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Presentations from Mercer on Active Management and Active Ownership

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This presentation covers:

- A study on active management and its impact on active ownership
- A survey based summary of active management practices of other similar sized funds

Active management and active ownership

Emma Hunt

Active management and active ownership

Aim and methodology

- Aim: to undertake an assessment of the relationship between active management and active ownership
  - To what degree can active management have a positive influence on the possibilities for exercising active ownership?
  - If it can, how and why does this come about?
- Methodology: qualitative assessment
  - Understand latest views from academia through a review of academic research around active ownership
  - Understand latest views from practitioners through a series of confidential in-depth discussions with 18 of the world’s leading engagers and passive managers

What is active ownership

- Use of shareholder rights and position to influence the behaviour of a company
- Most commonly associated with:
  - voting and shareholder resolutions
  - one-to-one engagement
  - collaborative engagement
  - Policy or market level engagement
- Typical active ownership issues include:
  - Corporate actions
  - Corporate governance matters
  - Wider shareholder value issues such as environmental and social issues

Benefits of active ownership

- Protect or enhance shareholder value
- Protect or maintain the wider investment system
- Protect reputation and institutional identity
- Support theory of the firm, and the fundamental rights and obligations of shareholders
- Demonstrate investor responsibility, show leadership and avoid ‘free-riding’
- Good portfolio management

Factors that influence the effectiveness of active ownership

- Most frequently cited factors include:
  - Resources deployed to voting and engagement
  - Size of holding (individual holding, or combined holding)
  - Reputation of investor
  - Simple and clear engagement objective
- Investment style was noted as having an influence on the nature of the engagement undertaken*

Passive investors	Active investors
Policy or market-level issues	Company or sector-level issues
Longer term horizons	Short to medium term horizons
Risk mitigation	Used as a portfolio management tool

*Both passive and active investors had good coverage of corporate actions, reasonable coverage of corporate governance, with only some coverage of environmental and social issues

Different models available to funds considering active ownership

- Active ownership at the heart of the product strategy i.e. focus funds
- External engagement overlay services
- In-house corporate governance or investor responsibility function
- Active ownership integrated into role of fund’s (in-house or external) portfolio managers
- Contracted out voting services
- Participation in formal of informal collaborations

Potential advantages from active management

- Access to research and knowledgeable portfolio managers
- Regular access to companies
- Greater ability to identify issues of concern
- Ability to use the investment position as a lever for change
- Using active ownership as a proactive alpha-generating strategy

Potential advantages from passive management

- Strong incentive for undertaking active ownership as voting and engagement are two of the very few tools available to passive investors to protect or enhance shareholder value
- Real ability to address market risk and promote a robust and healthy investment system
- Potential for scale creating a powerful lever for change
- Ability to operate within a long term perspective

Common obstacles to active ownership from both active and passive management

- Cost versus the perceived benefit can act as a barrier to deploying resources to active ownership
- Free-riding is a major issue, and can act as a disincentive for investors to undertake their own active ownership
- Business models of commercial active and passive managers can act as a potential barrier to undertaking high quality active ownership

Closing comments

- Numerous and growing opportunities exist for funds and investment managers to engage in active ownership
- Investment style may impact the effectiveness of an active ownership strategy, but it does not appear to be a dominant factor
- Investment style is more likely to impact the nature of the active ownership
- Dynamic area, with increasing pressure on investors to play a more active role in capital markets
- With increasing pressure on investors to be transparent about their activities, and the increasing trend towards investor collaboration, this area is likely to evolve considerably over the next few years.

Survey on active management

Divyesh Hindocha

Active management and active ownership
Aim and methodology

- Aim: to survey the use of active management in other funds (large, long term investors of comparable size and complexity). More specifically, the survey examined:

  (i) the composition of active management;

  (ii) the performance in active management in recent years; and

  (iii) recent changes in the use of active management

- Methodology: survey based approach
  - Survey of 14 funds in different geographies
  - Mercer of the view that the responses are reasonably representative of current thinking amongst this universe of investors

Composition of active management - beliefs

- Most of the survey respondents believe that the markets provide regular or periodic opportunities to extract excess returns from active management (net of costs)
- Most respondents believe that markets as well as securities can move materially from “equilibrium” thus providing an opportunity to add value from active management
- A minority view was that even though markets provide opportunities this was not a sufficient condition to extract excess returns
- In practice all the funds in the survey used some element of active management. One used active management only for illiquid strategies

Composition of active management - role

- The predominant view was that active management can enhance returns. A minority view was that active management is a useful risk diversifier
- Use of active management was also useful in building internal capacity
- Use of active management could be useful in outsourcing benchmark decisions – especially for sub-asset classes
- Opinion was mixed on whether active management is a positive or a negative in market distress conditions

Composition of active management – comparative advantages

- The main comparative advantage was deemed to be the (long) investment time horizon…. in practice this is manifested in the greater exposure to illiquid opportunities
- Other cited advantages were the ability to build and retain internal expertise and negotiating power (although responses were more equivocal in this regard)
- The need for frequent reporting was not considered (on the whole) to be a disadvantage

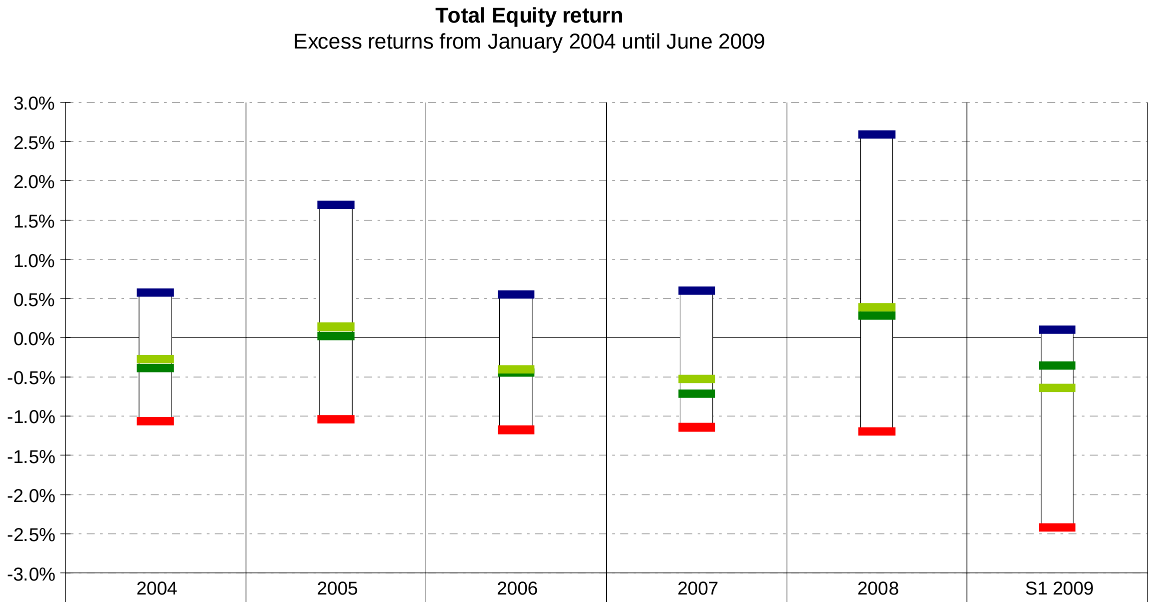
Composition of active management – factor exposures

- One of the challenges for investors is to decide which beta decisions to own and which to delegate to the active investment manager (external or in-house)

- Normal practice is for the big beta decisions (equity versus bond) to be owned by the investor but there is no market "best practice" on the allocation to other systematic risk factors (or return drivers) – e.g. value or small cap

- There was general agreement however that exposure to systematic risk factors should be a) identified b) impact understood and c) exposures should be monitored and managed

Active management : excess returns - equities

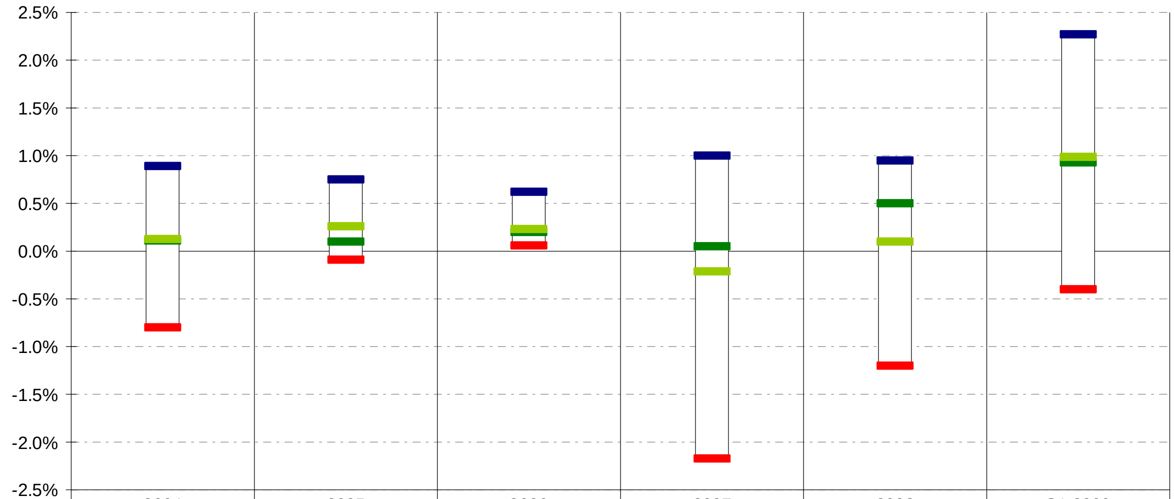


	2004	2005	2006	2007	2008	S1 2009
Maximum	0.57%	1.69%	0.55%	0.60%	2.59%	0.10%
Median	-0.39%	0.02%	-0.45%	-0.72%	0.28%	-0.36%
Average	-0.28%	0.14%	-0.40%	-0.53%	0.38%	-0.64%
Minimum	-1.06%	-1.04%	-1.18%	-1.14%	-1.20%	-2.42%
Number of funds	8	7	8	7	7	6

- Difficult to draw meaningful conclusions from small sample size and period of review
- Equity excess return has been mixed over the period – 2008 outcome was very variable with the “average” outcome being positive
- CEM data suggests an average excess “peer return” of 0% for 2008.
- Mercer universe of managers has a median excess return of -1.0% for large cap equities, institutional investors with a structural bias to small cap equity and emerging market equity would have experienced a worse outcome for 2008 (but a better outcome in 2009).

Active management : excess returns – fixed income

Total Bond return
Excess returns from January 2004 until June 2009



	2004	2005	2006	2007	2008	S1 2009
Maximum	0.89%	0.75%	0.62%	1.00%	0.95%	2.27%
Median	0.11%	0.10%	0.20%	0.05%	0.50%	0.93%
Average	0.13%	0.26%	0.23%	-0.21%	0.10%	0.99%
Minimum	-0.80%	-0.09%	0.06%	-2.17%	-1.20%	-0.40%
Number of funds	7	7	7	7	7	6

- Fixed income outcomes have been more favourable than equity
- CEM data suggests an average excess “peer return” of -4.8% for 2008
- Mercer universe of fixed income managers has global fixed income median excess return to be -6.4%, US core fixed income median excess return of -8.0% and US MBS median manager excess return of -5.5% (all for 2008).
- Strategies with exposure to spread products struggled in 2008 – but many of these strategies rebounded strongly in 2009.

Looking forward : active management in the wake of the financial crisis

- The respondents do not expect to materially reduce the "risk budget" to active management as a consequence of the financial crisis
- Respondents expected to enhance their risk control of their active management, for example a better understanding of the underlying risk exposures, considering better metrics to evaluate the value added from managers
- Respondents were also considering the following changes
  - exposures to illiquid strategies, on the whole this was likely to increase exposures (arguably this is not a direct consequence of the crisis)
  - exposures to leveraged strategies, on the whole this was likely to result in less exposure to leverage
  - approaches to active management (fundamental versus "systematic") although there was no "consensus" on the likely changes
- Respondents were also looking for a better alignment of interest between the active managers and themselves and to consider in-sourcing some of their actively managed assets

Closing comments

- The events of the later part of 2008 and the early part of 2009 presented a number of challenges to all participants in capital markets. Investors are still in the process of evaluating the lessons and reflecting these in their investment decision-making
- The key conclusions of the survey are:
  - other large funds of similar size and complexity to the Government Pension Fund – Global believe that active management has a role to play in their investment policies, their long term time horizon being a comparative advantage in this area
  - the funds are not materially changing their risk allocation to active management nor making any radical changes to their approach
  - the crisis may have accelerated what may be deemed to be evolutionary changes to develop approaches to better understand risk exposures and associated measures to monitor and manage these
- Mercer would formally like to thank the fund participants for their time devoted to responding to our survey and follow up questions

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