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EXECUTIVE SUMMARY

QUARTER II, 2008: INSTITUTIONAL CONSULTING

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Editor's note: This is the second issue of a new quarterly publication produced exclusively for members of Investment Management Consultants Association. This article presents information from institutional-consultant respondents. Subsequent articles will cover the following topics: managed accounts, asset manager and product selection practices, and alternative investments. Please let us know your thoughts about this new benefit via e-mail at info@imca.org or phone us at 303.770.3377.

Methodology: In February 2008 IMCA distributed an electronic survey to more than 6,800 U.S. members. The respondents included 496 broker-dealer representatives, 84 registered independent advisors, and 99 institutional consultants who completed the survey instrument using Cerulli Associates' online survey engine. Wholesaler representatives and other professionals who did not currently work with clients were encouraged to NOT complete the survey, making the response rate 12 percent. The analysis includes the results from the survey as well as additional input from Cerulli Associates' qualitative discussions with institutional investors.

The organization, structure, and various services of institutional investment consultants remains an underresearched area. Institutional investment consultants often are the gatekeepers to massive pension funds, endowments, and foundations. They also are playing a key role in shaping the future of the U.S. retirement industry—an industry estimated to reach \$16.8 trillion in assets by the end of 2008 and almost \$22.5 trillion by 2012. In the following research report, we discuss the findings from our research and report on significant changes in traditional fund management and how institutional consultants are a driving force behind such change.

Institutional consultants perform a variety of services, but most often they are recognized for thorough investment manager due diligence and performance analysis; asset allocation and investment policy statement work; and their ability to be trusted, independent, and objective advisors. Increasingly, firms that built their business in the traditional pension fund and endowment space are taking on more defined contribution (DC) clients. Cerulli analysts have

extensively researched both the defined benefit (DB) and DC space, and we are finding more commonalities between the two. As the institutionalization of DC occurs via custom target-date funds, more open architecture, and more-effective due diligence, consultants will find increasing opportunity in the DC segment. Several years ago, Cerulli analysts chronicled the evolution of institutional investment consultants away from manufacturing entities focused on selling performance reports to a business driven by their advisory capabilities. These key advisory services will help not only with investment manager due diligence in a more open-architecture DC plan, but also with plan design guidance. Also, in DC the trend toward implementing more-customized tar-

get-date funds has been a growth business for many institutional consultants. We see that trend

continuing, especially because target date has been by far the most-discussed topic in the DC space.

In the traditional pension fund, endowment, and foundation markets, the demand for absolute return is the most frequently discussed topic. One of the key themes in the institutional con-

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sulting industry that was repeatedly discussed in our qualitative discussions was the increasing demand by institutional clients for true alpha, which in turn is driving increased search activity for hedge funds and private equity. The demand certainly is there at the fund-sponsor level, but many consultants are struggling to keep up, because hiring analysts and field consultants with alternatives expertise is extremely difficult. Furthermore, compensation at hedge funds and other alternative investment managers makes hiring someone with that specific level of expertise even more challenging.

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A discussion of alternatives is not complete without talking about what constitutes the bulk of the portfolio: equities managed by traditional long-only managers. Many investment consultants find that their research and manager selection capability are differentiating factors and that they can help their fund-sponsor clients find outperforming managers. However, to complement the alpha portion of the portfolio, many institutional consultants with whom we spoke increasingly are looking for more inexpensive ways to expose their client to beta. But there is much disagreement about the viability of this concept. In certain styles and sub-styles, adding alpha can be an extremely challenging task. One institutional consultant with whom we spoke said that his firm has consistently shown that traditional managers often generate negative alpha, especially in the large-cap core space. Indeed, the separation of alpha and beta can be a difficult, if not impossible, task. However, the institutional market is heading toward strategies that incorporate alternatives combined with indexed

or hedging assets to generate beta, and this trend shows no signs of abating.

Because we have discussed the asset classes within the portfolio, a discussion about asset allocation and strategic management of the pension fund is warranted. In the corporate DB space, portfolio construction is becoming dominated by liability-driven investment (LDI) themes. This involves managing pension assets within a framework focused on paying out liabilities, often with the liabilities as a benchmark. It should be noted that we do not exclusively define LDI as long-duration fixed income. The funded status of the plan is of paramount concern to the DB sponsor, and mark-to-market accounting has forced the true funded status onto the balance sheet. The Pension Protection Act of 2006 (PPA) also has imposed more market-based funding rules, including a

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segmented yield curve to discount liabilities and more severe penalties for underfunded plans. These regulatory changes have caused pension sponsors to demand asset-liability management (ALM) services. Many institutional consultants reported to us that ALM was a key area of differentiation for their practices. We see LDI as managing the pension portfolio with respect to the liabilities, and this is more about risk management and strong ALM work than specific fixed-income solutions. In fact, if thorough asset-liability analysis is conducted, many funds may find that they do not need to be more conservative and can afford the volatility that comes along with the equity risk premium.

The full results of the Cerulli Associates-IMCA survey on institutional consulting are available to IMCA members as an exclusive member benefit. IMCA members receive four quarterly research reports and six issues of *Investments & Wealth Monitor* each year. For a \$395 annual membership fee, you can continue to receive cutting-edge investment consulting and wealth management content.