Exposure to Diligence Performed by Your Institutional Investment Consultants

Allianz GI Structured Alpha Fiasco: Could It Happen in Your Pension Plan?

You have surely read how large pension plans invested in Allianz's Structure Alpha strategies, each losing 5% to 50% of their assets, in March 2020. How could such catastrophic losses happen when these pension plans were all supported by board directors, investment staff, and large investment consultants? Is that not the model used by most large pension plans, including your own?

We think every pension plan should review the entirety of their investment governance process. The strong similarities in your governance process to the loss-ridden pensions, alongside increasing degradation in the quality of work at some large investment consultants, suggests that your pension could lapse into similar mistakes quite easily.

What Happened With the Allianz Strategy And Why Does It Matter?

First, let us review what actually happened with the Allianz Structured Alpha losses. Prominent investment consulting firms recommended it, pension staffs endorsed it, and pension boards approved it. The program superficially looked quite appealing as it did produce higher returns for years. The important caveats that its investors missed are that it could produce a -100% return in a market crash, like the one in March 2020, and that the Funds massively overcharged clients for the services provided. Some pension boards placed 5% to 7% or more of their portfolios in this single high-risk strategy with a single manager, and then lost 75% to 97% of all their monies invested. Frankly the return-enhancement strategy—selling "lottery tickets" in the form of far out-of-the-money put and call options—is widely viewed as a "joke" among sell-side risk managers, who would look askance at their own bank and brokerage traders ever pursuing such a strategy.

We are of the view that a strategy considered to be a "joke" is unsuitable for a pension plan. How did it get into the pension portfolios? Most board directors, through no fault of their own, never worked at an investment bank or on a trading floor, and thus board directors rely heavily on staff and investment consultants. Some of their staff ideally should have the expertise to recognize the strategy's weakness in a market crash. Large investment consultants should certainly have understood that the strategy was simply unsuitable for their clients, yet they still endorsed it.

Key Areas Where Pensions' Existing Investment Protocols Become Unreliable

We find that pension plans face several key areas of vulnerability with their existing investment process:

Faulty Internal Processes – Internal due diligence processes often have rigorous and lengthy checklists that provide investors with a false sense of comfort. It would be easy to see the Allianz strategy score highly against a detailed yet naïve checklist, presenting as it did a very attractive multi-year performance track record and managed by a large, deep-pocketed asset manager. No checklist is a substitute for investment expertise. If staff, the investment committee, and the investment consultant *think* they understand the strategy, but do not, the checklist approach will amplify the collective sense of false confidence.

Excessive Reliance on Institutional Investment Consultants – Pension staff and board directors rely heavily on the large investment consultants to perform a thorough analysis of each manager and strategy. Pensions should also be paying attention to what is happening inside the large investment consultants. Many have become for-profit firms that are not necessarily focused on providing the best research, and some of their due diligence reports read more like cheerleading for managers than presenting a balanced assessment. We have seen senior due diligence staff report to accountants and deep cuts to manager research efforts following acquisition by for-profit firms. Some consulting firms also face myriad conflicts of interest that may not be adequately disclosed. These problems are exacerbated by the extremely low fees paid to pension consultants. We have even seen employee-owned investment consulting firms themselves outsourcing their due diligence work. With the Allianz situation, we have seen some involvement by three different large consultants, so this type of failure is prevalent.

Pension's Internal Investment Staff Lacking in Numbers, Training, or Experience - Earning a CFA or CAIA credential should ensure that the employee is qualified to understand and evaluate a simple strategy like Structured Alpha. Yet, one remembers the axiom about doctors: the procedure they are about to perform is the topic they got wrong on the medical boards! The same holds true for CFAs and CAIAs. An additional risk is that frequent employee turnover, common in the investment industry, or lack of professional development for staff, can disrupt the diligence and controls.

Even with an outstanding internal team, asking them to cover too many investments can lead to material oversights and omissions. Pension investors should carefully assess whether their processes include sufficient internal analytical resources to pursue the breadth of strategies in their portfolio. Needed workloads should be carefully quantified and compared to the workload asked of staff, to ensure a good alignment.

Limited Bandwidth of the Board Directors - Investment committees often contain members with varying degrees of investment expertise, or with substantial outside commitments. Often less vocal committee members feel may hesitate to challenge the more forceful voices, but they miss the opportunity to voice important insights. Nonetheless, the fiduciary duty remains with the full investment committee and ultimately with the board. *Board directors could face liability issues if they fail to detect major omissions in the pension plan's investment process.* With the apparently diminishing reliability of the larger investment consultants, we believe board directors will face an increasing number of crises in their portfolios, along with the potential risk of personal liability.

Recommended Solution – Undertake an Investment Governance Review

The catastrophic losses in the Allianz funds occurred for investors despite a perceived robust investment process. Pension fund fiduciaries are right to be concerned about other possible problematic holdings already in the portfolio that have escaped proper vetting. There is a solution already widely available to help ferret out these "ticking time bombs." An Investment Governance Review [IGR] addresses the following critical areas:

Governance Review -- A review of the entire processes by which your pension considers, reviews, monitors, and deploys capital, to ensure that your duties of care and loyalty are met. This review is a detailed, step-by-step examination of the governance structure and how the duties are discharged.

This would help ensure that the Board fulfills its Duty of Care as fiduciaries. Such an assessment, an "Investment Governance Review," should occur at least biennially, if not annually. including:

Complete Portfolio Review – The assessment would review all current holdings with an eye to identifying whether the investment holds material hidden risks, correlations, or weaknesses, and whether the investment is properly characterized in the pension's holdings and risk reports.

Assess Your Diligence Processes – A thorough review of diligence and approval processes typically leads to improvements in diligence practices. While no investment process is perfect, identifying strengths and weaknesses can help pensions mitigate and manage risks so that the portfolio will perform in a manner consistent with expectations. Moreover, our review often leads to improved future performance of investment staff, who become more effective with improved investment processes, and better at prioritizing and communicating with board directors. Too often, in-house analyses are colored by employee compensation concerns, wanting to avoid challenging the party who recommended the investment, or unwillingness by employees to admit that they simply lack the ability internally to analyze certain types of structures or asset classes. Complacency can arise when an investment has been held for a multi-year period, its returns are within the expected range, or alternatively the Pension Fund holds other investments obtained from the same provider. In such circumstances, style drift and changing risk profiles can be easy to overlook. We identity misalignments and provide recommendations on how to reduce or eliminate those problematic vulnerabilities.

Robust Analysis of Problem Investments - The Board may well be concerned with a specific investment that they currently own and have a vague/strong feeling of discomfort. We can perform a specific one-off analysis to vet the strategy, structure, and risks of a specific investment. Too often, the board directors see the investment listings neatly lined up in a report and the completeness of the report is assumed since all investments are listed. We would point out that the quality of the data that populates a holdings report (or risk report) can vary dramatically by asset type and structure, liquidity, and other critical factors. Often there are short cuts, estimates or other expedients or manual adjustments made that are not captured or disclosed on the report. These artificial constraints or "plug factors" can be themselves concealing risks or vulnerabilities from the Board.

The Allianz Structured Alpha Funds evidenced a fundamental failure in basic due diligence. In fact, the strategy can be viewed as quite simple with few moving parts. Surely there was sufficient expertise within each Pension Fund to perform a sufficient analysis. The strategy was simply the sale of put options on equity and sale of volatility options and the Fund pocketed the option premiums which were described as income/returns. Several of the largest losses occurred where the plan sponsor did hire large investment consultants to track and report on risk but that proved in retrospect to have provided a false comfort. For less than $20K per investment, these plan sponsors could have easily hired an independent expert team to dissect the entire structure and produce a detailed 10 -12-page analysis usually within a month of each request.

Our Value Proposition for Pension Plan Sponsors

Our Investment Governance Reviews provide a detailed assessment of your entire investment process. We assess the quality of services provided by your investment consultant. We review your portfolio construction and compare it to your investment policy statement. We review your board investment committee activities and reporting packages to see if your process is sufficiently agile yet comprehensive. We assess the quality and workloads of your staff, to ensure that your investment process is being managed with the care you would expect in an institutional setting and to propose ways to improve the investment process. Moreover, the IGR is much less expensive than hiring a second consultant to monitor your portfolio. You benefit from our experience covering the investment consultants and OCIOs, and this benefit accrues to you in lower fees.

We are experts at assessing institutional consultants and financial governance processes, and we have helped clients address exactly the concerns we describe in this letter. We have also reviewed over 40 institutional investment consultants and can help you identify the strengths and weaknesses in your coverage from them. We possess strong capital markets backgrounds as well, and we have evaluated over 2,000 managers since 2003, covering virtually every asset class and investment style. Moreover, we have deep networks of experts developed over the last 30 years to ensure full product and strategy expertise. Our analysis is performed only by senior analysts. This team approach ensures than 90+ years of combined investment expertise is focused on your portfolio and your diligence.

We are an independent firm, a boutique that has NO conflicts and works SOLELY in the interests of the pension fund. We do not recommend investments and are paid only under retainer agreements with our clients, with strong NDA protections for those clients.

Importantly, we are not seeking to compete with your investment consultant. We have likely already evaluated them as potential candidates in our OCIO and institutional investment consultant search business, and we have a good understanding of their strengths and weaknesses. You can benefit from our expertise in those markets, because we offer a broader perspective on this market than you could possibly build internally from an occasional consultant search effort.

We look forward to speaking with you and answering any additional questions that you may have.

Want to learn more? Please contact Chris Cutler, Tom Donahoe, or Safia Mehta at 917-287-9551.

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