quite varied. It usually comprises a hard dollar transparent or a soft dollar hidden fee. The hard dollar fee is usually based as a percentage on the assets entrusted, a fixed inflation adjusted fee or a base time spent fee plus extras for services such as manager selection. An all inclusive hard dollar fee is the most commonly applied charge.

The soft dollar fee has many variants but includes the recurring receipt of an introducer's fee, the sharing of commissions and manager fees or where mutual funds are used the retention of the annual fee rebate.

Soft dollar fees are often attractive to the consultant as separate fee notes and invoicing are unnecessary and the fact that the consultant receives compensation at all is often forgotten!

The conflicts in retaining soft dollars are numerous and damaging to the reputation of the industry. First, there is the simple matter of whether the consultant can truly act in the interest of the Trust if the lower

the negotiated fee the lower the revenue the consultant will receive. Similarly, what of the conflict where an investment manager refuses to enter into revenue, commission or trail fee sharing arrangements? Does this mean that the consultant might narrow their selection universe to firms that only pay rebates and exclude those that do not?

Another conflict arises from consultants having *multiple business models*. To increase the profitability of their business, many consultants have widened their service offerings to support more than just the traditional investment consulting client base. This has been manifested in many additional service offerings ranging from the launch of mutual funds, the provision of advice to the investment industry or the marketing of performance services to the investment industry.

The launch of mutual fund of funds to clients is vindicated as a cost-effective way for smaller clients to access the talent and skill sets of consultants where ordinarily this would not be possible and in one regard it is positive as it clearly demonstrates whether the consultant genuinely adds value. However, the offering of such funds puts the consultant in direct conflict with the very investment industry it is seeking to review.

For any consultant who receives fees from the investment industry whether it is a review of their investment platform, writing an impartial report or collating performance data for manager marketing purposes, the real question is whether the consultant can truly be impartial when advising a Trustee to select or fire an investment manager when they are receiving fees from the very same investment manager. Certainly, the investment managers themselves consider the cost of using a consultants service as a double benefit, to first gain access to the service but second to increase the chance of being referred work or being retained for work.

These conflicts are not widespread but do affect the perception of the industry and the normally correct belief that the industry applies the highest of integrity to its working practices. As a matter of good practice, we provide prospective clients with a list of key

questions that should be asked when searching for a consultant and we have outlined a few essential areas to address below.

Questions to ask

Although identifying the right consultant is not easy, I have offered some suggestions as to which questions might aid Trustees' own due diligence process.

General:

- Please provide an overview of your corporate structure?
- What are your minimum client size and your average client size?
- What value of assets do you oversee in this service?
- What percentage of your revenue is derived from this service?
- What other services do you offer, in particular to the Investment Industry?

Security:

- Who is your regulator? What protection or assurances does this body provide?
- Please provide details of your professional indemnity insurance?

Team/People:

- How many people do you specifically employ in Investment Consultancy?
- What has been your staff turnover in the last five years?
- What long term arrangements have been made to retain your staff?

Service:

- How many clients does each relationship advisor look after?
- Could I expect to have the same relationship for life?

Independence:

- Do you receive any commissions, fee sharing, introduction fees?
- Do you negotiate and pass all fee reductions to our account?
- Will you include and review institutions we wish you to consider?
- Do any of your employees have directorships or shareholdings in any institutions you have a relationship with?
- What is your performance history for the approach we are considering?

Process:

- Please outline the steps that would be taken in developing our investment objective, asset allocation and manager selection?
- How large is your investment universe?
- Which asset classes are included within your investment universe?
- Do you advise on tactical allocation?
- What would be the ratio of effort between Qualitative and Quantitative Analysis?
- Do you allocate assets regionally or globally?
- What is your view on having a local currency bias?

Industry trends

The material growth in the investment consulting industry reflects the growing complexity and challenge facing trustees in determining the correct path when wishing to allocate assets. This has led to a fragmentation of the industry, a blurring of roles between consultants and the investment industry and will as a result start to create more formal lines between pure investment consultants and hybrid firms.

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The events of the last 10 years continue to highlight the importance of pro-active decision taking and at the investment level, we expect to see more consultants invest time and money on macro-economic models to improve the asset allocation process whilst also investing heavily in human resources, notably to recruit top down and tactical decision takers such as economists and investment strategists.

Interestingly, the increased demands placed upon consultants combined with greater client knowledge in terms of the industry conflicts is likely to lead to fee rises as the hard dollar segment of the marketplace seeks to maintain its position compared to the less transparent soft dollar models.

We expect the industry and investors alike to demand greater transparency which could lead to the creation of an industry body to represent and market the interests of consulting firms and to define and apply greater responsibility within the marketplace and industry ethics.

Concerns with regard to conflicts of interest will not dissipate and the ever increasing sophistication of investors will make this a more significant issue in the years ahead. Implementing a kite mark of standards combined with an industry body which defines the level of quality through the creation of standardized questionnaires and online database resources will provide a carrot and stick motivation for the industry.

Another trend within the industry will be the increasing differentiation between those firms that clearly articulate the contribution and value added of their services as reflected by the aggregated performance and those that do not. Attribution, in terms of how performance results have been achieved will become more widespread and those firms that do not transparently convey their contribution to clients will be perceived to fall into a secondary category of firms who for opaque reasons do not convey their results.

Finally, the increased transparency reflected above will also lead to the investment industry demanding greater openness and accountability and the application of the same standards that are applied to the

investment industry. This will further highlight the significant differentiation between consulting firms.

Conclusion

The Trust marketplace is continuing to evolve at an ever rapid pace, the increased demands of clients combined with the greater pressure and responsibilities placed on Trustees have not diminished. At the same time, the standards and expectations placed by clients on Trustees in the oversight of their wealth has also increased to such an extent that it is rare that Trustees have the internal talent to provide the desired level of support.

This has led to much greater collaboration with consultants whose approach is very closely aligned

to the Trustees needs and whilst the outsourcing of the profiling, strategic asset allocation, manager selection and aggregated reporting has solved a major problem for Trustees it has been replaced by another one, namely the reliable selection of consultants.

The growing diversity of consultants across numerous market segments and disciplines raises new challenges for the Trustee in conjunction with the need for a Trustee to select consultants with limited or no conflicts of interest. Demands from clients will lead to the creation of an industry body and consultant standards which should alleviate some of the challenges facing a Trustee when selecting a consultant in what normally is a very well-suited partnership.