Submission to the CMA regarding their Investment Consultant performance proposals.

24 September 2018

Dear Sir/Madam,

I enclose my thoughts on the Investment Consultant performance proposals. There may be suitable bodies that you can forward this to.

I feel, whilst well intentioned, they are misaligned to the outcomes CMA are trying to achieve. They will reduce the quality of advisor selection decision-making and reduce the incentivisation to provide higher quality advice.

I enclose the submission in the form of a blog post that articulates why I feel that the CMA's Investment consultant performance proposals are like organising a bicycle race for fish...but worse

Kind regards

Nick Spencer, MA FIA

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About the Submitter

Nick Spencer is a qualified actuary with over 25 years experience of the Pensions and Investment industry. About half Nick’s experience has been as an advisor and half as an asset manager. He is not currently employed by either a manager or an advisor, and so is not bound by a house view or potential vested interest/fear of speaking out from either side.

The blog is deliberately written in an attention grabbing style - but Nick believes the analogue to be accurate and I hope it helps the point to be made.

In the addendum beneath the post, Nick provides some background to the issues of creating consultant performance tables, he enclose some examples from his own experience of advice – and why past performance is often a mis-leading or irrelevant guide to the quality of the advice. At the end he also add his thoughts on how to measure the quality of an advisor (without a league table!).

Please let Nick know if you have any questions or would like to discuss in further detail.
The CMA’s Investment consultant performance proposals: like organising a bicycle race for fish…but worse

I guess it’s part of the human condition. It does not matter how many times we are told “past performance is no guide to the future”, we still want to measure past performance and can’t help ourselves dousing for meaning amongst the quivering lines.

Astrologers have scientific methods for determining star alignments and planetary positioning. But that doesn’t mean that the charts produced have any meaning for any specific person or for the future. However precisely constructed we must take care that results have meaning for the purpose they are being used. **Maybe we want to know which is the fastest fish, but organising a bicycle race for them won’t help much.**

Actually the proposals for measuring performance of consultants are worse. Not only do they measure the wrong thing but they misalign responsibilities, misdirect attention and will incentivise behaviour on managing performance results. That will add to the pressure for consultants to become asset managers, to standardise approaches. Advising, a skill which is already diminishing and distinctly de-emphasised by those
growing asset management (or “fiduciary management”) businesses, will come under further pressure and decline.

So what is wrong with the performance measurement of advisors?

1. Performance measurement inevitably focuses on what can be measured rather than what is most relevant

2. Even where measurement is possible, given past performance is not a guide to the future: why are you measuring and what are you going to do with the information? Despite evidence that short-run under-performance of a strong manager is the best time to invest, it’s typically the hardest action for individuals to take. So almost certainly performance tables will led some to switch between advisors at the wrong moment.

3. But most fundamentally, an advisor is not there solely for performance but as importantly (if not more so) to guide on risks. A good advisor is one that can advise on the type of risk to be taken and the appropriate balance of risks within a portfolio based on the preferences of their clients. Sometimes strategy decisions are made for prudential reasons agnostic, or in spite, of expected returns. An asset manager can look to maximise return within the mandate parameters, but typically a good advisor will seek the most reliable, all weather-path. That by design is not the highest return or even the highest return/volatility. (Volatility is a poor measure of the asymmetric and remote risks that an advisor should always be considering.)

Whilst asset managers should be paid for views and measured on value added for the risks they take (or their efficiency in index tracking), **advisors should focus on advice. Their skills and value added are in their guidance on strategy. They should seek to uncover and communicate risks so that a client can agree which are appropriate to take.** They can then advise on how these risks should be aggregated, and help guide clients on their overall risk appetite and risk tolerances. Implementation in the selection of managers and investing in markets follows – and can be a further source of added value – but given 80% of outcomes are determined by strategy, how that strategy is obtained is the key measure of the quality of the advice.

In the examples below, I highlight different ways in which good advice can be different from seeking or achieving the best performance. How seeking robust strategy is different from maximising returns, that 5 years is not enough, the broader array of advice and the other factors such as communication and innovation. I also believe that good advice is customised to each individual client situation and credit should be given for this.

**No doubt some will still argue that we should quantify performance because advisors are important, well paid, that they “need holding to account” and that “the information will help decision makers”. Does it?** Performance tables would:

- not measure 80%+ of the advice
- be poorly aligned to the quality of the advice
• be a poor indicator of the outcomes even of the element of the advice it seeks to measure
• ignore broader elements such as customisation, communication and innovation
• relate to past performance which is not a guide to the future

And consider that
• … we know from behavioural finance that decisions are unduly and irrationally weighted towards any quantified number especially within a league table
• … performance tables would not only create compliance costs and a distraction of efforts but will actively create pressures for consultants to focus on asset management activities and away from generating high quality advice

Then surely the only answer is that we will be much better off without this. If you actually want to measure the quality of advice, a performance number doesn’t work. More detailed and complex diligence is required into all the different elements of the advisor’s work. Judgement needs to be applied to the quality of the advice. It sounds contradictory, but you are likely to do a better job evaluating the quality of advice if you don’t have a league table of poorly related numbers. Not having the league table number will force attention on the actual important issues and avoid anchoring to a false signal.

Focusing on quality of advice without a performance league table is likely to help improve industry standards of advice and attract high quality advisors. Having a league table, likely to impair it and dissuade good advisors from staying.

To create an industry that is incentivised and focused on creating better advice, and for the better decisions from the advice that follows, then Trustees should:
• reject siren calls of consultant league tables and wasting time generating strategic benchmarks to create a performance measure for their consultant
• seek evidence of truly quality advice: evidence of identifying key risks and balancing risks together in strategy that is align with your preferences, whether they have provided clear communication and evidence of potential impacts, are they keeping pace with industry developments and can they demonstrate any innovation
• consider the different ways that your advisor has aided them and any areas they have fallen short

And please, just ask the regulators, your peers and the industry press, not to organise bicycle races for fish!

Nick
Addendum: Examples of Quality Advice that goes beyond past performance

To help illustrate the issues of creating consultant performance tables, I enclose some examples from my own experience of advice – and why past performance is often a misleading or irrelevant guide to the quality of the advice. At the end I also add my thoughts on how to measure the quality of an advisor (without a league table!).

The challenges of performance measurement and why an advisor should be focused on advising on risks

By necessity, quantified performance has to focus on manager selection with a few extensions to strategy. But that is all asset management. If that’s what an investors wants from their advisor, fine – but that’s still asset management. Hopefully the advisor is better than other asset managers in managing assets, but the peer group for those tasks are other asset managers and should be measured as such.

What investors also need is advice: an analysis of objectives, risks and strategy. A good advisor here is making visible the key risks and finding resilient paths that reflect their needs and preferences. What matters is not just what happen, but what might have happened. A good advisor helps clients met their required outcomes through a survivable, robust strategy not good luck.

Whilst many different things may happen in the future only one thing happened in the past. Measuring performance of a good investment approach is more complex than simply “how did it perform?” Measuring good strategy needs to consider both the opportunities that were missed and also the risks that were avoided. A good approach also helps incentivise good behaviours, facilitate positive actions and alignments moving to better outcomes even if they weren’t directly controlled. Let me illustrate these features through some examples of what performance tables would miss.

1. Management of risks
   a. Vodafone takeover of Mannesmann in late 90s: when Vodafone acquired Mannesmann, it created a stock that was more than 10% of the UK stock market. At the time, many UK Pension Funds invested over 50% in UK Equities and so an index weight would have broken a long-standing prudential rule for maximum of 5% in any one company. Despite some significant protestations from the investment managements, we refused to make an exception. In practice, the TMT market crash post 2000s made this a good return decision as well as prudential risk one. But how should you attribute that performance for the advisor?
   The advice was not based on any outlook for Vodafone/Mannesman but simply prudential rules. And if performance should be measured, creating bespoke benchmarks would be additional expense and time.
b. **BrExit**: at a close 48/52 voting outcome, the only robust analysis was that it was hard to be sure of the outcome! Good advice would have been to consider the tolerance to market impact of the different outcomes. There could be a bias to expected changes but crucially any bias this should have been modest and in particular any potential adverse outcome was survivable. Bad advice would have been to load portfolio significantly to either expected outcome whether or not that proved to be right or wrong. Negligent advice would have been not to have looked. The point being that the quality of advice on Brexit is not related to the outcome, which was uncertain, but the process and reviews undertaken.

c. **Warren Buffet famously said in late 90s he didn’t understand technology risks**: so he didn’t invest in them. In the late 90’s, he got good absolute returns but lagged the market indexes – did that make him a poor advisor? Subsequently, he caught up after the dot-com crash. But what timescales are appropriate? And if you are not quite as good as Warren Buffett, is a longer time to recover ok?

2. **Advice on other risks and structures**

There are many examples of advice that don’t fit into neat performance measurement categories.

a. **Advice on some risks can not be quantified simply** – this includes advice on credit guidelines, collateral management, credit default swaps, the potential for a MIFID II collateral car crash (fortunately didn’t happen), and setting liquidity testing limits considering interplay illiquidity, leverage & hedging.
   - The impact on the amount of leverage used can be considerable – either positively or not. In particular, many schemes have used LDI (leveraged gilts) to match interest rate risks whilst rates have been falling. Over the last 10 years it’s been all but a one-way trade. So more hedging has been beneficial. But what’s a prudent level of leverage? Should liquid reserves be set for a 1-in-20 or a 1-in-100 year event? Does that answer change if you are going to run the strategy for 20 or 30 consecutive years? The best outcome for the last 10 years would have been to ignore these remote risks and leverage as much as possible. Liquidity hasn’t bitten and investment in risk assets has paid off. But does maximising leverage with little regard top liquidity risk represent the best advice? Will such advice remain true for the next 10 years? Should you risk getting the timing right for a shift in such advice?

b. **Designing investment structures**: asset allocation can dominate investment outcomes over long periods. For asset managers, there is limited scope to invest in a single asset allocation decision if they are expected to perform consistently over 3 and 5 years. So whilst a property manager was in a better
position than Trustees to judge the balance of opportunities between UK and Overseas, they had limited scope to make allocations significantly different from a 50:50 benchmark. In almost all market conditions, they would be unlikely to use a full 40/60 range.

Our solution was to create regional benchmarks for the 40% baseline allocations (UK and Overseas) and an absolute return benchmark for the “varying regional allocation” of 20%. In that way the manager would retain at least 40% to each region but they were incentivised to allocate the variable 20% to their view of the best performing markets. The Trustees could now leave the allocation decision to the manager rather than try to fix it on an annual basis themselves. But how would the performance of such advice be measured? Is it just the manager’s performance against the new benchmark? Or is it against the old 50:50 one? Or a proxy that the Trustees might have chosen from year to year?

c. **Implementation leakages and daylight risks:** the costs of change – and risk management during it – are often overlooked. Quality advice here can make a very significant impact on a cost basis but these may be small savings in context of the whole scheme performance. Lower turnover will be lower cost but not all change is due to the strategy, some may be due to scheme-based cashflows. There are no simple or clear ways to aggregate such impact across multiple clients.

d. **Long term and absolute return benchmarks:** these create specific challenges in finding appropriate benchmarks.

- Private Equity outcomes are not known until the last distribution and performance rarely clear until at least 5-7 years into each fund’s mandate. An ongoing program will have a mix of vintages including expected negative performance of some initial investments.
- An absolute return equity mandate might target a 6% return but 2% might represent a great outcome in a bear market whilst 8% could be disappointing in a bull market. An understanding of such performance can be quickly lost if aggregated into a whole fund’s return or even the role of such strategies during a 10 year bull market.

3. Challenges in creating a robust and representative measure

There are many challenges and issues of creating the performance measurement around performance of research function, notional portfolios or client strategies. It’s true that with sufficiently heroic assumptions then this can be done. And for fiduciary management, where the consultant is acting as an asset manager with a pre-agreed, specific outcome and with control over decisions and timing, the measuring performance is critical and must be done.

However within an advisor’s role, there is too much specific detail that is lost in comparisons to research rankings or model portfolios. In practical terms these results can
have little more relation to a client’s reality than backtests. We see these gaps in asset managers. Almost every asset manager’s research model performance is very different to their portfolio outcomes. They tend to only be closely related with tightly defined rules and complex allowances for implementation costs. For an advisor, there are no tightly defined rules and connections.

This means that the connections between measured performance used in league tables and actual individual client experiences are likely to be tenuous at best. And this will be even less so for future performance as past performance is not a guide to the future. As an analogy, consider rolling a die. The average roll is 3½. If the last 5 rolls have generated an average score of 4, how much is known about the average score of the next 5 rolls, and with how much confidence? An average score of 4 is not enough to know the dice is unfair, and if the dice is fair we know nothing about the scores of future rolls.

Yet, if performance league tables become an impactful measure in attracting or retaining clients, the successful business models will be those closest to asset management. There will be evolutionary incentivisation to charge and act like an asset manager. Those focused on creating edges on advice will be pushed out by those focused on asset management. Good advisors will leave (why stay?) and inevitably less focus will be placed on quality advice.

4. Factors beyond risk and return

Being a good advisor goes beyond numbers. Quality advice should be customised to a client’s need and communicated well.

Good advisors help clients understand what they need to achieve along with both their risk preferences (what they would like) and risk tolerances (what they can survive). With risks there are no guarantees. Almost all beliefs and strategies will be tested at some point. It is the resilience to survive or adapt appropriately to those tests that is critical. Resilience requires pre-testing of reactions to stresses. It is ensuring risks are survivable by clients, their understanding of the necessity of such risks and incorporating their preferences or those that best fit within their own psyche and beliefs. Education and helping generating resilience is a key element of a good advisor.

There are also strong trade-offs between simplicity, cost and transparency; all of which lead to different strategies and solutions. These are hard to measure and clients will progress and adopt these at different rates. All of these impact individual performance and strategy.

Finally, advisors should be measured on their innovation, edge and excellence. Whilst past performance is not a guide to the future, innovation and preparing for it is! Recently there have been demands that consultants increase their focus on ESG and climate change risks. Consultancies will remain flat-footed if focus is on implementation and narrow performance tables rather than innovation and forward thinking.
Epilogue: my brief thoughts on measuring an advisor's performance

I believe investors should consider the quality of their advisor – but it’s important to look beyond the investment performance. Performance fees can be built into advisory agreements but I’d recommend these don’t use performance as the key measure. One way is to create a “balanced scorecard” built around assessments of different aspects of advice weighted by importance eg:

- 40% on quality of strategy advice: bringing clarity to the risks taken and helping balance chosen risks together
- 30% on quality in which advice was custom to the client’s specific needs
- 20% on quality of the communication
- 10% on the advisor's innovation and edge, are they moving forward, how much of an edge do they offer?

Different schemes are likely to have different needs and thus weight the above differently. 30% for customisation is biased to my experiences with large schemes. Smaller schemes might want something “off-the-shelf” and both reduce that weighting and possibly replace this element with “access and consistency of implementation of the advisor's best ideas”.

Whist balanced scorecards are a possibly, one of my clients simply had full discretion without any scorecard. My experience was very positive for both the feedback and client engagement it created throughout the year, not just at the year-end. Given a choice, and provided the client was comfortable, that is what I would personally recommend.