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Decoding Investment Consultant Alpha

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The investment professional that has the greatest impact on the investment success of an institutional investment plan is the investment consultant. Yet, paradoxically, there is a troubling disconnect between the high level of responsibility and the low level of accountability. The disconnect stems from a lack of investment performance disclosure by the investment consultant. Regulators, plan sponsors, and plan beneficiaries should take notice of this disconnect and close the disclosure gap as it is silently costing institutional investment plans greatly.

This open letter follows the decisions of a newly hired investment consultant over the course of their first six years. It demonstrates how investment consultant reports are incomplete such that plan sponsors truly have no idea if and how their investment consultant is helping or hurting. Many plans have fallen into "critical" or "endangered" status precisely because of poor investment advice given by their investment consultants. Ironically, to improve funding levels, many of these plan sponsors are seeking higher returns and taking on greater risk by relying on advice from the very same investment consultant that got them into the problem in the first place.

This open letter clearly explains the disclosure gap and offers a blueprint for solving this serious problem.

The investment consulting industry has grown tremendously over the past 40 years. Many of today's prestigious consulting firms evolved from full service brokerage by offering institutional clients specialized services including advice on asset allocation, manager selection, performance reporting, and soft-dollar trade execution. Today, the investment consulting industry oversees many trillions of dollars for 1,000's of plan sponsors and has further expanded their services with vast research departments filled with large teams of professionals, trade execution studies, asset-liability modeling, Monte-Carlo simulations, host client conferences, and today are seeking discretionary authority over plan assets.

Despite this evolution, in one crucial area the investment consulting industry still lives in the Stone Age. The simple truth is that investment consultants do not self-report. Their plan sponsor clients are left in a fog of uncertainty and cannot answer the question, "Is my investment consultant adding value?"

Since the dot.com bubble bursting in 2000, the WorldCom scandal, Enron and other financial debacles, regulators such as the U.S. Department of Labor (DOL), the U.S. Securities and Exchange Commission (SEC) and the Department of the Treasury, have greatly increased regulations and disclosures to ensure openness and transparency in financial markets and fees paid to investment professionals. Further, Congress passed legislation such as the *Pension Protection Act* and *Sarbanes Oxley Act* to further ensure greater transparency, openness, responsibility, and disclosure by market participants.

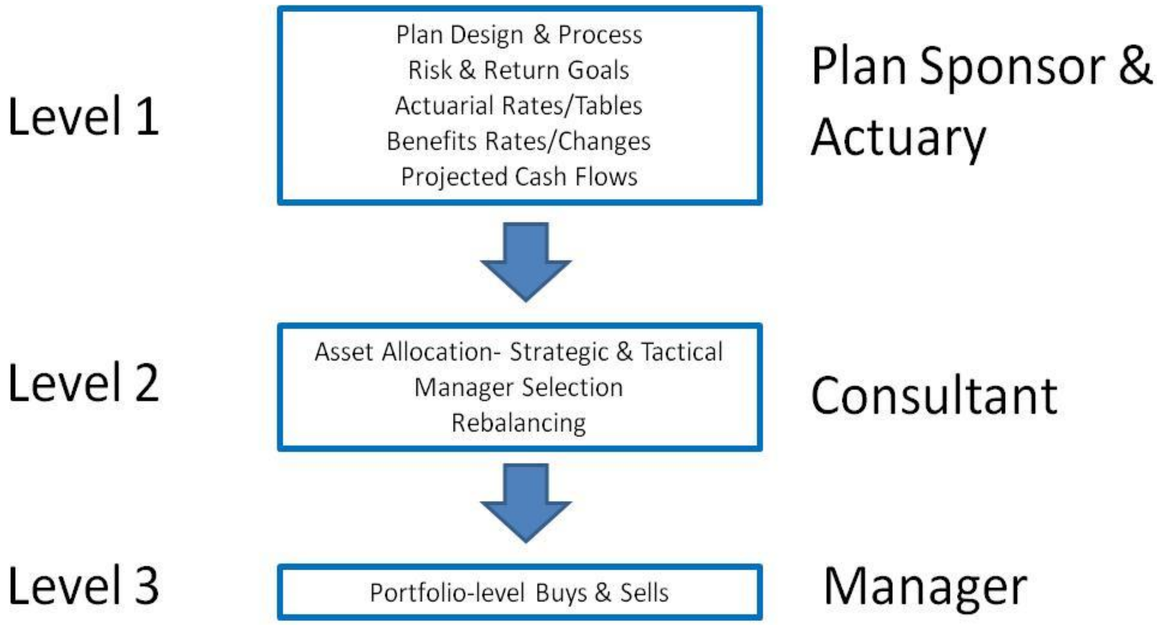
Despite greater regulation of their plan sponsor clients, investment consultants have largely escaped these reforms and remain in the Stone Age providing insufficient disclosure to their clients. This lack of disclosure should trouble plan sponsors and regulators as it makes it virtually impossible to effectively monitor the professional most responsible for the investment process and success.

During my 20+ years of investment management experience, primarily working with Taft-Hartley plans, I have worked with dozens of investment consultants concerning the asset allocation and manager selection functions. Following this experience, this open letter will walk the reader through the key aspects concerning the investment consultant's role and demonstrate how their reporting is woefully incomplete such that their clients will find it nearly impossible to evaluate the consultant's ability.

Regarding the last sentence above, experienced regulators and professionals may find it hard to believe there is a lack of disclosure. After all, given that investment consultant reports are routinely more than 100 pages filled with 1,000's of figures, charts, tables and graphs, how can there be a lack of disclosure? The key to understanding the investment consultant report, which is often the only plan-wide performance report plan sponsors review, is that it only reports on the *Level 3 portfolio-level decisions* of the various investment managers, and not the *Level 2 decisions of the investment consultant*. In other words, the investment consultant does not report the alpha impact of their own Level 2 decisions.

There may be investment consultants in the marketplace today that provide performance analysis of their Level 2 decisions. However, those consultants are the exception. Investment consultant reports lack critical feedback loops regarding their most impactful decisions when it comes to achieving investment success. Combine this fact with them normally being the sole provider of overall plan performance, and it becomes nearly impossible for the plan sponsor to gather the necessary data to quantitatively evaluate the investment consultant's ability to make profitable decisions.

Let us briefly analyze these Level 2 and Level 3 decisions and show how they differ. The following chart separates the key levels of investment-related decisions for institutional investment plans.



Level 1 decisions concern plan design. They are long-term in nature and therefore should seldom be altered as they are meant to last forever. Most of the plan design features are based on long-term projections of expected asset returns and actuarial projections such as mortality and retirement age.

Level 2 decisions are then made to achieve the Level 1 objectives. Normally, the plan sponsor hires an investment consultant to draft an *Investment Policy Statement* (IPS) which serves as the written guidelines for accomplishing the investment goals of the plan. The primary decisions in executing the IPS concern asset allocation and manager selection. *These are the key Level 2 decisions that are not reported in the investment consultant reports and it will be shown later how that is accomplished.*

Level 3 decisions are the portfolio-level decisions made by the investment managers. The results of buying and selling securities are the Level 3 decisions that are the *primary focus of investment consultant reports*. The performance reporting on the various investment managers are normally relative in that they are compared to a benchmark and universe of similar managers.

Let us now follow a hypothetical plan as they hire a new investment consultant and this new investment consultant makes nine Level 2 decisions over the course of six years.

The United Industrial Metal Workers Defined Benefit Plan is a hypothetical, multi-employer, defined benefit plan governed by the Employee Retirement Income Security Act of 1974 (ERISA). At of the end of 2006, it had $500 million in assets. It has 10 trustees that are fiduciaries with 5 representing the employees (labor) and 5 representing the contributing employers (management). Collectively they are a plan sponsor that follows a trust agreement. To fulfill the terms of the trust agreement, the plan sponsor hires various professionals. With regards to investments, they currently have six investment managers and one investment consultant. These investment professionals are also fiduciaries under ERISA.

The United Industrial Metal Workers Defined Benefit Plan has an investment consultant named Allison Alpha. She is the sole owner of All Alpha Investment Consulting, a small firm located in the Midwest. She has been working for this client for the last 5 years. At the beginning of 2006 Allison announced that she will retire in 2007. She has been grooming her son, Allen Alpha, to take over the business. In response to this announcement, The United Industrial Metal Workers Defined Benefit Plan performed an investment consultant search. The trustees felt that although they performed near their policy index, since they are paying active management and consulting fees, they should be achieving above-benchmark returns. Besides, they do not have much confidence in Allison's son, Allen.

The search concluded with the hiring David Dashing, CFA of Mega Money Investment Consulting. Mega Money is a nationwide consulting firm with a large research department, "a rigorous and disciplined manager selection process," and a Global Research, Execution, and Allocation Team ("GREAT") with an average of 20+ years of experience. Mega Money was the obvious choice to replace All Alpha.

The new consultant will begin January 1, 2007. Further, the plan sponsor has given David Dashing, CFA and Mega Money discretionary authority to change the asset allocation and hire and fire investment managers. They expect this will save on time, quicken execution, and improve returns.

The final report given by Allison Alpha contains the following performance summary:

United Industrial Metal Workers Defined Benefit Plan

Net of Fees Performance Summary, December 31, 2006

	1-Year	**3-Years**	**5-Years**
Total Portfolio	+11.93	+9.09	+8.49
Policy Index (1)	*+12.27*	*+9.40*	*+8.48*
Large Cap Manager A	+11.26	+9.07	+5.99
S&P 500	*+15.80*	*+10.44*	*+6.19*
Small Cap Manager A	+21.37	+15.83	+11.69
Russell 2000	+18.37	+13.55	+11.39
Intl. Equity Manager A	+22.35	+18.11	+14.31
MSCI-EAFE	*+26.35*	*+19.93*	*+14.98*
Fixed Income Manager	+6.33	+4.01	+5.44
Barclays Aggregate Bond	*+4.33*	*+3.70*	*+5.06*
High Yield Manager	+15.85	+9.82	+13.89
Barclays High Yield Corporate	+11.85	+8.49	+12.58
Real Estate Manager A	+17.09	+15.54	+11.98
NCREIF-NPI	*+16.59*	*+17.02*	*+13.27*

(1) 30% S&P 500, 7.5% Russell 2000, 7.5% MSCI-EAFE, 37.5% Barclays Aggregate, 7.5% Barclays High Yield, 10% NCREIF-NPI

David Dashing, CFA and his firm analyzed the plan's asset allocation and managers and gave a detailed report to this new client at the end of 2006. An excerpt included the following comments:

> *"Overall, most of the money managers have performed satisfactorily, net of fees. Although the real estate manager has under-performed its benchmark, the fees for real estate investing are generally high and account for most of the negative alpha. However, the international equity manager's negative alpha is too great. We will replace the manager with Superior Global Investors. Superior's risk-adjusted performance is very good and their management fee is lower than your current manager. Further, we will increase the international equity allocation by 5%. This will be offset by a 5% reduction in domestic large cap equity. International equity has returned about twice as much over the previous five years as domestic large cap and we expect this trend to continue."*

The international equity manager change and asset allocation change took place January 1, 2007. The trustees were impressed that these two changes were made the first day on the job.

In 2007, not only did international equities outperform domestic large cap (as measured by the MSCI-EAFE and the S&P 500,) but Superior Global Investors achieved 400 basis points of positive alpha, net of fees. This was a great move by David Dashing, CFA and Mega Money.

In 2007, the plan's net of fee performance was +7.01%. The Policy Index return was +6.99%.

David Dashing, CFA again provided a detailed report at the end of 2007 to his client. An excerpt of the report included the following comments:

> *"Similar to the success we achieved in the international equity allocation, we feel a similar opportunity exists in core and leveraged real estate. Real estate has performed extremely well the last several years and your fund has benefitted from its 10% allocation. An additional 5% allocation should improve your overall risk and return profile over the long-term. We recommend that your existing real estate manager be replaced with Sky High Real Estate Investors Group. They offer a much more diversified and leveraged product. We recommend that the increased allocation be funded by a reduction in domestic fixed income. After all, the yield on domestic bonds is below your actuarial rate of 7%."*

On January 1, 2008, the real estate manager and asset allocation changes occurred.

Unfortunately, 2008 was a very tough year for investors. Real estate returned -6.46% in 2008. So the move did not garner much attention as the markets experienced the "global credit crisis." Further, Sky High Real Estate Investors Group under-performed its benchmark due to higher leverage. David Dashing, CFA assured his client that "over the long-term, with a larger portfolio and higher leverage, they should perform better than the former manager."

In 2008, the plan's net of fee performance was -19.41%. The Policy Index return was -18.43%.

David Dashing, CFA again provided a detailed report at the end of 2008 to his client. An excerpt of the report included the following:

> *"We continually monitor your managers for performance, personnel changes, and risk-adjusted returns. We are confident that the international equity and real estate managers have done well since hiring. However, both of your domestic equity managers, large cap and small cap, are both below their respective benchmarks over the 3- and 5-year periods. We recommend replacing both managers. We will replace your large cap manager with Royal Excelsior and your small cap manager with Strategic Apex Investors. We have worked with both of these managers over several market cycles and we are confident they will deliver superior risk-adjusted returns for your defined benefit plan.*
>
> *After several discussions with your high yield manager, we have also concluded that the benchmark for your high yield manager should be changed from the Barclays US High Yield Corporate to the I-Boxx USD Liquid High Yield."*

On January 1, 2009, the manager changes occurred and the high yield benchmark changed. In 2009, both Royal Excelsior and Strategic Apex Investors exceeded their benchmarks with positive alpha.

In 2009, the plan's net of fee performance was +16.13%. The Policy Index return was +15.36%.

David Dashing, CFA again provided a detailed report at the end of 2009 to his client. An excerpt of the report included the following comments:

> *"2009 was a good year in which we recovered significantly from 2008 on an absolute basis. Further, we had positive relative performance versus the Policy Index of 77 basis points, net of fees. All active managers continue to perform well. We will initiate a 5% position in commodities which will be managed by Worldwide Resource Advisors. This will be funded by a 2.5% reduction in domestic large cap equity and a 2.5% reduction in domestic small cap equity. This move into commodities will provide a better inflation hedge as well as correlation benefits. In addition, we will increase by 2.5% our position in high yield. It will be funded by a 2.5% reduction in domestic fixed income."*

On January 1, 2010, the asset allocation changes occurred and the commodity manager was funded.

In 2010, the plan's net of fee performance was +11.51%. The Policy Index return was +11.35%.

David Dashing, CFA again provided a detailed report at the end of 2010 to his client. An excerpt of the report included the following:

> *"The markets continue to stabilize and returns appear to be more predictable. Your managers continue to perform well, and none should be placed "on watch." Further, we do not see the need to alter the asset allocation. We have, however, been exploring alternative asset classes such has hedge funds of funds and private equity. However, because of the high fees, lack of transparency, and lack of liquidity, we do not see them as attractive options at this time."*

No asset allocation or manager changes were made by David Dashing, CFA and Mega Money in 2011. In 2011, the plan's net of fee performance was +5.24%. The Policy Index return was +3.78%.

In 2012, no asset allocation or manager changes were made by David Dashing, CFA and Mega Money. In 2012, the plan's net of fee performance was +11.42%. The Policy Index return was +10.84%. David Dashing, CFA presented the following performance summary page as of December 31, 2012:

United Industrial Metal Workers Defined Benefit Plan

Net of Fees Performance Summary, December 31, 2012

			Average Annual Returns	
	1-Year	**3-Years**	**5-Years**	**10-Years**
Total Portfolio	+11.42	+9.35	+4.12	+7.45
Policy Index (1)	*+10.84*	*+8.60*	*+3.80*	*+7.28*
Royal Excelsior	+18.00	+11.89		
S&P 500	*+16.00*	*+10.87*		
Strategic Apex Investors	+20.35	+12.38		
Russell 2000	*+16.35*	*+12.24*		
Superior Global Investors	+21.31	+6.11	-2.50	
MSCI-EAFE	*+27.31*	*+3.56*	*-3.69*	
Fixed Income Manager	+3.45	+6.43	+6.28	+5.61
Barclays Aggregate Bond	*+4.20*	*+6.19*	*+5.95*	*+5.18*
High Yield Manager	+12.15	+13.09	+8.99	+10.46
I-Boxx USD Liquid High Yield (2)	+14.15	+10.84	+7.75	+9.32
Sky High Real Estate Investors	+8.54	+11.11	-0.13	
NCREIF-NPI	*+10.54*	*+12.63*	*+2.13*	
Worldwide Resource Advisor	+3.08	+4.54		
S&P- GSCI	*+0.08*	*+2.55*		

(1) The Policy Index is a linked blend of the strategic asset allocations as they were implemented. (2) Prior to 2009, the benchmark was the Barclays High Yield Corporate.

Referencing the performance report above, David Dashing, CFA reported at the March 2013 trust meeting "great news." The fund was up +11.42% in 2012, and exceeded the policy index by 58 basis points, net of fees. He concluded his report with the following talking points:

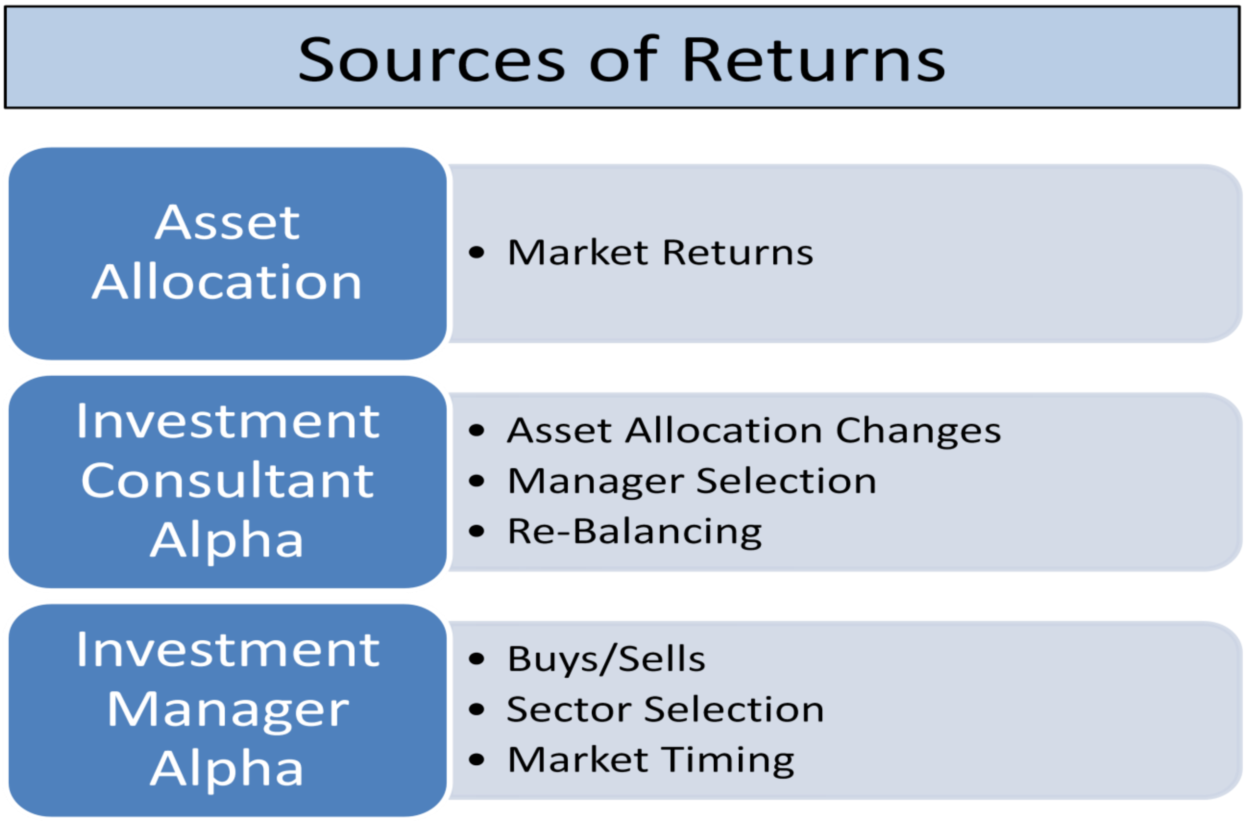
1) 4-out-5 of the active managers we hired beat their benchmark, net of fees.
2) The Total Portfolio has out-performed the Policy Index over 1, 3 & 5 year periods, net of fees.
3) Over the 5-year period, the average annual total alpha, net of fees, was 32 basis points.

David Dashing, CFA then asked for a $100,000 annual fee increase. He explained that inflation and the costs necessary to keep "grade-A talent" demands that they increase their fees. Besides, "we've done a really good job and helped produce positive alpha, net of fees, during these really difficult markets."

The trustees analyzed the report and agreed with his points. Given that Mega Money has brought good managers and they have beaten the policy index since hiring by a decent margin net of fees, the trustees voted to approve the raise.

The real question for the trustees is, “do the trustees have adequate disclosure from David Dashing, CFA and Mega Money to make *an informed decision* that justifies the decision not only to grant a raise, but to even retain Mega Money as their investment consultant?”

The simple fact is that plan sponsors do not receive adequate disclosure from their investment consultants to gauge their Level 2 success. Here are the only sources of returns:



The simple truth is the Level 2 decisions constituting *Investment Consultant Alpha* is not reported.

Let us examine the nine Level 2 decisions that David Dashing, CFA performed over the last six years working for the United Industrial Metal Workers Defined Benefit Plan. He made five manager changes, and four asset allocation changes. These nine Level 2 changes account for the investment consultant alpha. *Again, it will be shown that these are not captured in standard investment consultant reports.*

The five manager changes were:

2007- Replace International Manager A with Superior Global Investors
2008- Replace Real Estate Manager A with Sky High Real Estate Investors Group
2009- Replace Large Cap Manager A with Royal Excelsior
2009- Replace Small Cap Manager A with Strategic Apex Investors
2010- Add Worldwide Resource Advisors

The four strategic asset allocation changes were:

2007- Increase International Equity by 5% from Domestic Large Cap Equity
2008- Increase Real Estate by 5% from Domestic Fixed Income
2010- Increase High Yield by 5% from Domestic Fixed Income
2010- Add Commodities by 5% from 2.5% Domestic Large Cap and 2.5% Domestic Small Cap

For simplicity, let's assume that the plan experienced neutral cash flow over these last 6 years such that there were not any contributions or withdrawals and investment fees were paid from the invested assets. Further, note that all changes are effective at the close of business the previous year and the funds are fully invested at the beginning of the first trading day the following year. Finally, both the portfolio and the index are re-balanced at the beginning of each year with no other re-balancing.

Let us start by evaluating the five manager changes.

In 2007, David Dashing, CFA replaced the existing international equity manager with Superior Global Investors and increased the allocation by 5%. Let us examine the "alpha component" of these Level 2 decisions, i.e. manager selection. The "beta component" of asset allocation will be analyzed separately.

The first manager change is a prediction that Superior Global Investors will perform better than International Manager A, net of fees. 15% of the plan assets, or $75 million was moved on January 1, 2007. The subsequent annual performance of the two managers was:

	2007	2008	2009	2010	2011	2012	Total	Alpha
Superior Global	15.18%	-41.38%	25.77%	2.76%	-4.15%	21.31%	1.47%	9.35%
Intl Equity Manager A	9.18%	-39.38%	33.77%	4.76%	-16.15%	18.31%	-7.99%	-0.11%
MSCI-EAFE	11.18%	-43.38%	31.77%	7.76%	-12.15%	17.31%	-7.88%	n/a

David Dashing, CFA had a "win-win" on this decision. Not only did Superior Global Investors beat its benchmark by 935 basis points, but International Equity Manager A lagged it by 11 basis points. These combine to create $7,095,000 [75,000,000 x (.0935 - (-.0011))] in "manager selection alpha." For simplification, note that the starting asset value is not adjusted for annual re-balancing or growth.

The Level 2 decision of manager selection can be evaluated like any other Level 3 portfolio decision. For example, imagine you are a stock portfolio manager and you decide to replace a particular holding. The new holding may go up 50% over the next year and you think "that was a great decision." But if the holding you replaced went up 75%, your opinion should definitely change. Because investment consultants *drop the fired managers from their reports*, this vital "other side of the coin" is a mystery and thus the consultant's Level 2 manager selection ability is swept under the rug.

For purposes of determining the terminated manager's performance, we can simply rely on composite performance reports, adjusted by the previous fee. This would be the same composite performance that investment consultants rely upon to search the manager marketplace looking for new managers.

The next manager change occurred at the beginning of 2008 with Sky High Real Estate Investors Group replacing Real Estate Manager A. $80,258,835 was moved and the managers had the following results:

	2008	2009	2010	2011	2012	Total	Alpha
Sky High Real Estate	-6.46%	-20.86%	10.11%	14.76%	8.54%	1.54%	-9.57%
Real Estate Manager A	-7.46%	-18.86%	12.11%	14.26%	12.04%	7.77%	-3.34%
NCREIF	-6.46%	-16.86%	13.11%	14.26%	10.54%	11.11%	n/a

Sky High did not beat its benchmark, but neither did the former manager. Again, the manager selection alpha of David Dashing, CFA is the alpha difference between the two managers. In this case, it equates to -623 basis points over five years. In terms of dollars, the impact is -$5,000,125 [$80,258,835 x -.0623].

The next manager change occurred at the beginning of 2009 with Royal Excelsior replacing Large Cap Manager A. $108,205,883 was moved and the managers had the following results:

	2009	2010	2011	2012	Total	Alpha
Royal Excelsior	27.47%	14.56%	3.61%	18.00%	78.56%	6.18%
Large Cap Manager A	28.47%	15.56%	5.11%	18.00%	84.15%	11.77%
S&P 500	26.47%	15.06%	2.11%	16.00%	72.38%	n/a

Royal Excelsior did beat its benchmark since hiring, but the former manager did even better. The manager selection alpha of David Dashing, CFA, despite Royal Excelsior beating its benchmark, is negative. This is similar to the Level 3 example above concerning a buy going up 50% and the sell going up 75%. The decision is not as good as was reported. Analyzing the numbers, the manager selection alpha was -$6,048,709 [108,205,883 x -.0559].

The next manager change also occurred at the beginning of 2009 with Strategic Apex Investors replacing Small Cap Manager A. $32,461,765 was moved and the managers had the following results:

	2009	2010	2011	2012	Total	Alpha
Strategic Apex Inv.	29.18%	29.85%	-9.19%	20.35%	83.33%	3.49%
Small Cap Manager A	23.18%	24.85%	-1.19%	18.35%	79.85%	0.01%
Russell 2000	27.18%	26.85%	-4.19%	16.35%	79.84%	n/a

This is another example of David Dashing, CFA finding a manager that not only beat its benchmark, but also the terminated manager. The manager selection alpha was $1,129,669 [32,461,765 x .0348].

The final manager selection occurred in 2010 with the hiring of Worldwide Resource Advisors to manage a 5% position in commodities. $25,132,882 was given to Worldwide and they had the following results:

	2010	2011	2012	Total	Alpha
Worldwide Resource	11.03%	-0.18%	3.08%	14.25%	6.42%
S&P- GSCI	9.03%	-1.18%	0.08%	7.83%	n/a

Since there was not a terminated manager, the alpha is simply the difference between the net of fee returns and the benchmark. The manager selection alpha was $1,613,531 [$25,132,882 x .0642].

To summarize the investment consultant's manager selection alpha:

	Level 2- Mgr. Selection	Asset Class	Amount	Alpha	Gain/Loss
2007	Hire Superior Global	Intl Equity	75,000,000	.0946	+7,095,000
2008	Hire Sky High RE	Real Estate	80,258,835	-.0623	-5,000,125
2009	Hire Royal Excelsior	Large Cap	108,205,883	-.0559	-6,048,709
2009	Hire Strategic Apex	Small Cap	32,461,765	.0348	+1,129,669
2010	Hire Worldwide Res.	Commodities	25,132,882	.0642	+1,613,531
					-1,210,634

The assertion by David Dashing, CFA that 4-out-of-5 managers beat their benchmark is true. However, *only 3-of-5 manager changes actually helped*. Overall, the manager selections cost the plan $1,210,634.

Let us now turn our attention to the other Level 2 decisions concerning asset allocation. The analysis is very similar to manager selection: compare the increased asset class to the decreased asset class. To avoid the possibility of double-counting we will disregard fees. However, plan sponsors should keep in mind the differences in the fees associated with the different asset classes. The four examples we will analyze typically move from lower-cost asset classes to higher-cost asset classes.

The first asset allocation change was the beginning of 2007 with increasing the allocation to international by 5% and decreasing domestic large cap equity by 5%. The amount is $25,000,000. The two benchmarks to be compared are the MSCI-EAFE and the S&P 500. The index returns were:

	2007	2008	2009	2010	2011	2012	Total
S&P 500	5.50%	-36.99%	26.47%	15.06%	2.11%	16.00%	14.58%
MSCI-EAFE	11.18%	-43.38%	31.77%	7.76%	-12.15%	17.31%	-7.88%

Comparing the two asset classes, the S&P 500, the decreased asset class, performed better than the MSCI-EAFE by 2,246 basis points. The asset allocation change beta capture by David Dashing, CFA and Mega Money was -5,615,000 [25,000,000 x -.2246]. Similar to manager selection, for simplification we will not adjust the starting asset value due to re-balancing or appreciation.

The next asset allocation change took place in 2008 with a 5% increase to core real estate with a corresponding decrease in domestic fixed income. The amount is $26,752,945. The two benchmarks to be compared are the NCREIF-NPI and the Barclays Aggregate Bond. The index returns were:

	2008	2009	2010	2011	2012	Total
Barclays Aggregate	5.24%	5.92%	6.56%	7.84%	4.20%	33.49%
NCREIF-NPI	-6.46%	-16.86%	13.11%	14.26%	10.54%	11.11%

Comparing the two asset classes, the Barclays Aggregate Bond, the decreased asset class, performed better than the NCREIF-NPI by 2,238 basis points. The asset allocation change beta capture by David Dashing, CFA and Mega Money was -5,987,309 [26,752,945 x -.2238].

The next asset allocation change took place in 2010 with a 5% increase to high yield bonds and a 5% decrease in domestic fixed income. The amount is $25,132,882. The two benchmarks to be compared are the I-Boxx USD Liquid High Yield and the Barclays Aggregate Bond. The index returns were:

	2010	**2011**	**2012**	**Total**
Barclays Aggregate	6.56%	7.84%	4.20%	19.74%
I-Boxx USD Liq HY	12.59%	5.95%	14.15%	36.16%

Comparing the two asset classes, the Barclays Aggregate Bond, the decreased asset class, performed worse than the I-Boxx USD Liquid High Yield by 1,642 basis points. The asset allocation change beta capture by David Dashing, CFA and Mega Money was $4,126,819 [25,132,882 x .1642].

The last asset allocation change also took place in 2010 with the addition of a 5% position to commodities with a corresponding 50/50 decrease in domestic large cap and small cap equities. The amount is $25,132,882. The three benchmarks to be compared are the S&P-GSCI, the S&P 500 and Russell 2000. The index returns were:

	2010	**2011**	**2012**	**Total**
S&P 500	15.06%	2.11%	16.00%	36.30%
Russell 2000	26.85%	-4.19%	16.35%	41.41%
S&P GSCI	9.03%	-1.18%	0.08%	7.83%

To compare the three asset classes, we must first average the two stock indices. The blended index return was 38.86% [(36.30 + 41.41) / 2]. The commodities index return was 7.83%. The difference between these two is -3,103 basis points. The asset allocation change beta capture by David Dashing, CFA and Mega Money was -$7,798,733 [25,132,882 x -.3103].

To summarize the Level 2 asset allocation decisions made by David Dashing, CFA and Mega Money, let us review the following table:

	Level 2- Asset Allocation	**Amount**	**Alpha**	**Gain/Loss**
2007	Domestic Large Cap ---> Intl Equity	25,000,000	-.2246	-5,615,000
2008	Domestic Fixed ---> Real Estate	26,752,945	-.2238	-5,987,309
2010	Domestic Fixed ---> High Yield	25,132,882	.1642	4,126,819
2010	Large Cap/Small Cap ---> Commodities	25,132,882	-.3103	-7,798,733
				-15,274,223

David Dashing, CFA and Mega Money have been charging the plan $400,000 per year. For the last six years, this equates to $2,400,000. If we add their fees, manager selection alpha, and asset allocation beta capture, we get the total alpha by the investment consultant. The investment consultant alpha is:

Investment Consultant Fees:	-$2,400,000
Manager Selection Alpha:	-$1,210,634
Asset Allocation Beta:	-$15,274,223
Total Value Add/Loss:	-$18,884,857

These nine examples of dissecting Level 2 decisions are very simple and can be easily performed by almost anyone. The numbers are readily available and this type of analysis should be a part of any report to ensure adequate disclosure to plan sponsors.

Two questions should immediately come to mind. First, how can the Mega Money report appear so positive in terms of comparing total performance and the policy index? Second, why don't investment consultants provide this simple disclosure of their Level 2 decisions?

The answer to the first question is simple. David Dashing, CFA and Mega Money use *Benchmark Linking* to create the policy index. This widely-used investment consultant practice was described in my white paper *Benchmark Linking: What Plan Sponsors Should Know*. It can be read at: http://www.icevaluations.com/IceValuations_benchmark_linking.pdf.

Benchmark linking masks the Level 2 asset allocation decisions made by the investment consultant by mirroring the strategic asset allocations of the plan. In this example, the policy index for the last six years was changed each time there was an asset allocation change. The linked policy index was:

	2007	2008	2009	2010	2011	2012
S&P 500	25.00%	25.00%	25.00%	22.50%	22.50%	22.50%
Russell 2000	7.50%	7.50%	7.50%	5.00%	5.00%	5.00%
MSCI-EAFE	12.50%	12.50%	12.50%	12.50%	12.50%	12.50%
Barclays Aggregate	37.50%	32.50%	32.50%	30.00%	30.00%	30.00%
High Yield	7.50%	7.50%	7.50%	10.00%	10.00%	10.00%
NCREIF-NPI	10.00%	15.00%	15.00%	15.00%	15.00%	15.00%
S&P- GSCI	0.00%	0.00%	0.00%	5.00%	5.00%	5.00%
	100%	**100%**	**100%**	**100%**	**100%**	**100%**

So, if an asset allocation change was beneficial, both the plan performance and the policy index should improve by the same margin. If an asset allocation change was harmful, both the plan performance and the policy index will suffer by the same margin. Any effect of the asset allocation change is hidden.

A simple way to discern whether or not an investment consultant is adding value through their Level 2 asset allocation decisions is to compare the linked benchmark with the last benchmark before the changes went into effect. To evaluate David Dashing, CFA and Mega Money, compare the following:

	2007	2008	2009	2010	2011	2012	Total
Linked Policy Index	6.99%	-18.43%	15.36%	11.35%	3.77%	10.84%	28.94%
Pre-2007 Policy Index	6.70%	-17.53%	16.23%	11.83%	4.22%	11.02%	32.35%

The above table indicates that David Dashing, CFA and Mega Money cost the plan 341 basis points over the last six years with their asset allocation changes. The dissection of the four asset allocation changes indicates the total alpha of the asset allocation changes was -$15,274,223. The average balance over the last 6 years was $533,251,950. Multiplying the average balance by 341 basis points we get $18,183,892. This figure is very close to the $15,274,223 derived from dissecting the four Level 2 asset allocation changes. This "back of the envelope" method is very easy for any investment consultant to add to their reports. However, it is not as accurate due to changing levels of plan assets.

The second question is why don't investment consultants report their alpha from Level 2 decisions? The answer again is really simple. *Neither plan sponsors nor regulators require it*. From the investment consultant's perspective, why risk showing you are destroying value if you don't have to?

Although this lack of disclosure greatly hinders compliance monitoring and blocks the plan sponsor from knowing whether or not the investment consultant is doing a good job, there is actually a much bigger problem. That problem is it hinders improvement in *future* Level 2 decisions. By not disclosing mistakes, neither the plan sponsor nor the investment consultant learns thus blocking improvement! Further, plan sponsors may be unwittingly following poor investment advice and never know it. They will never know if they are being led down the path to investment ruin- until it's too late.

Although plan sponsors and investment consultants may be worried about knowing their mistakes, besides hindering the ability to improve, there is another practical reason to learn from them. For long-term investment success, due to the effect of negative compounding, loss avoidance is absolutely vital. Negative returns due to poor Level 2 decisions require even greater positive returns to break even. For example, a 100% return is needed to overcome a 50% loss. If you don't know your past mistakes, how can you avoid future ones?

To add a finer point, improving investment success through making fewer poor decisions stems from the inability to make "winning" decisions. Millions of professional investors are working 24/7 around the globe trying to make profitable decisions. They use strategies that rely on the ability to trade milliseconds quicker than the competition. They scour financial statements, interview the CEO's, CFO's and COO's of publicly traded companies, survey customers, survey suppliers, etc. All of these in an effort to gain advantage over other market participants, who are doing the exact same thing.

The simple truth is the United Industrial Metal Workers Defined Benefit Plan and every other similarly managed plan, is not in a position nor designed to make "winning" decisions. In his must-read book *Winning the Loser's Game*, Charles Ellis wrote, "…very few investors have been able to outsmart and outmaneuver other investors often enough and regularly enough to beat the market consistently over the long term, particularly after covering all the costs, including the taxes of 'playing the game.'" Although this quote refers to investment managers, it seems just as applicable to the Level 2 decisions made by investment consultants for widely diversified, institutional investment plans.

The above decoding of the investment consultant's Level 2 decisions provides the blueprint for closing the disclosure gap. To solve this problem, plan sponsors need to demand of their investment consultants tracking of their Level 2 decisions, specifically:

Compare hired managers against the fired managers
Compare increased asset classes against decreased asset classes

This open letter has demonstrated how investment consultant reports mask the Level 2 decisions made by the investment consultant. It is time that plan sponsors and government regulators demand relevant disclosure as too many institutional investment plans today are in critical or endangered status precisely because of poor Level 2 decisions made by their investment consultants.

Does your investment consultant report like David Dashing, CFA?