

SEARCH & EMPLOY

By Caroline Cakebread

Plan sponsors are seeking out new managers who can boost their pension funds' performance. And money managers are under the gun like never before.

The financial woes experienced by Canada's defined benefit (DB) pension funds have been making headlines all year. Numbers presented by actuaries at a recent Association of Canadian Pension Management (ACPM) forum showed that, on average, the typical private sector pension plan is 78% funded. And when the results are indexed, the ratio drops significantly to 54%. Public sector plans fare better with a funded ratio of 109%, dropping to 72% when indexed.

Given the current environment, it's no wonder Canadian plan sponsors are taking a long, hard look at their pension fund performance and taking action to improve it wherever they can. That means investment managers are under the gun like never before.

Many industry observers say there's been a spike in the number of investment manager searches over the past year and expect the trend to continue, or even increase. Others say the trend has already peaked. They do agree on one thing: plan sponsors are getting tough with their money managers, responding to negative returns by taking a closer look at performance and risk.

SEARCH TRENDS

Stephane Amara, vice-president, sales, with Montreal-based Bank of Ireland Asset Management (BIAM) says he has seen U.S. data indicating a marked decrease in searches south of the border. But Amara says that is not the case in Canada—at least not in BIAM's experience. "2002 was a good year for new business for us" he says, adding that it has picked up again since the middle of this year, with increased



CHOOSING A NEW MANAGER?

Hiring and firing money managers isn't easy, so you'd better ask the right questions.

1. Is the firm's investment philosophy consistent?
2. What's their track record?
3. Are their people compensated properly?
4. What is the level of employee turnover? It shouldn't be too high or too low.
5. How are their analysts compensated? Is it appropriate?
6. Does the firm have a strong business model? And can they explain it clearly?
7. Avoid knee-jerk reactions. Chasing performance isn't the answer.

activity in all of the company's major funds: global, international and European equities.

Amara believes the number of manager searches in Canada represents a ripple effect from the negative returns of last year. "Everyone thought the world was collapsing on their heads," he says. While last year, at the height of the market turmoil, was not the right time to make major changes, plan sponsors embarked on key evaluations necessary to check both plan solvency levels and asset allocations.

Having taken a close look at those factors, sponsors are now working to ensure they have the right managers in place. "If [plan sponsors] did that in 2002, then it's going to lead to a lot of implementation this year, which means a lot of manager searches," says Amara. While he doesn't envision a move en masse in this direction, Amara does foresee an increase in the number of searches over the next few months.

CHANGING ATTITUDES

David Service, a principal with Towers Perrin in Toronto, believes the biggest spike in searches happened last year. He attributes part of this to the increase in the federal foreign property limit to 30%, noting that plan sponsors have been looking for the best way to beef up the foreign allocations in their pension funds.

To a great extent, Service has observed a sea change in the way pension committees approach their managers. "If you go back over the years, committees had this tendency to be loyal to managers," he says, adding this mentality is changing quickly, as are committees' expectations. "Given what is happening to pension fund fundamentals lately, the loyalty to managers is

starting to disappear."

Plan sponsors are demanding performance, adds Service, with the attitude that managers should be delivering what they have agreed to regardless of the markets. If not, the incentive to stand by them just isn't there, he says. "The mindset has really changed. The ability to hang with a manager who is not delivering what you were looking for is reduced."

John Gilfoyle, national practice director, investment consulting with Watson Wyatt Worldwide in

Toronto, agrees that there has been an upward trend in the number of management searches. It has been a busy year for Watson Wyatt, with a 25% jump in the number of new searches in the first six months of 2003. "[The increase] is significant," he says.

Like Amara, Gilfoyle says there have been a lot more asset-liability studies recently in response to major changes in the capital markets and pension fund deficits. And he believes that while many managers are doing well, performance has been a big issue for a few. "There are some managers with serious performance problems," he points out. Some of yesterday's high performers aren't making the grade anymore—and that is a problem.

Gilfoyle adds that mergers and restructurings have also taken their toll on manager performance over the last few years. There have been significant reorganizations, sales, and mergers where the business nature of the company has changed. Such changes are not always welcome, says Gilfoyle and he points out that the underperformance of some managers has led to what he calls an 'enough-is-enough' attitude among plan sponsors.

Searches always turn in to new hires, says Gilfoyle, who stresses that hiring new managers is not an easy thing to do. "We don't like firing managers. We don't do it if we think it is not going to help." That is because firing and hiring costs money. Then, of course, there is Murphy's Law. "The best year the fired manager is going to have is the year after you fire them," says Gilfoyle. "The worst year your [newly] hired manager is going to have is the year after you hired them."

Amidst all this shuffling, what is it that plan sponsors are looking for from new managers? Joel McGurrin, a consultant with Towers Perrin in Toronto, says employers

are taking a closer look at alternative investment markets. “We are talking to a lot of clients about alternative investments, whether it be hedge funds, income trusts, private equity and so on.”

While McGurrin says plan sponsors are becoming a lot less tolerant of underperforming managers, they are also recognizing the value that an added 1% or 2% return can bring to a portfolio with today’s slim market returns. “If you get 8% or 9% as opposed to 7% or 8%, that is a big difference,” he says.

And when it comes to alternative investments, McGurrin says plan sponsors often want specialists as opposed to their existing equity managers. “[They] generally start from scratch in terms of who is out there. [They are] not likely to latch onto the fact that [their] key equity manager can provide them with this. For the most part, they’d be considering a whole new set of alternative managers.”

RISK MANAGEMENT

Risk is also a key factor, and plan sponsors are reassessing the relationship between risk and return in their plans. McGurrin says they are scrutinizing risk in relation to absolute returns—and the absolute volatility of returns. “You are probably seeing more searches where there is more of an emphasis on providing some downside protection. Not necessarily a wholesale shift into value, but clearly looking at risk less relative to a benchmark than in an absolute return sense.”

McGurrin also stresses managers are under a lot more pressure than they were when indexes such as the S&P 500 were averaging up to 20%. “It was a little easier to forgive a manager underperforming the benchmark by 1% or 2% when they were getting big double-digit returns,” he adds. “But in today’s environment they are much less forgiving and more likely to pull the trigger.”

Gilfoyle agrees. “When you are earning 20% or 15% and

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your manager underperforms, you can hang in since your actuarial assumption is 7% or 8%. But now, it is tough."

These days, Gilfoyle says he is looking at a number of factors when selecting managers. These factors include business people and processes. "Do [money manager firms] have a strong business model? Are people properly compensated? Is there ownership in the company? And if there isn't we want to make sure there are other ways of being compensated." Gilfoyle also looks at the way teams are set up, turnover rates, as well as consistency of philosophy and process.

Ultimately, expectations are changing across the pension industry. Towers Perrin's Service points out that plan

sponsors are waking up to a different reality. There is a recognition on the part of plan sponsors that simply rising and falling with the tides of the market is no longer going to be good enough.

"That means they are looking to managers not just to deliver results, but to ensure that those results are going to be there in the long-term. The pattern of results is really going to matter," says Service.

Will changing managers make a difference for most pension funds? Change always brings some uncertainty. But one thing is becoming evident: the attitude of the pension industry is changing. When it comes to managing the future of Canadian pension funds, both plan sponsors and their money managers have their work cut out for them. **BC**

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