

Selecting an Investment Manager / The Basics of Securities Lending & Commission Recapture

Commonwealth of Massachusetts
Public Employee Retirement Administration Commission



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5 Middlesex Avenue, Third Floor, Somerville, MA 02145

ph 617 666 4446 | fax 617 628 4002 | tty 617 591 8917 | web www.mass.gov/perac

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Robert A. Dennis, C.F.A., *PERAC Investment Director*

Investment Director's Letter

This document outlines three aspects of pension fund management. One of the most important functions of the retirement board in the investment area is the selection of managers to actually invest the system's assets. Such a selection must take place in a manner that meets the board's fiduciary duty. As a result, it is critical that in assessing the merits of various managers board members review the items noted. Over the years, boards have been presented with a number of ways to realize gains that are not directly related to investment of assets. Two of these are securities lending and commission recapture. A brief discussion of these practices is also provided.

In producing this material, our intent is to introduce board members and others to general concepts. This is not an exhaustive analysis of these subjects and prior to retaining a manager or commencing a securities lending or commission recapture program, a board must engage in more extensive research.

I hope this is helpful to you and if you have any investment related questions or comments please contact me at (617) 666-4446 ext. 922.


Robert A. Dennis
PERAC Investment Director

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Part I: Selecting an Investment Manager

After asset allocation, the most important decision facing a plan sponsor is the selection of money managers. This process is generally as much an art as a science and it typically takes several years to reliably determine whether the effort has been successful.

The Search Process

An investment management firm should be selected not because of its relationship with a particular consultant, not because it made the glitziest presentation, and not necessarily because it had superior performance in the recent past. A search for an investment manager should incorporate an examination of ownership and organizational factors pertaining to the firm, an understanding of its investment philosophy as well as the process by which it implements that philosophy, as well as thoroughly assessing past performance and determining how relevant it might be for anticipating future returns. Also, besides knowing exactly who will be managing the fund's money, it is very important to know about the frequency and quality of client service.

Basically, a search for an investment manager begins with a decision as to how the mandate would fit in with overall asset allocation. The process should end with the selection of a manager in whom the board has confidence not only in its capability to fulfill its investment mandate but also in its likelihood of treating the fund as an important client and offering excellent client service.

Since investment styles go in and out of favor, since very few managers outperform their benchmarks year-in and year-out, and since all firms are subject to organizational change, there are no "sure things" in investment manager selection. However, it is fair to say that the keys to a successful relationship between a sponsor and a manager involve not just a determination of investment expertise but also the establishment of a sense of overall comfort and mutual respect.

Selection Process Questions

The following is an outline of a number of the factors that should enter into a manager selection process.

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- People**
- What is the organizational structure of the firm, and of the specific investment group for this mandate?
 - What are the staffing levels of the firm, by department or function?
 - What are the biographical highlights of key personnel?
 - Who will be the primary manager assigned to this account?
 - Get to know him or her!
 - How many accounts does he/she manage?
 - Who will be his/her backup?
 - Do the staff in this investment group work as a team?
 - What has been the investment staff turnover rate?
 - How are key staff compensated?

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- Philosophy**
- What is firm's traditional overall investment philosophy?
 - Top-down, bottom-up, quantitative, etc.
 - What is the role of research?
 - In-house staff, or street research?
 - What factors are emphasized?
 - For in-house research, how are analysts organized and how do they interact with portfolio managers?
 - How is investment policy determined?
 - Is there an investment committee?
 - What is current investment strategy in major markets?
 - Has there been consistency in investment philosophy and strategy over time?

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- What are the basic characteristics of the investment process?
 - Are portfolios managed by teams or by individual managers?
 - Do individual managers have discretion relative to firm's investment strategy?
 - If so, how much?
 - What is the review and control system relative to managers' performance?
 - Separate account or commingled fund?
 - What is the methodology of portfolio construction?
 - How is security selection and trading done?
 - What methodology for security evaluation is used?
 - How are trades allocated among accounts?
 - What are the buy/sell disciplines?
 - Do portfolios typically have high or low turnover rates?
 - Are portfolios typically highly concentrated or highly diversified?
 - To what extent are derivatives used?
 - Is there a system of risk management and control?
 - How are broker/dealers for trade execution selected?
 - Does the firm have a trading system that seeks to limit trading costs?

Process

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- Are timely, accurate returns regularly calculated and made available?
 - How has performance been relative to benchmark for this product?
 - Is the benchmark appropriate?
 - Is performance presented objectively and fairly?
 - Has performance been consistent?
 - How volatile have returns been?

Performance

- Is there a system for detailed performance attribution?
- Is performance repeatable or has it been due to special, one-time factors?
- Is performance consistent or widely dispersed among accounts?

The Firm

- Is the firm independent?
- If not, what is nature of its relationship with the parent company?
- Are there any significant company affiliations or joint ventures?
- Do employees have a stake in ownership? If so, what %?
- What is the compensation and incentive program for investment staff?
- What is the code of ethics for investment staff?
- What is the corporate culture?
- What are the overall business objectives?
- What are current assets under management, categorized by product line?
- What are recent growth trends?
- What products are “hot”?
- Is there any limit on asset growth or new clients?
- What new products or other changes are contemplated?
- Is the client base diversified?
- Is the client base stable? How many accounts gained or lost recently?
- How is client service structured? Who will be the primary contact and what is the frequency and form of contact?
- Are portfolio managers accessible and responsive?
- Does the firm have existing public pension clients?

- Is the firm or its principals involved in any ongoing litigation or investigations?
- Is the firm strong financially?
- Are there any potential conflicts of interest?
- Recent material developments

Part 2: The Basics of Securities Lending

A lender (pension fund) transfers securities to a borrower (broker-dealer), who needs the securities temporarily to support trading strategies (such as “short” positions) or settlement obligations. The lender retains most economic benefits of security ownership (except voting rights) over the term of the loan and has the right to recall the securities within a short, stated period. The borrower puts up collateral (usually 102% or more, marked to market daily), may pay a fee, and promises to return the identical securities. A lending agent (custodian bank) arranges and manages the loaning of securities and the investment of the cash collateral.

What is it?

Investment returns from the collateral are divided among the borrower, the lender, and the lending agent bank. For the lender, returns are usually sufficient to offset custody or other administrative program costs.

Borrower Risk

A lender will typically maintain a list of approved borrowers (broker-dealers). Borrowers must have high grade credit ratings from Moody’s and Standard & Poor’s and meet certain other financial criteria, such as minimum total assets.

Risks

Diversification

A lender will typically set maximum levels of lending exposure to any one borrower

Collateral Investment Risk (if cash)

The borrower will set investment guidelines governing the collateral it holds.

Credit Risk

Permissible securities typically limited to money market instruments, repurchase

agreements, securities issued by the US or other approved sovereign entities, and other AAA-rated instruments such as asset-backed securities.

Maturity Risk

The average life of the collateral investment portfolio should not differ from the average life of the outstanding securities loans by more than a specific duration, such as 60 days. A minimum percentage, such as 10% of the portfolio should be invested in overnight instruments for liquidity purposes and a maximum effective maturity (such as 14 months) should also pertain to permitted securities.

Operational Risk

Principals in securities lending must have strong administrative capability to carry out all the mechanics relative to movement of securities, to continuously monitor participating broker dealers, to effectively negotiate terms of the loans, to receive and invest the cash collateral and mark to market daily, to handle all aspects of broker billings, and to provide comprehensive monthly reports to clients.

Summary

While not risk-free, participation in a well managed securities lending program is generally seen as a safe method of adding incremental income to a portfolio without any significant impact on, or risk to, the overall investment program.

Securities lending is a huge factor in world financial markets. Governmental studies have recognized securities lending as an important source of liquidity to the financial markets.

Part 3: The Basics of Commission Recapture

Commission recapture is a well established, widely used and relatively simple concept intended to help pension funds reduce their transaction costs.

Typically, only about one fifth of a broker-dealer's commission rate for securities transactions relates to the actual costs of executing the trade. The balance is intended to cover the broker-dealer's investment research or to serve as "soft dollars" to purchase another firm's research or other investment-related services. Deriving from a 1986 Department of Labor ruling that stated that brokerage commissions are an asset of the pension fund, not of the investment manager directing the trade, commission recapture basically allows for the "unbundling" of the two components of transaction costs. That portion of total commission beyond the trade execution costs is rebated to the pension fund either in periodic cash payments or as direct payments to some of the fund's service providers. Since paying for research and other costs through commission dollars remains a legitimate practice, commission recapture is typically used for less than half of total trading volume.

While a well designed and carefully executed commission recapture program can be a clear benefit to a plan sponsor, a poorly conceived program could cost a pension fund more than it saves. Certain structures, such as one that requires an investment manager to segregate a pension fund's orders from the balance of a block trade, could result in inferior trade execution that more than offsets the reduction in trading costs. Any commission recapture program that disrupts the normal flow of orders across a manager's trading desk could end up being unsuccessful.

In addition to making sure that their commission recapture brokers are rebating the maximum percentage of commission dollars and that the trading procedure minimizes the risk of inferior execution, the plan sponsors must closely monitor their investment managers to ensure their compliance with and proficiency in carrying out the program.

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