The Role of an External Manager

Petroleum Fund Management Seminar

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Alex Joia

alex.joia@bis.org

Tel: +852 2878 7069

Senior Asset Management Specialist

BIS Asset Management

Hong Kong

Agenda

- Reasons for using exteral managers
- The Investment Management Agreement – IMA
- Trust is essential

- Annex: The four-step outsourcing cycle
  - Selection
  - Implementation
  - Monitoring
  - Rotation

Reasons for using external managers

- Portfolio manager tasks
  - Monitor market developments for opportunity and risk
  - Make buy/sell decisions
  - Implement buy/sell decisions in the portfolio
  - Risk and performance reporting

- Investors – the BPA included – can
  - Manage their funds in-house
  - Outsource the management to an external manager
  - Combine in-house with external management of funds

Reasons for using external managers

Background

- Asset allocation studies show that risk-return characteristics of "future generation" funds benefit from broad diversification across asset classes
  - Failure to diversify can have a significant cost in terms of lower expected return

- Active management can be viewed as a potential source of future returns
  - Failure to use active management may also have a cost in terms of lower expected return

- Outsourcing offers one way to achieve the desired asset allocation and amount of active management

Reasons for using external managers

Internal capacity constraints (can't do it in-house)

- People
- Systems
- Location (market proximity)

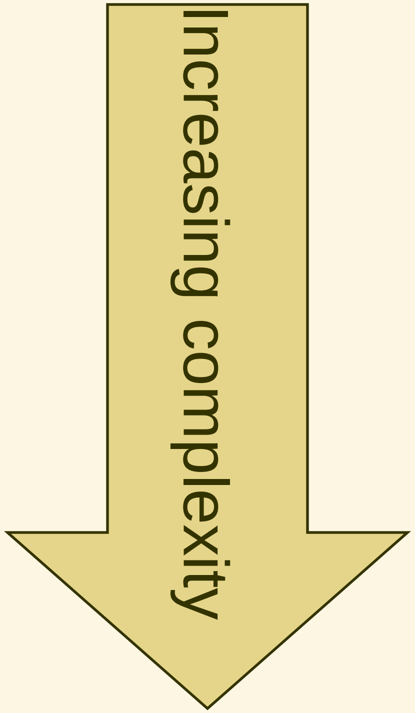
- A *"can't do it so won't do it"* attitude is not acceptable
  - As already noted: there is a cost in allowing these constraints to limit asset diversification
  - This cost grows as the size of the fund increases

- Using an external manager circumvents the internal capacity constraints

Reasons for using external managers

<u>Internal capacity constraints</u>

- Fixed term deposits and foreign exchange
- Government, government agency and supranational bonds
- Corporate bonds and equity
- Commodities
- Alternative investment (real estate, hedge funds, private equity)



- Economies of scale:
  - What can be done in-house on a USD300bn fund may not make sense for a USD6bn fund

Reasons for using external managers

Internal capacity constraints – active management

- Active managers try to outperform the market by incorporating their views in portfolio construction

- Successful active management is difficult
  - If it were easy all investors would do it and they would all outperform the market
  - But this is a contradiction since the market is comprised of all investors

- The challenge of developing and retaining the necessary skills for in-house active management is formidable
- External managers are often chosen on the expectation that they can add value through active management
  - Choosing successful managers is not easy

Reasons for using external managers

<u>Capacity building – training</u>

- The external manager can transfer knowledge and expertise
  - Especially useful if future in-house management is envisaged
  - Furthermore such capacity building may have wider benefits to the public sector and society
- Capacity building goes beyond portfolio management
- Capacity building involves:
  - Client visits – portfolio review and tailor-made training
  - Visits to the offices of the external manager
  - Participation in seminars and workshops organised by the manager
- Can the manager deliver?

Reasons for using external managers

As benchmark to measure performance of internal managers

- The performance of an actively managed internal portfolio may be compared to that of similar actively managed external mandates
- The positions of the external manager may be replicated in internal portfolios

Reasons for using exteral managers: summary

The Petroleum Fund of Timor-Leste

- External managers permit the Fund to be invested today across the appropriate asset classes

- Avoiding internal capacity constraints
- Ensuring optimal asset allocation
- Providing knowledge transfer and capacity building

The Investment Management Agreement (IMA)

- The IMA is a legally-binding agreement between the manager and the client
- The IMA reflects the investment parameters that the manager to operate within
- The negotiations to establish the IMA helps the manager understand the client, their investment objectives, constraints and risk-return preferences

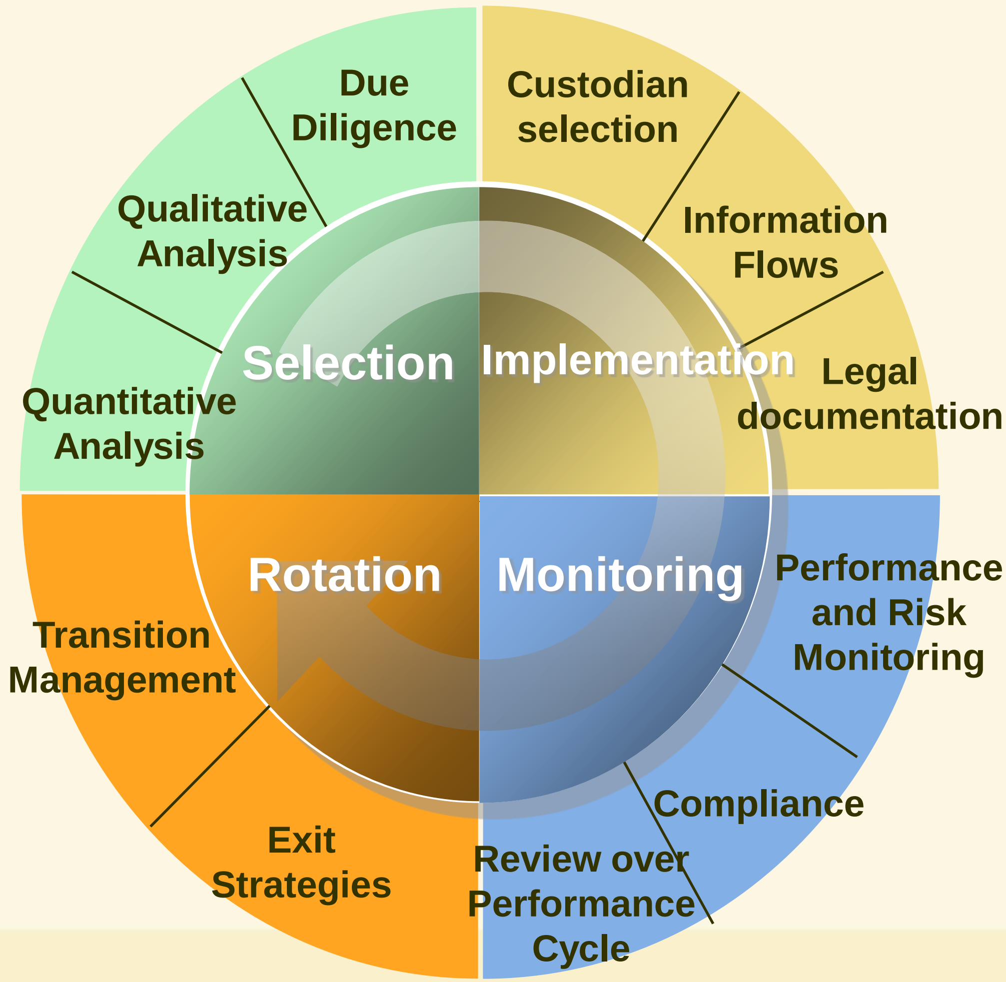
The Investment Management Agreement (IMA)

- The IMA will specify
  - The benchmark against which performance of the manager will be measured
  - Constraints that limit the types of instruments/risks that can be held in the portfolio and the extent to which the manager can deviate from the benchmark
  - Training commitments
  - Reporting requirements

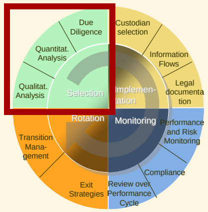
Trust is essential

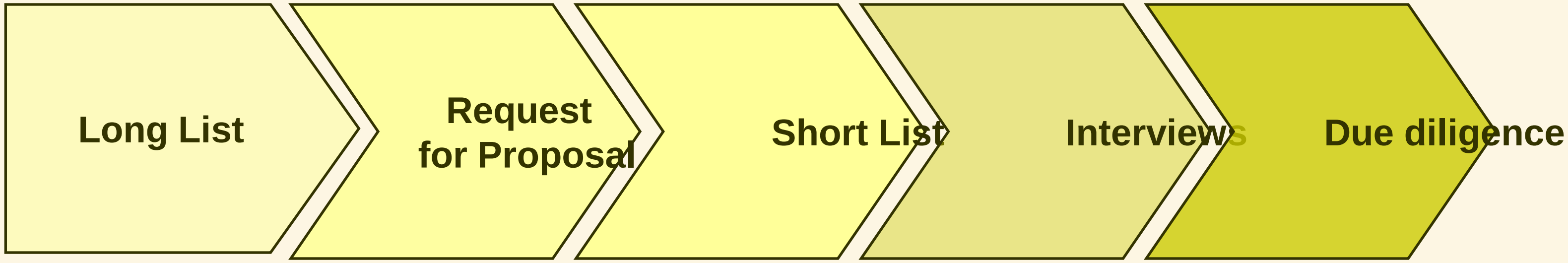
- *"A man I do not trust could not get money from me"*
  - – J. Pierpont Morgan, 1912

Annex: The four-step outsourcing cycle



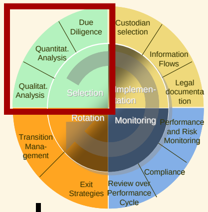
Selection



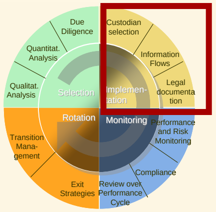


- A consultant can be used in the manager selection process

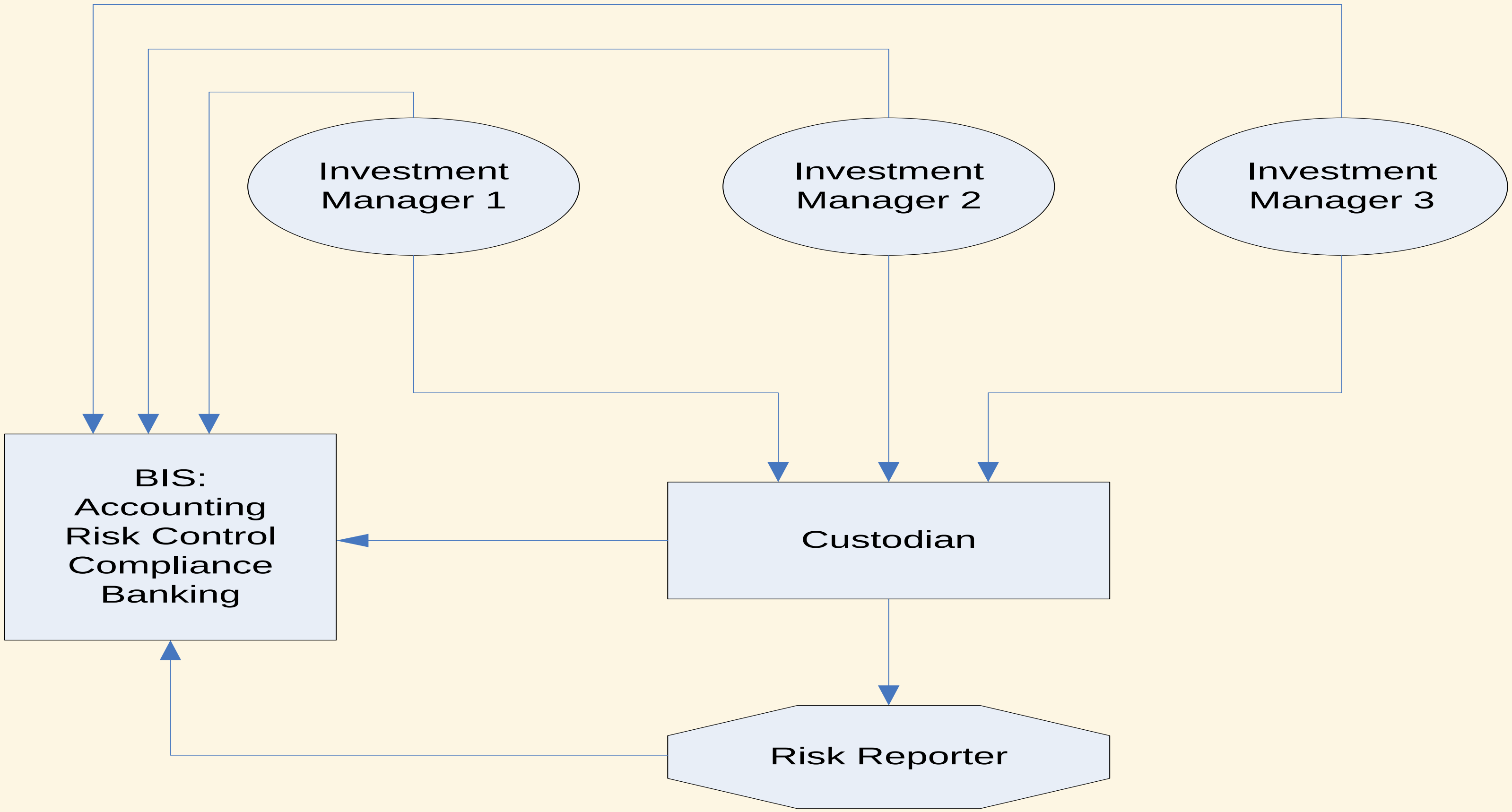
Selection



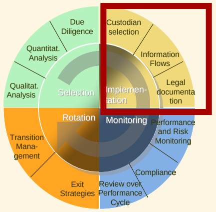
- Performance: historical record
  - Are you being shown a representative sample of historical performance? (GIPS helps ensure you are)
- Performance: style analysis
  - How has performance been achieved?
  - Are styles complementary across a multi-manager program?
- Performance: reliability
  - Is past performance representative of future performance?
  - Robustness of investment process, governance structure, internal controls, compliance and reporting



Implementation

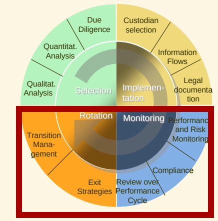


Implementation: the Investment Management Agreement (IMA)



- **Benchmark** is the basis for manager selection
- **Guidelines** are an important driver of performance
- **Tracking error** is an indication of risk appetite
- **Timeliness** of financial and risk reporting
- **Knowledge transfer** make sure expectations are clear

Monitoring and rotation



- Is manager delivering on expectations?
  - Performance
  - Compliance with guidelines
  - Training
  - Servicing
- Make them aware that you are constantly watching them
- Rotation should be decided on how well the manager has performed against these expectations over the performance cycle (typically three years)