BACK TO THE FUTURE

Twelve years ago, while working at one of Canada's premier investment consultant firms, I made several predictions for the future of the investment industry. Now, I've decided to take a look back to see where I was right and where I wasn't and to try my hand once again at predictions for the decade to come.

PAST PREDICTIONS

The predictions ranged from a growth in global equity mandates to what would be the future drivers of investment management excellence.

MOVE TO GLOBAL EQUITIES

THEN

In 2000, Canadian plan sponsors still had to contend with foreign content limits (which were eliminated in 2006). Therefore it was normal in Canada to have a domestic equity bias.

For example, the Pension Investment Association of Canada (PIAC) reported in a 1999 asset mix survey that Canadian equities represented an average of 33% of total assets of a portfolio, while US and international equities combined comprised an average of only 25%.

The PIAC survey did not distinguish between US, international and global equity mandates, but it would be fair to assume that in 1999 the majority of the assets in non-domestic equities would have been in separate US and international mandates.

Prediction 1: Stock concentration in the Canadian equity index would drive a move to a non-domestic equity bias.

Prediction 2: There would be a move to global equity mandates in preference to separate US and international equity mandates, which recognized that a broader range of stocks would offer active managers better added value opportunities.

NOW

Among the larger funds, there has been a move to a non-domestic equity bias. At the end of 2011, PIAC reported that Canadian equities represented an average of 15% of total assets, while non-domestic equities represented an average of 26%.

There has also been a shift to global equity mandates. The 2011 PIAC survey reported global mandates represented 14% of total assets, while US and international equities combined represented a mere 10% (and 2% in emerging market equities).

Small- to mid-sized funds generally still have a domestic equity bias. Based on the third quarter 2012 Mercer Pooled Pension Fund Survey of Balanced Funds, Canadian equities represented an average of 33% of total assets, while non-domestic equities comprised an average of 28%.

BETTER ALTERNATIVES

THEN

In Canada alternative investments were generally the focus of discussions rather than investments with institutional investors. In the 1999 PIAC asset mix survey, alternative assets comprised, on average, around 3% of total assets.

Prediction: Alternative assets would play a very meaningful role in portfolios in the next 10 years, recognizing that plan sponsors would be attracted by the diversification benefits offered by alternative investments.

NOW

Alternative investments have materially increased in allocation for the larger funds. The 2011 PIAC asset mix survey reported alternatives comprised an average of 23% of total assets. The type of assets included private equity, infrastructure, real estate and hedge funds.

Small- to mid-sized funds have not embraced alternative investments. This is likely due to a combination of cost, availability of suitable products or solutions for the small- to mid-sized market and the lack of available internal resources to support the oversight of these investments.

THE NAME'S BOND, CORPORATE BOND

THEN

Within fixed income markets back in 1999, investors took the availability of government debt too much for granted, which dominated this segment of the bond market. In contrast, corporate bonds represented only 21% of the Universe Bond Index and 17% of the Long Bond Index.

Prediction 1: Corporate debt would dominate the fixed income indices in the future rather than federal debt.

Prediction 2: The supply of longer-dated bonds, which play an important financial risk management role for pension funds, would be significantly reduced.

NOW

The corporate allocation to bond indices has increased but has not reached the dominance predicted. The credit crisis in 2008 slowed the growth in the corporate bond market. However, at the end of 2011, corporate bonds had risen to 26% of the DEX Universe Bond Index and 22% of the DEX Long Bond Index.

At the end of 1999, the value of the DEX Long Bond Index was $107 billion, while at the end of November 2012 it was valued at $367 billion. Therefore, the long bond market has grown and not reduced in size as predicted. However, the factors contributing to the growth include:

1. The significant drop in bond yields over the past decade has increased the value of long bonds
2. Increased government debt outstanding is primarily a consequence of deficits stemming from the credit crisis
3. Companies and provinces (particularly provinces) terming out their debt to take advantage of very low interest rates

Despite the growth in the value of the long bond market over the last decade, the future challenge for institutional investors, such as pension funds, is that the demand for long-dated bonds could easily dwarf the supply and put pressure on long-term interest rates to remain low.

INVESTMENT MANAGEMENT EXCELLENCE

THEN

Back in 2000, I noted three past drivers of investment management excellence:

1. Investment firms need great business management skills, not just investment management skills.
2. Investment firms need strong compliance and back office support to avoid the risk of "under surveillance" due to lack of investment controls.
3. Successful investment management depends on great people. For any large investment firm, a senior human resources professional should be considered as critical as the roles of the Chief Executive Officer and the Chief Investment Officer.

Prediction: These same three past drivers of investment management excellence will continue to be key drivers for the next decade.

NOW

The investment markets have become even more complex over the past 12 years and the regulatory scrutiny has become an even bigger burden for the investment management industry. Therefore, the importance of strong business management and compliance abilities has increased in importance and become a bigger draw on overhead for investment managers.

Yet, due diligence meetings with prospects are still heavily focused on people, process and performance. Too much is taken for granted with respect to the relative business, compliance and back office capabilities of investment managers.

BIGGEST INVESTMENT MISTAKE

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Back in 2000 I made an observation rather than a prediction that the biggest investment mistake by institutional investors had actually been something they had not done, namely maintain good documentation to support the decisions made at all levels of the investment process.

My concern was that insufficient documentation had often led to indecisiveness or bad timing with respect to the hiring and firing of investment managers. I believed better documentation would lead to better decision-making in the future.

NOW

Today, my concern is that perhaps the pendulum has swung too far and documentation has become a crutch for many institutional investors and has not necessarily facilitated better decision-making.

For example, a policy document such as the Statement of Investment Policies and Procedures (SIPP) that pension plan investors maintain lists the permissible strategies and investment guidelines. If a strategy is put forward as a possible solution to a problem facing the pension plan, but it is not permitted under the SIPP, the strategy is typically dismissed without appropriate consideration.

The objective of maintaining good documentation should be to summarize those decisions that had been made and not to act as a summary of what can or cannot be done in the future.

Good governance is very important, but documentation should not become the "tail wagging the dog" and interfere with future investment solutions.

NEW PREDICTIONS

OUT WITH THE OLD IN WITH FIDUCIARY MANAGEMENT

Institutional investors such as defined benefit (DB) plan sponsors and endowments have almost exclusively operated a traditional fiduciary model whereby oversight and decision-making is made by a committee supported by non-discretionary advice from investment consulting firms. In other words, the consultants make recommendations, but the final decisions are made by committee.

The types of investment choices and solutions have significantly increased in number and complexity. However, many governance structures have not evolved to keep pace with the increased complexity overseeing institutional assets.

The shortcomings of the traditional fiduciary model have been revealed with the bursting of the technology bubble in early 2000 and the global financial crisis in 2008/2009 which contributed to the financial woes faced by institutional investors today.

Prediction: These shortcomings will be drivers of a material move to a fiduciary management model where a range of services will be outsourced.

The degree of the outsourcing will depend on the resources and preferences of individual institutional investors. The services addressed under the fiduciary management model include:

- Strategic services, such as risk budgeting;
- Implementation services, such as liability hedging; and
- Governance services, such as monitoring of investment performance and risk.

While there will be different degrees of outsourcing, the benefits to institutional investors will include:

- Ability to draw on practical investment experience in a range of traditional and non-traditional investments;
- High degree of risk management expertise;
- Single point of contact for all operational activities; and
- Fully integrated and consolidated performance and risk reporting.

Accepting new investment strategies and an ability to respond to market experience (whether good or bad outcomes) in a timely manner will be critical in helping institutional investors navigate the next decade better than the one past. For some institutional investors this may be best achieved through a fiduciary management model rather than the traditional non-discretionary model commonly used today.

MOVE FROM FIXED TO DYNAMIC

With respect to managing asset mix, institutional investors have generally developed a fixed long-term asset mix that is periodically reviewed but generally does not materially change. When markets are trending, the fixed asset mix approach is effective, but tends not to be as effective during periods of significant market stress, which happens more often than many investors expect.

Some institutional investors allow for tactical shifts to be made around the fixed strategic mix. Over longer-term periods, tactical shifts are not expected to be a major contribution to the total return.

Prediction: A dynamic approach that adjusts the asset mix based on pre-determined triggers, that will be applied based on how the markets actually perform rather than how they are expected to perform, will become the predominant approach to making asset mix changes in the next decade.

There will be different approaches to implementing a dynamic solution to reflect the different types of investors. For example, for a DB pension plan, the triggers to determine an asset mix change will be based on how both the assets and liabilities perform. This approach recognizes that a positive impact to a DB plan funding position could be as a result of very strong asset performance, or as a result of a decline in the liability value.

There will also be different guidelines to determine the degree to which the asset mix can evolve under the dynamic approach. For example, there will be minimums and maximums for how much can be moved out of the return-focused component of a portfolio (comprised of equities and other growth assets) in order to ensure that the total portfolio does not become too conservative, which will impact the potential return.

While there will be different designs to reflect different investors and objectives, the common goal will be to identify a measure of success based on actual return experience that will trigger a reduction in the portfolio's risk profile so that it can be better positioned for future adverse volatility.

NEW YEAR, NEW IDEAS

Predicting the future is always a dicey proposition. But the future will bring change, challenge and an ongoing need for new ideas. Hopefully, this article has provided some perspective on what we have faced in the past and what may await us as we move ahead into the next decade.

For more information regarding these predictions contact:

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