REFLECTIONS AND A LOOK FORWARD

by Thomas H. Dodd, CFA, CAIA, FSA
Executive Director, Pavilion Advisory Group Inc.

With the acquisition of Pavilion by Mercer, I thought it would be appropriate to reflect on salient changes that have occurred in the investment consulting industry over the past 25 or so years. After all, I started my investment consulting career at William M. Mercer in 1992, having transitioned from the liability side of the business as an actuary. In 1994, I left Mercer and joined what was then a small investment boutique that became Pavilion Advisory Group. It seems as though I have come full circle, but the industry looks much different now than it did in the early 1990s and I'm certain that in 10 years it will look even more different than today.

Governance

Perhaps the tsunami in the institutional investment industry is the significant shift in assets from a non-discretionary consulting platform to Outsourced Chief Investment Officer (OCIO, although this form of governance goes by many other monikers). Approximately 16% of institutional assets were managed through an OCIO arrangement in 2017; this trend is expected to increase to 23% in three years[1]. This shift is remarkable given that the percentage was in the low single digits merely 10 years ago. In broader terms, this represents a fundamental change in the governance of institutional assets.

What accounts for this shift and can we expect it to continue? I believe that the watershed event that changed the views of institutional investors regarding OCIO was the Global Financial Crisis. The non-delegated consultant/investment committee governance model had endured with very little change for over 30 years. Investors believed that they had the expertise, experience and risk controls to weather a significant market downturn. However, the magnitude of the Global Financial Crisis led investors to question the efficacy of the traditional governance model, especially since it followed so closely to the dot-com bubble. Issues with the non-delegated model that were magnified in the Global Financial Crisis were:

1. lack of resources;
2. not enough fiduciary oversight;
3. lack of risk controls;
4. lack of flexibility;
5. slow decision making;
6. dysfunctional investment committees; and
7. acceptance that a tactical asset allocation strategy may have a place in an institutional portfolio.

In the aftermath of the crisis, many investors came to believe that the OCIO governance model may be superior to the non-delegated model. Once OCIO had a few early and notable adopters, more and more investors jumped in.

I believe that the OCIO governance model will continue to attract investors. In the right circumstances, it may offer significant advantages over the non-delegated model. Also, as an alternative to the holistic OCIO approach, there are myriad partial delegation options. Regardless, OCIO, or some derivative of OCIO, will continue to attract attention and garner assets.

Tactical Asset Allocation

For years investors were told by market pundits that tactical asset allocation (TAA) could not be successfully executed (for purposes of this discussion, I am lumping all forms of TAA together, from very modest allocation tilts to radical asset allocation shifts). A long-term asset allocation was the prudent strategy, not to be altered as market environments changed…borrowing a line from an infomercial, many called this "set it and forget it." As with governance, the Global Financial Crisis altered the landscape regarding asset allocation.

1 - The Cerulli Report, U.S. Investment Consultants 2017

The long-held orthodoxy in institutional asset management was that TAA was heresy. An investor completed an asset allocation study every three to five years, determined long-term asset allocation targets and kept the actual allocation true to those targets, regardless of market conditions. Some investment advisors tried to get around the negative connotations of "tactical asset allocation" by calling it something different, such as "style tilts". Still, most investors could spot TAA under any other name.

The Global Financial Crisis changed investor perceptions regarding TAA. This perception change occurred not because of proof that TAA works, but because investors came to believe that "set it and forget it" doesn't work. Also, in practice, very few investors adhered to a true "set it and forget it" philosophy. In the face of steep market declines, no investor would rebalance to targets. They watched their portfolios experience significant declines and concluded that there had to be a better approach. It was irrational to rebalance to asset allocation targets that were developed in a completely different market environment.

I believe that the change in investor viewpoint regarding TAA is near universal; today most investors subscribe to some form of TAA. That said, the issue facing investors is what form TAA will take and how will it be implemented. TAA requires a (1) topdown investment thesis; (2) an investment process; and (3) an implementation process. Decisions need to be quick and implementation precise. A traditional investment committee governance structure is ill-equipped to manage a TAA solution and there lies the conundrum: how to incorporate TAA into an investment program? One solution is OCIO. The investor can search for an OCIO manager that has a TAA solution that fits the investor's risk tolerance. Absent an OCIO manager, the investor has few choices. One solution used by some investors is the "strong CIO model." With this model, there is an internal CIO that reports to the investment committee. The committee delegates the TAA decision-making to the CIO. The CIO will inform the chair of the investment committee of any changes in asset allocation, but does not need to obtain their approval.

Interest in TAA remains high and it will help speed the flow of assets into OCIO. However, those not willing to consider OCIO will probably look to the "strong CIO model" or its variants for a solution.

Environmental, Social and Governance

Environmental, Social and Governance (ESG) investing has finally come of age. Formally known as socially responsible investing, ESG has moved beyond its roots when it had a very narrow focus and was implemented largely through the use of "negative" security screens. Negative screens were traditionally developed from "sin" stocks (and in some cases bonds). Investment managers could not purchase securities on this list.

In the past few years, we have seen the focus shift from exclusion (negative screens) to inclusion (positive screens). Some investment managers now incorporate ESG into their investment process. A poor ESG score will cause the security to be excluded from the manager's buy list. A positive ESG score will increase the security's chances of appearing on the manager's buy list. As part of their vetting process, consultants now routinely ask managers to explain how they incorporate ESG into their investment process. At the root of this change from exclusion to inclusion is a gradual acceptance that positive ESG is related to security outperformance.

More and more investors are embracing some form of ESG investing. As demand for inclusive ESG increases, more investment managers will start incorporating ESG into their investment process. There is no turning back on this trend.

Defined Contribution

I suspect that the biggest growth segment in the investment consulting industry has been defined contribution (DC) plans. Twenty years ago it was common for defined contribution plans to be managed out of a plan sponsor's human resources department. There was little involvement from finance and certainly no retention of an outside investment consultant. Occasionally, the defined benefit investment consultant would be asked to review the DC plan investments and this review would most likely be completed as a courtesy. The expectation was that as part of the DB consulting arrangement, the consultant would periodically consult on the DC plan for no additional fee.

With the demise of DB plans and the ascendance of DC plans as the primary source of retirement income, the consultant's role has dramatically increased. This trend has been aided by the fact that DC plans have become a frequent litigation target. Plan sponsors need expertise in managing fees, plan design and investment choices. Another change is the merging of plan design consulting with investment consulting into a single unified practice.

Remarkably, the penetration of consultants in the DC segment still remains low. Currently, only 15% of DC plans use a consultant, although based on assets, the penetration increases to 51%[2]. The DC segment will continue to see considerable growth of consultant coverage in the years ahead.

Industry Challenges

There have been a number of changes in client needs that are driving changes in the industry. Client portfolios have become more sophisticated and complicated. There is increased use of private markets and hedge funds. Various investment strategies have seen their popularity wax and wane: overlay strategies, risk parity, portfolio insurance and long/short strategies. Not only has the use of passive strategies increased, but clients are exploring factor-based strategies. The net effect is a large increase in the demand for consultant resources at a time when there is considerable pressure on fees. The solutions are to a large extent unscalable. Each investment challenge is unique to that client and demands a customized solution that is very difficult to export to other clients.

In response to these pressures on the traditional consulting business model, firms have responded by exploring lines of business that are scalable, examples being OCIO and digital services (in essence a Morningstar platform for institutional investors). In many cases, the solution is to merge firms with complementary strengths. Industry consolidation has been a dominant theme for several years with no end in sight. The investment consulting business model will continue to evolve as investment environments and client demands change.

Conclusion

I've highlighted changes that not only seem important from a historical perspective, but also are likely to change the structure of the consulting industry going forward. The staid consulting model that resisted change for many years and through many market environments is undergoing a meaningful shift. It is hard to predict the outcome, but a different consulting model will emerge. Consulting firms will need to be nimble and have the right resources available in order to respond to changing environments.

Inquiries or comments concerning this article may be addressed to:

Thomas H. Dodd, CFA, CAIA, FSA
Executive Director
Pavilion Advisory Group Inc.
tdodd@pavilioncorp.com

2 - The Cerulli Report, U.S. Investment Consultants 2017