



KAMP INSITE



# Fireside Chat

Your Monthly Update from KCS

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## Asset Consulting – Shooting Itself in the Foot?

For an industry that has only been around for roughly fifty years, the business of asset consulting has gone through more changes than Tootsie, and most haven't necessarily supported their effort or economic viability. This *Fireside Chat* will review the history and evolution of a great but underappreciated industry. Will asset consulting survive another fifty years? Time will tell, but if it is to survive, it had better learn from its mistakes of the past.

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### An Industry is Born

The Investment Advisors Act of 1940 required delegation of investment responsibilities only to an advisor registered under the act or to a bank or an insurance company. As recently as the 1970's, the retirement industry was dominated by banks and insurance companies. In most cases, these "pillars of society" controlled the entire asset base for a company's retirement plan, and thus the fate of the plan's beneficiaries and the company's balance sheet. Any attempt to monitor the effectiveness of these entities was limited to performance measurement, which was in its infancy at that point.

### Measuring Up

The Bank Administration Institute (BAI) made time-weighted returns a standard requirement in 1968 with the publication of their Performance Measurement Standards, which endorsed time-weighted, date specific, monthly-linked calculations as the most appropriate form of performance measurement. This was followed shortly by the Investment Counsel Association of America's (ICAA) study in the early '70s, which also felt that time-weighted returns were superior to *dollar-weighted* returns (dollar-weighted returns are another name for Internal Rates of Return). It is amazing to think that this "standard" would be the catalyst that spawned hundreds of asset consulting firms during the next 25 years.

## Industry Pioneers

Early entrants into the asset consulting / performance measurement business included A. G. Becker (SEI), George Russell from the Frank Russell Company, Ed Callan of Mitchum, Jones and Templeton (Callan), and Bill Crerend, Paine Webber (which would become EAI). Our own Larry Zielsinski started in the business in 1969. Their efforts began in the late 1960's, and as usual, started at brokerage firms, where payment for services was often transacted through soft-dollar arrangements.

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## The 1970’s: ERISA Sets the Stage

The consulting industry really didn’t take flight until the passage of ERISA (Employee Retirement Income Security Act) on September 2, 1974. ERISA is a federal law that established minimum standards for pension plans in private industry (and a framework for public plans) and provides extensive rules on the federal income tax effects of transactions associated with employee benefit plans. ERISA was enacted to protect the interests of employee benefit plan participants and their beneficiaries by:

- Requiring the disclosure of financial and other information concerning the plan to beneficiaries;
- Establishing standards of conduct for plan fiduciaries;
- Providing for appropriate remedies and access to the federal courts.

ERISA’s hallmark legislation created full employment opportunities for actuaries, attorneys, accountants, asset consultants and investment advisors.

## The 1980s: Opportunities Seized...and Missed

As the asset consulting community developed, its services began to increase in complexity and scope. Our own Russ Kamp started in the business in 1981 and Lillian Jones in 1982. What was once a plain vanilla performance measurement service model evolved into the drafting of the investment policy statement, asset allocation, investment structure, manager selection (away from banks and insurance companies) and deeper, richer attribution analysis that began to set some of the players apart. These additional services provided consultants with richer fees and more control over the plan’s assets.

Firms began treating aspects of their primary consulting services as a loss-leader, with the hope of extending into higher margin business such as actuarial, brokerage, custody and fund of funds assignments. Pricing power was eroded for pure asset consulting firms, and as a

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## The 1980s: Opportunities Seized...and Missed (con't)

result, revenues declined, margins were compressed with the negative result of smaller research teams. Therefore, the “blue ocean” of opportunity quickly faded, as strong competition from asset class specialists in venture capital and real estate began to take market share from the generalist consultants. Later on, the alternative consultants would further whittle away the share of a portfolio that generalist consultants would control. This trend was most notable among the large (greater than \$1 billion) plans.

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*“Consultants underestimated the growth potential and importance of the defined contribution space and did not allocate resources or a model to service this plan type.”*

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In addition to the competition from these specialist consultants, the advent of defined contribution plans began to put defined benefit (DB) plans at risk. In 1986, there were 114,000 DB plans according to the Department of Labor. It has been reported recently that only about 38,000 DB plans are still operational. Many of the shuttered plans were replaced by defined contribution (DC) offerings. Consultants underestimated the growth potential and importance of this space and did not allocate resources to service this plan type, as they struggled to find a role other than performance measurement. Consultants play a major role in DC with compliance, fund management, performance and fiduciary / participant education.

Asset consultants and their clients enjoyed fairly strong markets for most of the 1980's, as the U.S. began its long bull market in bonds and domestic equities, much of it fueled by the LBO craze through Michael Milken and Drexel Burnham Lambert. The good times lasted for most plans until the fall of 1987 and the great market declines on October 16, 19 and 20, 1987. Asset allocation policies within DB plans were still fairly basic and the 60/40 (equity / bond) model was still the dominant policy objective. Many new tools were coming to the market through the investment management industry. Of particular note was the idea of portfolio insurance. Unfortunately, this strategy in many cases didn't perform as advertised, helping some, but in the process creating significant volatility which exacerbated the decline.

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*“The S&P 500 generated an 18% annualized return during the decade, far exceeding normal expectations for the asset class. However, those good times covered a lot of sins for the U. S. consultants and their clients.”*

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## The 1990's: Let It Ride

The savings and loan crisis of the late 1980's and early 1990's tempered returns for equities and real estate. Shortly after the beginning of the first Iraq War in 1991, the markets exploded. What transpired during the next 8 years was as good a period for investments as one could imagine. The S&P 500 generated an 18% annualized return during the decade, far exceeding normal expectations for the asset class. However, those good times covered a lot of sins for U.S. consultants and their clients.

As fixed income yields fell further and further, the idea of using bonds in a diversified portfolio became less appealing, especially with

## The 1990's: Let It Ride (con't)

client return on asset targets (ROA) in the 8-10% range. Pension plans changed their focus from covering liabilities to sources of earnings, especially among corporate plans. Equity exposures ratcheted up, private equity allocations grew, international and emerging market exposures were introduced and increased throughout the decade, and the concept of pension “earnings” was introduced.

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*“Unfortunately, instead of taking risk off the table following these good times, consultants and their clients adopted a ‘let it ride’ mentality until March 2000, when the equity markets reminded us that down-side risk does exist.”*

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By the end of the 1990's, many plans were sitting with surplus funds, while taking contribution holidays. Unfortunately, instead of taking risk off the table following these good times, consultants and their clients adopted a “let it ride” mentality until March 2000, when the equity markets reminded us that down-side risk does exist. The technology sector, most everyone's darling at the time, led the decline that saw equity markets under pressure until April 2003.

## The 2000's: Alternative Lifestyles?

It wasn't too long after the poor start to the decade of the 2000's that alternative consultants began to pick up market share, and alternative managers (absolute return) were being added to defined benefit plans. Pension plans and their consultants were looking at many strategies, both long and short, that would provide returns commensurate with what they had enjoyed in the 1990's.

Many strategies began to take advantage of the housing boom, from direct real estate to REITs to credit, etc. Some proved successful, while many didn't. One failed product, although not driven by consultants, was the 130/30 strategy. Interest in this strategy was primarily driven by the prime brokers who benefited from every dollar sold short (they got paid through borrowing costs).

The collapse of the markets in late 2007 placed significant stress on both consultants and their plans, as asset values plummeted and declining interest rates further exacerbated pension funding issues. Contribution costs escalated at a time when both corporations and public entities could least afford it.

## The 2010's: Enjoy the Roller Coaster Ride

Asset consultants have continued to face challenging times from lawsuits brought by clients (Alaska and San Diego to name two), to further consolidation among the leading firms, such as Mercer, Hewitt and Watson Wyatt, to OCIO models favoring large institutional managers, including BlackRock, GSAM and State Street.

With regard to acquisitions, some of the activity is being driven by the need to find economies of scale to improve lackluster margins. In

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## The 2010's: Enjoy the Roller Coaster Ride (con't)

addition, generational changes have inspired others, as first generation owners / operators are looking to monetize their businesses as younger employees lack the financial wherewithal to acquire these mature businesses.

Interestingly, performance measurement and consultant databases, once a value-added service and differentiating characteristic for some firms, became commoditized. The commoditization of manager data through firms like eVestment Alliance has significantly leveled the playing field among consultants, both large and small.

With the massive introduction of hedge funds during the last 10 years, coupled with the continuing explosion of product from traditional shops, including the launch of the ETF industry, consultants are overwhelmed with the responsibility to adequately vet them with their internal research teams. As a result, smaller, immature investment shops are often overlooked, and plan sponsors may not be getting access to the greatest alpha potential.

Fees, always an issue, remain underwhelming given the considerable responsibility that asset consultants have and the lack of economies of scale, as each plan is different. In most cases, the success or failure of a plan relative to its performance objectives is driven by asset allocation, which remains the domain of the asset consultant. The impact of low fees / margins on the consultants' businesses often results in young talent moving either among consulting firms or worse, to the investment management side of the equation, where greater scale and margins can accommodate their desire for more competitive compensation. In the end, you get what you pay for!

## Looking Ahead – Revisit Your Game Plan

There is a U.S. retirement crisis. The Wall Street Journal recently reported that 57% of workers surveyed had accumulated less than \$25,000 in savings and investment, excluding their homes. Furthermore, nearly 30% of workers would not be able to raise \$2,000 in one month to meet an unexpected expense. These statistics are both staggering and frightening.

The demise of the DB plan is much to blame for this issue. Fewer than 20% of private sector workers are now covered by a DB plan. Our society cannot afford to have the Baby Boomer generation retire into poverty. We need to preserve DB plans, but it will take a new direction. As Albert Einstein stated, *"The significant problems we face cannot be solved at the same level of thinking we were at when we created them."* We absolutely agree.

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## Looking Ahead: Revisit Your Game Plan (con't)

Pension consultants need to help plan sponsors improve their approach to management of pension assets. The focus on the return on assets (ROA) as the primary objective has proven to be the wrong benchmark. The plans exist to meet a liability and that liability needs to be the focus. As such, liabilities need to be measured more often and asset allocation needs to be geared to the liabilities. As the funded ratio changes (hopefully improves), asset allocation needs to be responsive. As a pension plan moves closer to full funding, risk should be reduced and the “victory” secured.

One significant movement at this time is the outsourcing of pension management to either a consulting firm or investment manager. The OCIO model can be applied to a portion of the corpus or the whole plan. There are many practitioners at this time. There are too many questions related to the OCIO model to appropriately discuss them in this piece. However, our greatest concern is whether the transfer of day-to-day responsibility is actually providing value added net of the additional fee to the plan sponsor.

The significant consolidation that has occurred within the asset consulting industry is not necessarily good for clients, as fewer players mean more group think. Consultants earn their stripes by providing interpretation, advice and recommendations, and NOT by presenting fancy performance reports to the plan sponsor.

We don't know if the consulting business will continue to evolve away from being a trusted advisor to a greater fiduciary role through the outsourced CIO model, but in either case, new solutions need to be presented that will preserve the viability of defined benefit plans. Experience, advice and recommendations matter! *"The measure of intelligence is the ability to change"*, said Albert Einstein. Our retirees are counting on us to come up with a game plan that will preserve their retirement benefit.



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