Management Adviser

Volume 9 | Number 3 | Article 9

5-1972

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Recommended Citation

Dratler, Louise H. (1972) "Investing Pension Funds Sensibly, Profitably, Safely," *Management Adviser*: Vol. 9: No. 3, Article 9.
Available at: https://egrove.olemiss.edu/mgmtadviser/vol9/iss3/9

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Advantages, disadvantages of outside vs. in-house pension fund management discussed at Conference Board's Seventh Annual Financial Conference in New York —

MANAGING PENSION FUNDS SENSIBLY, PROFITABLY, SAFELY

by Louise H. Dratler
Associate Editor

LONGER life-spans, rapid technical obsolescence, greater automation, earlier retirement—these are some of the factors making pension plans so important to today's workers. Few people want to rely solely on Social Security benefits in their old age.

The increasing sums of money being contributed to pension funds have made them important to the financial community as well. The funds represent a source of long-term investment capital. However, it is up to responsible company officials to select the right investment advisers to make these funds grow. Companies are giving increasing time and thought to the management of pension funds and have evolved several methods of handling them profitably.

This was the topic at a Conference Board panel session, "Challenges in Pension Fund Management," at its Seventh Annual Financial Conference, February 23-24 in New York. The three panelists addressed themselves to different methods of handling these funds, either through the employment of one outside "money manager," of several, or of do-it-yourself pension fund management.

Corporate pension funds currently account for over $100 billion, William A. Hayes, director of pension fund investments for the International Telephone and Telegraph Corporation, told The Conference Board members. Pension funds are both a large asset base and an escalating expense item for corporations, he noted, and are presently one of the most dynamic growth markets in the United States. Over the decade there has been a threefold jump in benefits paid and almost a threefold jump in contributions to the funds.

Mr. Hayes considered the question of how a company should choose a money management firm from the many available, or "how

to choose the best from the best." In its search for a money manager, the company must consider such questions as: How much weight should be given to the manager's past performance? Should a large or small firm be selected? Are we striving for geographic dispersion in our investments? Should the fund invest in growth stocks?

At the start, the company should decide what performance and what return it will ask for on its investments. Ten per cent per year or more is quite an acceptable rate, Mr. Hayes said.

Four check marks

When reviewing a financial management firm's [in the parlance, a money manager's] record, Mr. Hayes advised, four checks should be made: What level of risk has the firm assumed? Are the same people that helped to establish this record still with the firm? Has the market changed from the period encompassed in the firm's record? Does the record cover several market periods, bear as well as bull?

A checklist of ten key characteristics to help in the selection of a pension fund manager was outlined by the ITT pension fund investments director:

1 - Does the firm have a clear philosophy of operation? It should not try to "play all games at all times." Does the firm's philosophy agree with yours?

2 - What is the firm's depth of talent? "There should be more than just a strong leader at the top." One should try to meet as many members of the team as possible.

3 - Does the firm have a strong research base and a record of good stock selection? "The best money managers typically pay top dollar for the best research available."

4 - Does the firm have the ability to cope with time compression, volatility, and emotional content of the market? "Go visit its office to see."

5 - Does the firm have a combination of "macro" and "mini" thinkers? It should show evidence of making quick, firm decisions, and "not get lost in GNP figures," which could disguise the conditions affecting a particular investment.

6 - What is the quality of the firm's holdings? The firm should have been through at least one bear market.

7 - Does the firm have a sense of market history? It should show signs of "watching the crowd from a safe distance."

8 - Does the firm have a strong concept of risk and reward? What are the risk parameters of the manager's portfolio?

9 - Does the firm have the ability to recognize its errors? Does it realize its past mistakes and know what it should have bought or sold?

10 - The men managing investments should be "having fun"; they should still be fascinated by the securities market.

A company's relationship with its pension fund money manager will usually be a long one, Mr. Hayes said. These ten characteristics should provide the outline for a dialogue to give the company a perspective of the manager's work and ability.

Splitting fund management

Splitting pension funds, that is, allocating money to various investment managers to improve long-term performance, is a technique employed at General Telephone and Electronics Corporation as well as many other big corporations with large assets, said panelist James M. Dunn, Jr., assistant treasurer and director of pension fund administration for GTE.

Before splitting a pension fund the primary considerations to be weighed are: *The size of the fund*—if it is too small (under $5 million) it should not be split; *the characteristics of the pension plan*, such as the age of the work force and the cash flow; *the economics of the business*, such as the difference in contributions going into the fund; *the time horizon*—30 years is typical, for while you don't want to lose money in the short term, it is the long term that should always be paramount; and *the desired reward/risk levels*—what is the risk level managers should assume, remembering always they are investing for a pension fund.

Company's objectives are factor

Mr. Dunn said the company must rank its objectives; at some points in a company's history some objectives are more important than others. There must be communication, both written and oral, of the company's objectives to the investment manager. The communication should be two-way between the manager and the company.

GTE has a $900-million pension fund. Some of the characteristics it looks for in its money managers are: organization and experience; philosophy and approach; historical performance; strategy development; and motivation. GTE looks for overall professionalism in its investment managers and asks what is the likelihood of good long-term performance, Mr. Dunn said. "The guy who says he can do 20 per cent per year compounded is exaggerating," he said. "Five to 12½ per cent is realistic."

He then cited the advantages of splitting a pension fund. Splitting affords a wide range of expertise because of the many talented managers involved. It allows for flexibility, as it enables switching between managers. Splitting gives the fund diversification in terms of issues, risk talent, etc.

Splitting also motivates the money managers to perform well because there is competition among fund managers. GTE employs a "weed and feed" approach with its money managers, Mr. Dunn explained. Those managers that do well are given a larger portion of the fund's portfolio and all managers are told how they are performing relative to one another. Splitting also allows an education period for the fund money managers. This is a "farm team concept," Mr. Dunn said, which allows GTE to give a manager a small portion of the cor-

poration's portfolio and to increase the portion as the manager's performance warrants. The final advantage, and the advantage that all the others are supposed to lead to, is the possibility of improved long-term total return, Mr. Dunn stated.

There are disadvantages to splitting the pension fund. Mr. Dunn cited "the dilution of excellence" as one. Splitting dilutes the effect of what one good manager could accomplish. There are added expenses because of splitting, i.e., implementation funds, more trustee fees, more home office time spent. Also, splitting adds to the communications necessary. Splitting presents the danger of overdiversification. When this happens, "weed and feed" procedures are called for, Mr. Dunn advised.

If a company decides to split its pension fund among several investment managers the methodology involves four phases. First, the dollars have to be allocated. "Obviously you want to put the most with the guy doing the best," Mr. Dunn said. However, the company should have some money with managers it is grooming for future use. A second group of tasks is communications and motivation. The third is monitoring and evaluating results. Finally, the company must deal with performance. If a manager is not doing well, as a last resort you get rid of him, but it is a last resort because it is expensive, he noted.

In splitting, the reward comes from selecting the right money managers, he said. You must get talent to work with your assets, Mr. Dunn reasserted.

In-house management

What about in-house management of pension funds, where the company does its own investment management? Unlike many home handymen who turn to do-it-yourself projects because they lack the funds to call in a professional repairman, do-it-yourself pension fund investment management is being done by the companies that have the most money to work with and could easily afford an outside professional's services. Usually, of course, these are the companies that have staffs with the necessary expertise.

William R. Donnelly, vice president of TRW Inc., said that his company now has six separate pension funds, one of them managed in-house, while the other five are handled by outside investment managers. TRW receives daily reports of the buying and selling activities of all its managers and holds monthly meetings with them. In-house investment management is reached by a slow, evolutionary road, Mr. Donnelly said. The largest companies are those doing the most in-house management. G.E., U.S. Steel, General Tire, and DuPont are some of those that have successfully tried in-house investment management, the TRW vice president added.

Mr. Donnelly pointed out the advantages of in-house pension fund investment management: There is clearly defined responsibility of fund management under corporate officers, which eases the problem of communicating company objectives to fund managers. In-house affords greater control of portfolio selections. Mr. Donnelly cited the example of one fund manager buying a stock while another is selling the same stock, so that the fund winds up trading with itself and has multiple broker fees to pay. None of this can happen with in-house investment management. He also cited the possibility of an outside fund manager buying stock in a business the pension fund's company is trying to acquire, thus running up the price of the stock.

Outside investment advisers often have a high turnover in personnel and every time the pension fund is assigned to a new man the company's objectives must be explained to him. With an in-house operation, company management has the ability to select, hire, and retain employees it finds satisfactory, Mr. Donnelly said.

An in-house operation also gives the pension fund the ability to make quick market decisions. Information developed by in-house officers in other divisions is available to an employee while it might not be to an outside adviser. In-house management allows the company to direct commissions to the firms it prefers and to save commission expense by dealing in third and fourth markets [transactions not made through an exchange or normal over-the-counter procedures] or arranging new negotiating rates through large block sales. Finally, in-house investment management protects the company from potential conflicts of interest.

In-house drawbacks

The disadvantages of in-house management include adding to direct corporate costs the salaries of staff personnel for this function. With an outside manager these costs would be absorbed by the pension fund or included in the commission fee. In-house management also creates a new department to supervise with the attendant difficulty of finding the right staff for it, something beyond the ordinary capabilities of most personnel departments. Mr. Donnelly also observed that generally the members of many companies' boards are older individuals who tend to be ultra-conservative. They worry about making a bad investment decision for the pension fund because they fear risking a class action suit.

The growth of pension funds is large enough for both in-house and outside advisers to work in the same market, Mr. Donnelly said. "I think the more aggressive firms will be moving to in-house where they have more control of their funds," he said.

In a question and answer session that followed the panelists' presentations, Mr. Dunn stated that Government regulation of pension funds is coming and said he hoped that the legislation which evolves will be fair and workable for all parties concerned.