INVESTMENT MANAGEMENT: MEETING THE NOBLE CHALLENGES OF FUNDING PENSIONS, DEFICITS, AND GROWTH

EDITED BY RALPH A. RIEVES AND WAYNE H. WAGNER

Preface

Some investment managers performed relatively well during the 2008/2009 credit crisis. They cut themselves away from the herd and adhered to their own disciplines and guidelines. These investment professionals have a heightened consciousness about their assumptions and a fierce commitment to reexamining those assumptions. Much earlier than 2008, we believed that the willingness to "think about one's thinking" was a key characteristic of a proficient money manager. And this belief was what prompted us to undertake this book.

People in the investment industry are among the most highly educated in the world; nonetheless, those associated with large investment portfolios need to stay abreast of the search for knowledge in finance. This is similar to the ongoing education of physicians who need to stay abreast of the most recent developments in medicine. Both sets of professionals bear burdens of implicit and explicit trust.

Investment professionals face *increasing pressure* to fund the retirement of millions of workers; as well as meet the capital formation needs that sustain businesses around the world. The rate at which that pressure increases pales, however, in comparison to the rate at which changes are occurring in areas that directly impact the practice of investing. Merger activities among bourses and exchanges, plus the continued emergence of electronic trading platforms are the obvious transforming events. However, new risk management strategies and instruments are even more impacting.

A Disagreeable Reality

Many investment professionals attempt to catch hold of the fast moving trains of investment innovation. The latest return-enhancing concepts are captured, refined and implemented with the hope that one has achieved enough advantage to craft a more enduring investing modus operandi. That hope is unlikely. The competition is too fierce. There is much traction up the learning curve. The willingness to synthesize what is "known" and to analyze what is "happening" confirms that all the players in the capital markets know that they are engaged in a complex state of affairs. What aggravates that complexity is not just the constant change in venues, theories and strategies, but also what Peter L. Bernstein characterized as a "state of disagreeable reality…being wrong on occasion is inescapable."

A Map for the Players

This work is intended to assist investment managers and the attendant players (trustees, regulators, and vendors) as they meet the challenges we characterize as noble. The authors of the chapters in this book strove to be descriptive. The goal is to describe circumstances in a manner intended to heighten an already sensitized awareness. The rate of changes within the milieu precludes prescribing any specific process or action. If there is prescription, it is only included to suggest means that a professional investor might consider when crafting (or re-crafting) an investment policy and a strategy. The chapters in this work are divided into five parts. Each part contains subjects which are tangential to each other.

PART I: The Challenges of Changes and Crises

The 2008-09 credit crisis roiled the already turbulent environment in which asset managers confronted their stewardship challenges. Jacqueline Charnley and Christine Røstvold describe the turbulence and change in the industry, and introduce the themes prevalent in this book. Wayne Wagner reminds us to take a historical perspective to ascertain the frequency of market shocks. He proposes some possible methods to address the challenges that those shocks bring. Keith Ambachtsheer recommends the collective actions that can be marshaled to avoid another asset erosion. And David Tittsworth addresses the need for industry solidarity in protecting regulations that have served and protected the advisory profession and beneficiaries since the enactment of the Investment Advisors Act of 1940.

PART II: Keeping the Challenges in Perspective

This part presents a selection of previously published works. They are included because they are elegant discourses on some attitudinal challenges forever present. The first of these chapters is a chapter from Peter L. Bernstein's classic book, *Against The Gods: The Remarkable Story of Risk.* In this chapter, he cites the research that challenges (and sometimes refutes) the assumptions held about risks and investor behavior. Bernstein's chapter is followed by revisiting George C. Selden's work from a century ago. In this work Selden reminds us again that "Historical parallels can be misleading." Arnold Wood's classic paper follows in which he reflected on "the triumph of temptation over reason." Few financial books in this century have had such a conspicuous reception as Richard Bookstaber's A *Demon of Our Own Design* (Wiley). From that book we have excerpted three pages of an analogy that prompts some incisive thinking about innovation and regulation. Robert Jaeger concludes Part II with an update of his reflection on fads and fashions in the business.

PART III: The Challenges To Theory and Practices

These chapters address the "town and gown" issues of the investment process. While the content in these chapters is likely to be overrun by events and discoveries now emerging; nevertheless, these chapters are essential for the intrepid and enterprising who utilize all of the navigational and meteorological aids in their voyages across the global markets. Quantitative managers Bob Hagin and Kathleen DeRose address the investors' challenges in the face of rapid technological change. We follow their discourse with a chapter discussing the relevance of EMH, and Ron Surz lays out the case for more informed and rigorous attribution analysis. We then share Harry Liem's insightful interview with Stephen Brown about the academic challenges. Robert Jaeger again concludes a part with a reflection on investment skill.

PART IV: The Challenges with Clients

The proper focus of investment management is on the client. Recent events and changes are more momentous from the clients' perspective than from the perspective of any particular purveyor of services or advice. The focus of the chapters in Part IV differs somewhat from the other chapters in this book. They are written so as to inform clients about some issues, as well as to heighten an investment manager's understanding about what this business is all about. The staff at fi360 and Ted Siedle each contributed chapters about trustees taking responsibility for discernment and oversight. There is a chapter addressing fiduciary duties and the future of "sustainable" investing. And Ron Gold prescribes the most effective ways of communicating with and marketing to present and prospective clients. The key feature of Part IV is the complete reprinting of the August 2008 paper by Amit Goyal and Sunil Wahal, *The Selection and Termination of Investment Management Firms by Plan Sponsors.* A paper we would like to have titled “Suspicions Confirmed.”

PART V: The Challenges of Execution

These chapters describe the transactional aspects of portfolio management. Timely and cost-effective trades are critical concerns. Understanding the technology and the evolving structures within markets and venues is crucial. Again the focus is on clients and costs. Francis Gupta and John Prestbo address how much cost benefits have been achieved through technology and adaptability. Steve Wunsch discusses the impact on the sell side from recent rule changes and advances in algorithmic trading. Wayne Wagner reminds us that transactional basis points will always impact performance. And Steve Webb and Simon Bennett of CAPCO discuss the impact of globalizations on clearing and settlement processes.

PART VI: The Challenges to Management

This part includes the “best practices” chapters. Managing an investment firm is as important as managing portfolios. These chapters focus on the attributes and characteristics necessary to sustain the growth of a firm: Substantiating policy, building a professional team, and utilizing emerging technology. John Minahan talks about examining one’s beliefs in light of theory, evidence, and alternative points of view. Jim Ware and Jim Dethmer address the leadership issues of ethics and of adaptability. Monika Muller provides keen insight about the challenges of staffing. Jamie Ziegler reminds readers that empathy and candor are key elements in communicating among peers, as well as with clients. Don DeLoach writes about the challenge of effective information management in the face of the increased flow of data, and the rapidity of technological change.

OUR PERSPECTIVE

Our conviction that a willingness to reexamine one’s assumptions was a key characteristic of proficiency has been derived from decades of working with scores of money managers, analysts, trustees, and theorists. While our work is, for the most part, tangential to actually managing assets, it has not been conducted from a distance.

Investment professionals, trustees, and regulators agree that Wayne’s work has saved investors *billions* of dollars. He was a founding partner of Wilshire Associates and designed the algorithms that governed the world’s first index funds at Wells Fargo. Later his Plexus Group validated the hidden delay and opportunity costs of trading. He is a fierce advocate for higher degrees of transparency and efficiency in trading. As the acknowledged authority on those subjects, he is invited to speak and write about them in venues around the globe. And he is the ‘quant’s quant’, as evidenced by his having been a director of The Institute for Quantitative Research in Finance for the last eight years.

As an executive editor at two book publishing enterprises, as well as being a co-founding editor of *The Journal of Financial Consulting,* Ralph has overseen the publication of over 100 books and references by the marquee players and academics in the field. Now a principal with Farragut, Jones & Lawrence, he continues to develop books for institutional investors, as well as assisting trustees in implementing the best practices of fiduciary oversight.

Our experience in the industry, as well as our regard and affection for it, is exceeded by those whom we invited to contribute to this book. Moreover, their contributions and achievements in meeting the noble challenges of global stewardship far exceed ours. We are blessed to have such a roster of seasoned pros.

Those readers who have joined the industry within the last five years may be bemused by the senior flavor of our list of authors and advisors. Here is our response to your bemusement: We chose our authors and advisors because, like us, they have learned to detect the industry's feedlot residue not only when they smell it, but also when they hear it or read it. Our wish is for you to acquire that same acuity, sooner than later.

In a time when capital flows instantly through borders, what enhanced return this morning probably won't work after lunch. The model-building challenge, then, *is how the stewards of the world's assets should think about their thinking*. We hope that this work will assist in that enduring challenge.