What can we learn from the policy and practice traits of plan sponsors who refuse to fall into the fund rotation trap?

Unintended Consequences of Investment Policy and Open Architecture

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HE BEST IS THE ENEMY OF THE GOOD.”
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Could the process of fund selection and oversight, along with advisors’ thirst to acquire more clients in an increasingly competitive marketplace, actually worsen participant outcomes by causing feckless, short-sighted fund changes in retirement plans? Has open architecture, in spite of its many benefits, effectively turned investment funds into commodities? Is it the case that having access to thousands of alternatives — funds that are in a constant state of change in performance relative to their competition — is creating an increased tendency to view money managers simply as fund manufacturers and less as strategic partners?

This article explores these issues and suggests some prudent policies and practices to assist plan sponsors and their advisors in managing their relationships with investment management firms. The goal: to improve overall investment returns.

Trigger-Happy Investing

A 2012 study from Towers Watson clearly demonstrates that replacing under-performing managers can hurt investors’ performance and, therefore, their retirement security. In a simulation of 10,000 different scenarios, the study found that an institution which keeps its managers through periods of underperformance substantially outperforms ones that fire managers who trail their benchmarks over a three-year period.

The authors also suggest a means to determine whether an investor is trigger-happy. Specifically, they recommend that investors calculate the average information ratio of all the fired managers in the three years prior to their termination. If this average is negative, then the investor probably has a preference for past performance. The antidote to being a trigger-happy investor is to simply use index funds instead of focusing on active management.

Perhaps the best study in this area is by Amit Goyal and Sunil Wahal. They examined the selection and termination of investment management firms by 3,400 plan sponsors, involving 8,755 hiring decisions and $627 billion in mandates between 1994 and 2003. The authors concluded that “plan sponsors hire investment managers after large positive excess returns but this return-chasing behavior does not deliver positive excess returns thereafter.” (Goyal & Wahal, 2008)

Other researchers (French, 2010, Penfold, 2012 and Barras, Scaillet & Wermers, 2010) support the same conclusion — investors tend to focus on performance to their own detriment.

Fat Tails and Black Swans

The analytics which underlie most investment reviews are derived from the Capital Asset Pricing Model (CAPM) (e.g., alpha, beta, Sharpe ratio, information ratio). This model assumes that returns are normally distributed, but in fact, they have “fat tails.” Emanuel Derman writes:

“It’s not surprising, then, that CAPM doesn’t correctly account for the returns on investments. CAPM may hold better in undramatic, liquid markets where informed investors determine prices. But the model’s assumptions fail badly during times of panic, fear, and limited liquidity. CAPM is a useful way of thinking about a model world that is, quite often, far from the world we live in.” (Derman, 2011)

Panic to sell can be so intense that it spreads to all securities like a wildfire in dry brush. Such events, which often matter the most, are sometimes called “Black Swans.” Investment prudence requires more than mathematics and numbers.

Reversion to the Mean

In 1985, Werner De Bondt and Richard Thaler studied constructed portfolios of the best and worst performing 35 and 50 stocks over many periods. They used monthly return data from the 1926-1982 period of all stocks listed on the NYSE. So, at the end of 1929, two 36-month portfolios were of the best performing stocks and the worst performing stocks. The authors concluded that “plan sponsors hire investment managers after large positive excess returns but this return-chasing behavior does not deliver positive excess returns thereafter.” (Goyal & Wahal, 2008)
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return over the benchmark mark was about +30% for the loser portfolios versus about -10% for the winner portfolios. Two of their findings stand out: “First, the returns for both winners and losers are mean reverting. Prior losers outperform the market average, while prior winners underperform. Second, the price reversals for losers are more pronounced than for winners.” (Richard Thaler and Werner F. M. De Bondt, 1992)

We tend to think of reversion to the mean as having mostly to do with the behavior of individual securities as the above study illustrates; however, the same dynamic is at work when chasing money manager returns. In a June 2013 column in The Wall Street Journal, Jason Zweig wrote:

My role, therefore, is to bet on regression to the mean even as most investors, and financial journalists, are betting against it. I try to talk readers out of chasing whatever is hot and, instead, to think about investing in what is not hot. Instead of pandering to investors’ own worst tendencies, I try to push back. My role is also to remind them constantly that knowing what not to do is much more important than what to do. Approximately 99% of the time, the single most important thing investors should do is absolutely nothing. (Zweig, 2013)

Open Architecture

In this context, the term “open architecture” refers to record keeping platforms that access most money management firms. As you look at its embedded incentives (mainly to focus on past performance), one might argue that it is facilitating “trigger-happy” investing. Open architecture is a “marketplace.” Money managers are often treated as if they were commodities like smartphones, sugar or airplane tickets. But instead of price, people are incentivized to buy on performance.

A commoditizing fund marketplace creates an environment in which many of the real factors that influence superior performance outcomes are ignored. The incentives can create a trap, and that trap is fund rotation. It is a vicious circle that drains investor return. It costs a plan sponsor valuable time that would be better spent elsewhere. There are hidden transaction costs. It also follows the hot money crowd, where investors dump cash into funds, drive up the prices of the underlying securities and, when investors flee, drive security prices down (i.e., buy high, sell low).

This shifting from low- to high-performing funds is reflected in the great disparity that exists between investment fund performance and investor return. Consider the following: Russel Kinnel, director of mutual fund research at Morningstar, analyzed mutual fund returns in 2010 through the last decade. The results showed that mutual funds overall, whether stock or bond funds, had better returns than the people who invested in them. The average mutual fund provided a humble average annual return of 3.18%, but individual investors ended up averaging a return about half that amount, 1.68%. (MarksJarvis, 2010) The culprit: mostly fund rotation.

Plan Advisors

It is not just about the incentive structure of open architecture. There is a coterie of plan advisors, largely inexperienced, who fly the banner of open architecture and play on the trigger-happy emotions of plan sponsors, often leading them into the fund rotation trap. The sales strategy is simple:

A. Prospecting Plan Advisor to Plan Sponsor: “Your portfolio is full of losers; I pick winners.”

B. Sponsor to Advisor: “Hired! Put in the winners.”

C. Fund Rotations = drained returns: transaction costs, sponsor time, buy high/sell low.

D. 3 Years Later: Now a loser portfolio, Plan Sponsor returns to Step A. The prospecting advisor wins business by saying, “Your current advisor picks losers and I pick winners.” The pitch will have CAPM window dressing (e.g., alphas, Morningstar ratings) but it is all about selling performance winners. Fund rotation becomes a permanent strategy to keep similar competitors at bay. Indeed, many of the software-based fund selection and monitoring tools are specifically designed to sell on this strategy. This sales strategy mostly occurs in the small DC plan marketplace and diminishes a great deal as plans become

Fig. 1
Average of Three-Year Test Periods Between January 1933 and December 1980

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<thead>
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<th>12 Months Later</th>
<th>24 Months Later</th>
<th>36 Months Later</th>
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<tr>
<td>Loser Portfolios</td>
<td>-5%</td>
<td>0%</td>
<td>5%</td>
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<tr>
<td>Winner Portfolios</td>
<td>10%</td>
<td>15%</td>
<td>20%</td>
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larger and the advisors and plan sponsors are more experienced. But as the Towers Watson study indicates, the fund rotation trap is found in all market segments, even though it may not be advisor driven.

Prudent Policies and Practices

As one examines the policies and practices of those plan sponsors who do not fall into the fund rotation trap, the following can be seen.

- They know that the money management firm is more important than the individual manager. Portfolio managers are not seers. Decision makers rely on a team of analysts, economists and traders, and an inner system of accountability and incentives. What is their philosophy and process, and are they deemed to be effective and prudent? How well do they attract top new talent? Do employees have a career path that rewards excellence? Is there turnover or stability in the firm? Is the firm as a whole a “seasoned investor”?

- They favor a few seasoned management firms in a lineup. They use their time to understand and evaluate the portfolio manager and the money management firm’s philosophy and process. They favor seasoned money and portfolio managers who have back-of-the-head experiences in very bad times and very good times. As Nassim Taleb writes: “A preference for distilled thinking implies favoring old investors and traders, that is, investors who have been exposed to the markets the longest, a matter that is counter to the common Wall Street practice of preferring those that have been the most profitable, and preferring the younger whenever possible.” (Taleb, 2001) The money management firm has a seat at the plan sponsor’s table.

- They hold managers accountable for implementing their philosophy and process. This is what the successful $15 billion New Mexico State Investment Council does. They have a disciplined philosophy and stick with underperforming managers, as long as the process is good. If they conclude that a manager’s underperformance is a result of a bad process, then the manager is replaced. Furthermore, if they no longer believe in the process, or the manager has changed the process, then they are likely to make a change. And if something has gone wrong with the process — the team hasn’t been following it or they’ve made changes to the process — they terminate and don’t look back.

When these policies and practices are integrated into the Investment Policy Statement and with all those seated at the table, the fund rotation trap is rendered impotent. The emphasis on forming long-term relationships between plan sponsors and their money managers makes understanding and real accountability the order of the day.

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REFERENCES


