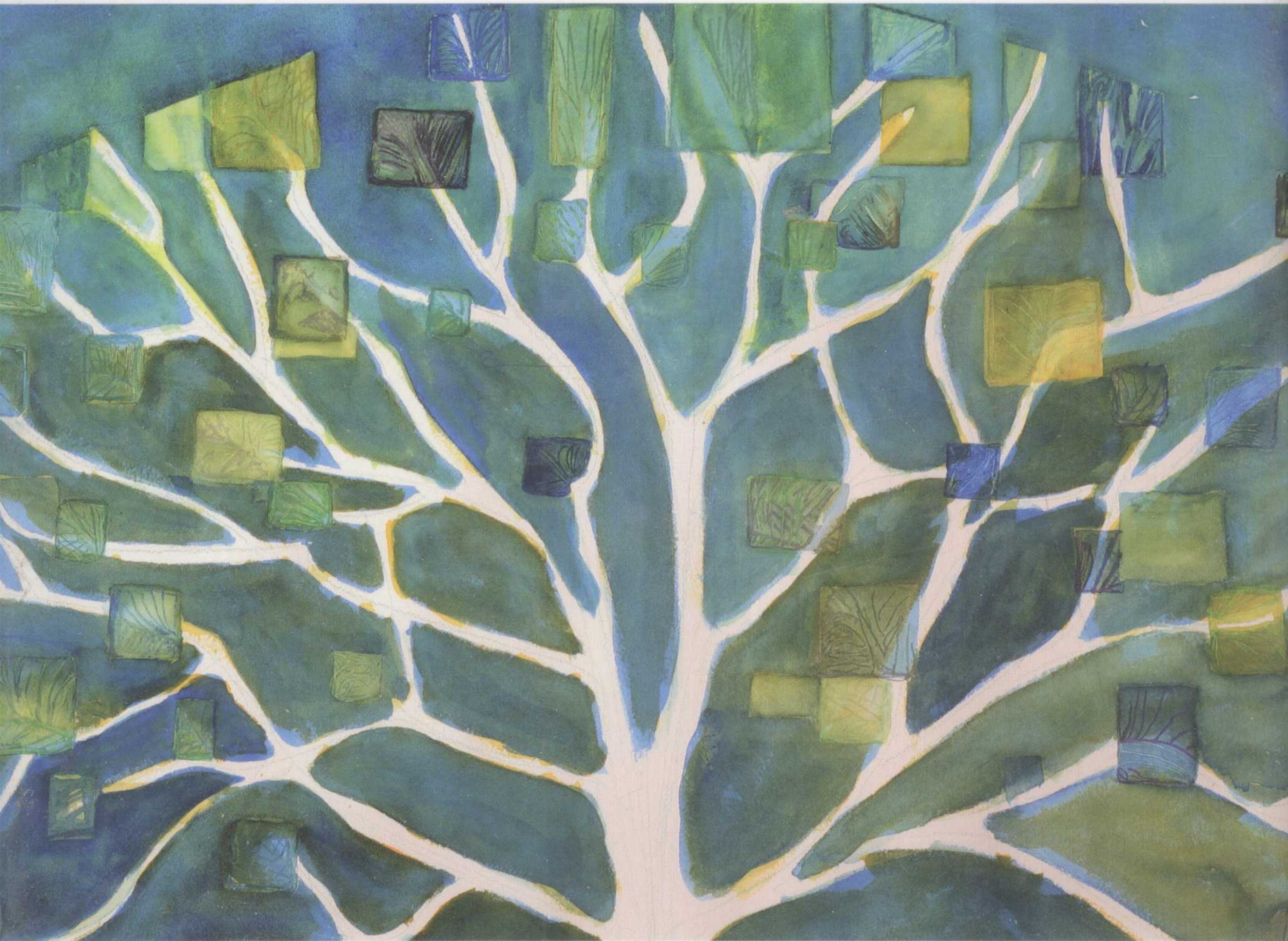
INSTITUTIONAL MONEY MANAGEMENT

An Inside Look at Strategies, Players, and Practices



David M. Smith and Hany A. Shawky, Editors

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INSTITUTIONAL MONEY MANAGEMENT

An Inside Look at Strategies, Players, and Practices

David M. Smith
Hany A. Shawky

The Robert W. Kolb Series in Finance

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John Wiley & Sons, Inc.

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data:

Institutional money management : an inside look at strategies, players, and practices [edited by] David M. Smith, Hany A. Shawky. – 1st ed.
p. cm. — (Robert w. kolb series; 16)
Includes index.
ISBN 978-0-470-61014-5 (hardback); ISBN 978-1-118-14878-5 (ebk);
ISBN 978-1-118-14877-8 (ebk); ISBN 978-1-118-14876-1 (ebk)
1. Portfolio management. 2. Investment analysis. I. Smith, David M.
II. Shawky, Hany Amin, 1947–
HG4529.5.I573 2011
332.6–dc23 2011021439

Printed in the United States of America.

10 9 8 7 6 5 4 3 2 1

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DMS: *To Shobha, Anisha, and Anjuli*
HAS: *To Manal, Joseph, and Amanda*

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Acknowledgments

We thank the chapter authors for their outstanding contributions.

We are grateful for guidance and encouragement from Bruce H. Geller, H. Kent Baker, John L. Maginn, Don M. Chance, Robert W. Kolb, Donald S. Siegel, and the Advisory Board of the Center for Institutional Investment Management.

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PART I

Foundations: Market Regulation and Performance Evaluation and Reporting

PART I

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CHAPTER 1

Institutional Money Management: An Overview

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INTRODUCTION

The spectacular growth in the size and scope of the institutional money management business over last few decades has propelled the industry into a dominant position in financial markets. According to the Organisation for Economic Co-operation and Development (OECD), institutional investors in the United States held $27.2 trillion in financial assets at year-end 2009. This total includes $12.4 trillion in equity shares and $11.4 trillion in nonequity shares other than derivatives. As the industry has grown, it has faced more intense challenges from investors, competitors, and regulators.

Institutional investors include mutual funds, pension funds, endowment funds, sovereign wealth funds, and insurance companies, among others. Many of these institutions have been established with the express purpose of serving large numbers of individual (retail) investors whose resources have been pooled. Pooling has a number of benefits, among them that it allows individuals and families to access financial services at affordable prices. The world's increased reliance on capital markets as a source of financing and risk shifting, together with demographic trends such as the aging of developed countries' populations, have heightened the societal importance of institutional investors. The institutional money management landscape has evolved as hedge funds and sovereign wealth funds have gained prominence, holdings of nondomestic assets have increased dramatically, and defined contribution pension plans have become the predominant new form.

The recent global financial crisis brought many important changes. Among these changes is a trend toward increased product commoditization. Faced with persistent low returns, both individual and institutional investors have been looking elsewhere to find better returns. One manifestation of this trend is that the fraction of low-cost, indexed assets has risen sharply. Among mutual funds and exchange-traded funds (ETFs), the dollar value of indexed assets represents 20.4 percent of all such assets as of March 31, 2011.[1] The increased global competition in the money management business is another important driver for commoditization. Investors of all types have many choices of service providers, and

information about those choices and their associated fees has become easy to obtain. A further cause of pricing pressure is the unbundling of services. Investors can obtain investment research, portfolio optimization, trading, and other services from separate providers, each of which may charge the industry's minimum price. As a consequence, many firms in the industry have moved toward product differentiation. Evidence of this can be seen in ETF expense ratios over time. As sponsors increasingly introduce proprietary and niche products, the average has risen from 0.41 percent in 1996 to 0.53 percent in 2011.[2]

The institutional money management industry tends naturally to attract talented and well-educated employees. For those whose passion is financial markets, portfolio management can be an ideal pursuit. In addition to being an intellectually stimulating endeavor for its practitioners, money management can also be highly compensatory given that annual fees are typically at least 1 percent of the value of managed assets. Effective management of its increasing costs of labor and other inputs is a matter of vital concern to money management firms.

The practice of institutional investment management presents a diverse set of challenges. Board members and portfolio managers are charged with maximizing beneficiaries' return in the face of a complex array of constraints involving risk limits, legal requirements, taxes, liquidity needs, and time horizon considerations, among others. While individual investors face some of these same constraints, many institutional investors work under a complex regulatory structure, and also deal regularly with issues of corporate governance and executive compensation.

The following sections provide a chapter-by-chapter overview of the book.

PART I: FOUNDATIONS: MARKET REGULATION AND PERFORMANCE EVALUATION AND REPORTING

Part I of the book presents the investment backdrop for institutions. It begins by reviewing U.S. market regulations designed to guide the management of portfolios and to protect investors. It then discusses the construction and use of benchmark indexes to evaluate performance. Finally, Part I examines portfolio performance measurement and reporting standards for institutional investors.

Chapter 2: Regulatory Issues in Institutional Investment Management

This chapter is written by Distinguished Teaching Professor David McCaffrey, PhD, an expert on financial market regulation. Professor McCaffrey examines three key regulatory issues in this chapter that pertain to conflicts of interest and have broad implications for financial markets. The first issue concerns the extent to which the SEC's regulation of mutual funds benefits individual investors. The second issue concerns the challenges that pension-plan sponsors face when they engage external consultants and money managers while at the same time being obligated to meet fiduciary obligations under the Employee Retirement Income Security Act

(ERISA). Ongoing business relationships among external service providers can produce conflicts of interest that, critics contend, harm pension plan beneficiaries. The third issue relates to how the Dodd-Frank Wall Street Reform and Investor Protection Act of 2010 attempted to balance the need for regulatory modernization and consumer protection against the need to allow institutional investors to remain competitive in the global market.

Chapter 3: Indexes: Purpose, Construction, and Performance

Chapter 3, written by Professor Vijay Singal, PhD, CFA, a preeminent researcher on index construction, contains a discussion of the principal methods used in the construction of indexes. Indexes have long been used as a means of aggregating market performance. They have increasingly also become crucial tools for performance evaluation and a basis for tracking securities such as ETFs. In addition to market sector differences, the key differences among indexes are weighting methods and index composition changes. Both continue to be highly controversial matters among the indexing community. Professor Singal proposes a more effective method for index creation in the future.

Chapter 4: Performance Reporting Standards and Verification

Chapter 4 is authored by Karyn D. Vincent, CFA, CIPM, founder of a major U.S. performance verification company. Ms. Vincent reviews performance reporting and verification standards for investment portfolios. The global investment performance standards (GIPS) provide an ethical framework by which firms are able to calculate and present performance in a standardized fashion. A firm claiming that it complies with the GIPS standards adds credibility to that claim by engaging an independent third party to conduct verification. Ms. Vincent cautions that the verification process does not guarantee investors that a firm is actually in compliance. She notes, however, that there are many potential benefits available to firms that choose to be verified. The chapter offers a detailed description of these benefits.

PART II: KEY INDIVIDUALS TO THE INVESTMENT PROCESS

Part II of the book examines the roles that key individuals—apart from the board of directors—play in an institutional investor's strategy and planning, analysis of investments, decision making, and implementation. These chapters emphasize the functions of the chief investment strategist/economist, portfolio manager, analyst, trader, and institutional investment consultant.

Chapter 5: The Chief Investment Strategist/Economist

Chapter 5 is written by Timothy G. Dalton Jr., CFA, founder and chairman of a New York–based investment firm that has achieved a record of outperformance spanning more than 25 years. His chapter describes the chief investment strategist's

role within a money management firm, the training and personal temperament necessary to perform the job at a high level, and the types of interactions that usually occur between the investment strategist and other constituencies. Mr. Dalton concludes with a case study in which he provides a detailed recounting of his 10-year projections from a decade ago, and he then assesses how those forecasts have turned out so far.

Chapter 6: The Portfolio Manager, the Analyst, and the Trader

This chapter is written by John Walthausen, CFA, founder and president of Walthausen Funds. His mutual fund has accumulated a three-year performance record that is in the top 1 percent among U.S. small cap value funds. Mr. Walthausen's chapter describes the typical role, characteristics, and training of the portfolio manager, analyst, and trader in a money management firm. These three professionals fulfill vital functions that are distinct from one another yet interdependent. Successful portfolio managers provide strong leadership to the investment team, which enables a fund to differentiate its approach and results from the competition. Analysts are the prime source of investment ideas and valuation opinions. Mr. Walthausen emphasizes the value that a skilled trader brings to the investment process, and provides observations on how to use the three main players to create a well-functioning team.

Chapter 7: The Institutional Investment Consultant

The author of Chapter 7, William H. Desormeau Jr., CFP®, is an experienced consultant who provides services that include fiduciary support to defined benefit pension plans, endowments, and charitable foundations. Institutional investment consultants (IICs) provide assistance to the fiduciaries responsible for making prudent investments to fulfill the institution's objectives. In the chapter, Mr. Desormeau examines various services offered and value added by IICs. Mr. Desormeau presents justifications for engaging an IIC, discusses the IIC hiring and compensation process, outlines the typical qualifications of an IIC, and enumerates the resources the IIC brings to the client. The chapter closes with a discussion of critical success factors for a consulting relationship and comments on the future of consultancy.

PART III: MAJOR INVESTMENT APPROACHES

Part III of the book describes the various equity and fixed income investment approaches used by institutional investors. This section begins with a survey chapter that compares various equity and fixed income decision-making approaches used by institutional investors. Chapters 9 and 10 present the debate on the virtues of active versus passive portfolio investment and the increasing use of quantitative techniques in investment management. The remaining chapters focus on equity markets, the management of equity portfolios, fixed income securities, and the management of fixed income portfolios.

Chapter 8: Investment Buy and Sell Decision Making

Chapter 8, written by the editors of this volume, reviews the frequency with which each buy decision and sell discipline approach is used by portfolio managers. It further examines the performance of portfolios managed under each approach. Equity decision-making criteria can roughly be distilled into the categories of fundamental or technical analysis. Fixed income buy criteria range from a macro orientation to a security-specific analysis. Equity sell discipline criteria cluster around two themes: a fixed target valuation or the manager's subjective assessment of fundamental deterioration. The chapter's most notable finding is of significantly different performance for portfolio managers without a stated sell-discipline criterion than for managers with a formal sell-discipline policy.

Chapter 9: Index Investing

Chapter 9 provides a lively discussion of the almost 50-year-long debate between proponents of active investing versus advocates of passive investing. The author, Albert S. Neubert, managed the S&P 500 index for many years and is one of the world's foremost authorities on indexing. Mr. Neubert discusses the rationale for indexing institutional portfolios and the various methodologies that portfolio managers use. In addressing the question of whether active or passive investing should be used exclusively or "joined together in a happy marriage," Mr. Neubert reaches what some may consider a surprising conclusion.

Chapter 10: Quantitative Techniques and Risk Management

Chapter 10 describes how quantitative techniques have become an integral part of the institutional investing world. Professor Ross M. Miller, PhD, former head of General Electric's quantitative finance R&D group, traces the development of modern quantitative finance techniques from their origins in the last century to the era of arbitrage. Practitioners of quantitative techniques often employ supercomputers as well as tools such as genetic algorithms and Kalman filters, which are derived from disciplines such as neuroscience and physics. Professor Miller explains why, "despite occasional mishaps, quants continue to thrive in the financial markets."

Chapter 11: Active Equity Portfolio Strategies: Dynamic Quantitative Models

This chapter is coauthored by a three-person team from State Street Global Advisors, led by Marc Reinganum, PhD, global head of active equities for developed markets. Using price data on publicly traded stocks, the authors empirically test several of the quantitative techniques presented in Chapter 10. They demonstrate the efficacy of a dynamic return-factor modeling approach in portfolio development. Their simple dynamic model updates its assessment of relevant market factors semiannually, which is necessary because of shifting market conditions. The performance of their approach, particularly during times of market turbulence, is likely to challenge the prior beliefs of skeptics of active equity management.

Chapters 12 and 13: Fixed Income Securities and Fixed Income Portfolio Strategies

Chapters 12 and 13 are coauthored by senior members of the bank loan and fixed income teams at Eaton Vance, a Boston-based money management firm with more than $75 billion in fixed income assets under management. The first of these two chapters examines the major categories of fixed income securities available to institutional investors, and provides an overview of the four key risks fixed income investors face. The second chapter focuses on investors' principal active and passive fixed income portfolio strategies, including indexing, laddering portfolios, and targeted duration and targeted maturity portfolios. Among the active strategies discussed are curve positioning, credit strategies, distressed debt investing, and relative value trading. The authors provide examples and case studies to illustrate the type of analyses required to invest in certain sectors.

Chapter 14: Asset Allocation and Life Cycle Investing

Portfolio managers with flexible investment mandates acknowledge that asset allocation may be the most crucial ongoing decision they have to make. Chapter 14 is written by Professor Edgar A. Norton, PhD, CFA, author of more than 30 articles and an expert on asset allocation. Professor Norton reviews evidence concerning the impact of the asset allocation decision on portfolio performance, over time and in different market environments. He reviews a framework for defining what constitutes an asset class, and uses asset liability management (ALM) as a unifying approach to portfolio construction. Several alternatives to Markowitz's techniques are presented, including the use of concentrated (undiversified) portfolios, inverse optimization, and resampling. The chapter closes by addressing a popular recent innovation related to asset allocation: target date funds.

PART IV: TYPES OF INSTITUTIONAL INVESTORS

Part IV of the book addresses the various types of institutional investors, with emphasis on their similarities and differences. The section examines more traditional and well-known investors such as mutual funds, pension funds, endowment funds, and insurance companies, and the list is then expanded to include hedge funds, sovereign wealth funds, venture capital funds, and wealth management firms. While the common thread among all of these institutional investors is that they manage large portfolios, these institutions have different objectives and constraints that drive investment strategy. Each institution operates under a unique investment mandate, has its own particular time horizon and liquidity constraint, and is subject to a distinctive set of regulations.

Chapter 15: Mutual Funds

Chapter 15 begins with a discussion of the increasingly important role that mutual funds and exchange-traded funds play in the U.S. economy. Professor Ying Wang, PhD, an expert on mutual fund and hedge fund performance evaluation, reviews traditional performance metrics and presents important recent innovations in this

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