Selecting, Reviewing and Replacing Investment Managers

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Prepared for
UWO Pension Plans for Academic and Administrative Staff

by
Investment Policy Committee

Executive Summary

The Investment Policy Committee of the UWO Joint Pension Board recommend that the documentation of the selection, review and replacement process for investment managers for the UWO pension plan assets is essential. This document is reference for the pension board and all other interested parties which illustrates the consistent method employed by the committee in these activities.

The Investment Policy Committee first apply the Joint Pension Board's principles, which are outlined in detailed in their policy & governance document, for the selection, review and replacement of investment managers. In particular the principles of *Choice, Fairness and Liquidity* are considered as well as the bias towards *Passive Management.* Consideration of these principles, however, does not provide all the answers. The committee also considers the universe of alternatives available for the task, the professional research and opinions provided by the pension board's investment consultant, the performance history of the managers, the style and investment process employed by managers as well as the administrative implications selecting or replacing a manager.

This document lays out the board activities with respect to investment managers and includes certain actions that will normally be considered by the committee given certain situations, such as a change in the opinion of our investment consultants or consecutive quarters of under performance of a benchmark.

Employing Joint Pension Board Principles

Principle of Choice

The board seeks to offer members diversified choices in investment vehicles. With this principle in mind, the Investment Policy Committee listens to the comments and suggestions of pension plan members regarding the current investment structure and potential new investments. When the addition of a new investment class makes sense and is administratively feasible, the committee researches the investment alternatives in that class and will make a report and recommendation to the Joint Board to either pursue or reject the implementation of the investment class. The investment manager for the class will generally be one which is included in the broad group of professionals whose organizations and products are monitored by UWO's investment consultant.

Principle of Fairness

The board seeks to maintain fairness among members in plan operations. Employing this principle, investment alternatives and manager processes will be rejected by the committee if the choice of one member will inequitably restrict or adversely affect the choice of another. In selecting and reviewing potential managers, the manner in which securities are selected and income allocated must be consistent with this fairness principle.

Principle of Liquidity

The board seeks to provide investment alternatives which possess high liquidity so that members are free to move monies from one fund to another. The asset class and the manager's administrative restrictions are considered by the committee in this context. It is important to note that the board seeks to maintain high liquidity for *each portfolio* offered as a choice to members, which could be maintained even if *part* of the portfolio is relatively illiquid. Liquidity is of greatest importance when the committee implements and reviews manager mandates and considers replacement strategies.

Intention of Passive Management

The board believes that in general active investment management cannot be expected to outperform passive management on a risk adjusted basis. The committee makes recommendations on the selection, review and replacement of investment managers in view of this intention. When a new asset class is being researched or when a replacement manager is sought, the committee will always consider the alternative passive strategies which are available to meet the investment objective of the fund. There are three possible grounds for exception to the general intention of passive management: 1) when there are implementation problems with passive management, 2) when there is reason to believe that a manager can add value with a "small bet" strategy which closely follows a capital market benchmark, and 3) when there is no clear or suitable market bench mark available for the asset class.

Selection of Investment Managers

Universe of Managers

Currently the University does not have resources to manage assets internally and there is significant doubt if it could do so in a cost-effective way. Therefore the committee delegates the securities selection tasks to external professionals. The committee generally considers the universe of professionals who have been monitored by the pension boards= investment consultant, currently *The Frank Russell Company*. This universe includes virtually all of the major institutional money managers in and outside of Canada. However, external managers are constantly approaching the pension staff and the board members with information on their products. The committee will consider one of these alternatives even if the firm is not monitored by *Frank Russell*, however the committee will always seek the investment consultant=s opinion of the product.

Research and Professional Opinion of Investment Consultants

The pension board=s investment consultant is a great resource for research regarding investment management organizations and individual products offered by these organization. They also have access to capital market data that can assist in the analysis of these portfolio products.

When a new asset class is being considered by the pension board, the consultant is first asked to provide data regarding the available market benchmarks and the performance and risk attributes of that asset class relative to other assets in the UWO pension plans. When a replacement manager is sought, the committee will review and revise or reaffirm the performance benchmark and risk attributes of the previous portfolio.

Once a benchmark is decided on and a preferred investment style (passive, synthetic, small bet, growth, value) has been determined, the investment consultant is asked to prepare a summary of investment managers that would be able to manage the portfolio. The summary may start with a long list of providers that the committee would then Ashort list@ to three or four possible candidates. In some situations, the asset class and objectives may be so narrow that only a few providers may be considered. The consultant is asked to bring forward only those firms for which their internal research indicates above-average confidence in achieving performance targets.

In general, if one or more of existing UWO pension fund managers is also experienced and proficient in the management of the new asset class being considered, these managers will be considered as candidates for the new portfolio (e.g. when the Long Term Bond fund was initiated, the manager candidates included those who had other UWO Canadian bond portfolios under management).

Historical Performance of Manager

The opinion of the investment consultant is very important in the selection of the new manager, but the past experience in managing similar portfolios is also important. Although one can never expect past performance of investment management to be repeated, it does tell the committee something about how well the managers have implemented their strategies compared to their objectives. This information reveals the degree to which the manager style will fit the objectives set by the committee. For example, the committee will likely not consider a manager whose mandate was to outperform a certain market benchmark but whose actual performance failed to outperform over the last 5 to 7 years. If this under performance was based on organizational and research issues for the firms, chances are that they would not be on the short list provided by the investment consultant anyway. If this under performance was based on the particular style of the manager, the committee may reconsider their style objectives or the benchmark for the portfolio.

Setting Investment Objectives, determining Style and Process

When selecting a manager, the investment objectives for the portfolio are set, taking into consideration the style and security selection process of the manager. The requirements may be for a manager with a specific style within a broader structure (e.g. small cap within the US Equity class). First a benchmark for the portfolio is agreed upon. Next, realistic value added targets are set. A time horizon for evaluation of the manager=s performance is determined (generally four years). Risk parameters are also established including: duration constraints for bond portfolios, credit risk constraints for corporate bonds, acceptable tracking error (deviation from benchmark returns), and acceptable deviation from benchmark weighting (country and/or sector).

The degree to which the portfolio should be actively managed is specified for Asmall bet@ managers either explicitly or by setting out the risk parameters.

The level of currency management and evaluation of currency management is indicated in the objectives. Finally, the degree to which cash can be used by the manager, if at all, is included. All these objectives are documented in the investment manager mandate which is drafted by UWO and signed by both the manager and UWO.

Administration of the Assets

When considering a new portfolio it is important that administrative issues are considered so that the investment manager will fit well with the structure in place. From an administrative point of view and from a cost efficiency perspective, it is preferred that the portfolio be a pool. A pooled structure allows for easier accounting of investments, reduced custodian fees, cross trading with other pool fund holders and greater diversification of the portfolio. Pooled funds are particularly attractive when the size of UWO=s allocation is unknown or may change dramatically at the member=s direction. The pool must be valued and accounted for at least monthly, but UWO=s preference is for more frequent valuations to allow cash allocations and redemptions, subject to fees for the service.

When the committee recommends specific risk parameters or investment objectives that cannot be met by an existing pooled arrangement, it may be necessary to set up a segregated portfolio.

Review of Investment Managers

Quarterly Performance Review

At the end of each quarter of the calendar year, a summary of the short and long term performance of each investment fund and each manager is reviewed by the pension board. The investment consultant provides details on relative performance and, where possible, an attribution analysis for the deviation from the benchmark for each manager and fund. Quarterly reports from the investment managers are also provided to the pension board for this review. The Investment Policy Committee will be asked to research certain issues based on this review which occurs at the Joint Pension Board level. In assessing performance, in all cases the primary emphasis is performance relative to a market benchmark and not relative to a universe of competing managers.

Annual meeting with the committee

Each year, the committee reviews the portfolio managed by each manager and if necessary, meets with the manager to discuss changes or issues with the fund.

The committee considers the latest manager performance, the most recent review from investment consultant, the current investment objectives and the current fee schedule. If there has been an organizational change with the manager, a deviation from the mandate or if there is a concern about recent performance, a meeting with the manager is arranged and they are informed of the specific concerns of the committee. The results of the meeting may include a change in mandate, a change in fee structure or a change in manager which is then recommended by the committee to the Joint Pension Board.

Research and Opinions provided by Consultants

The Investment consultant is retained to provide the committee with their latest research regarding the investment management organization and their products. *The Frank Russell Company* provide periodic reports on the products offered by most investment management organizations. These reports include commentary on the investment staff, organizational stability, portfolio construction, security selection, investment implementation and research by the firm with respect to the specific product being reviewed.

Frank Russell generally provide an overall recommendation for the product which can assume one of four values: **HIRE, RETAIN, REVIEW, TERMINATE**. For actively managed products, the recommendation is based on the degree of confidence Russell has with respect to a manager=s ability to perform relative to a benchmark. The committee generally holds these opinions in high regard, since it is difficult to argue that the committee can have any better information than Frank Russell have with respect to the internal operations of a manager. The rankings are used by the committee as one of several factors assisting them in their decisions.

Actions taken when under performance is observed

Our response to under performance recognizes that all managers will have such episodes and the response will depend on the nature of the asset class and the manager=s style. The committee may choose to meet with the manager regarding the under performance.

If the under performance continues, the committee will review the appropriateness of the benchmark, the nature of the manager=s style and re-evaluate their investment objectives. The period of evaluation of results, as agreed upon in the manager mandate, generally is observed before making any recommendations on the future of the manager=s mandate. The committee may recommend holding the manager because they believe the manager is still the best choice for meeting the objectives. Alternatively, the committee may recommend that the pension board consider replacing the manager.

Actions taken when Consultant opinion changes

When the investment consultant has downgraded their recommendation on a manager which UWO retains, the committee first reviews the report prepared by the consultant to identify the source for their concern. Generally only down grades to AREVIEW@ or ATERMINATE@ merit additional investigation. When a manager=s product is recommended for REVIEW, the committee may choose to meet with the manager to discuss the concerns presented by Frank Russell. The committee will then determine if they believe the manager has a well thought out plan to address the concerns raised. Changes in ranking will be reported to the Joint Pension Board and they will decide if further action is required by the Investment Policy Committee. Some actions that may be considered include:
1) withhold all future cashflows to the manager, if a multi-manager fund
2) rebalance the portfolio, allocating less weight to the manager in question
3) identify the administrative issues with discontinuing the portfolio (eg. Notification period, termination clauses)

When Frank Russell issues a ATERMINATE@ recommendation, then the committee will go through the same process as for a downgrade to a REVIEW, however, the Joint Pension Board will most certainly recommend that alternative managers be considered for the portfolio. Some actions that may be considered include:

1) withhold all future cashflows to the manager, if a multi-manager fund

2) invoke the back up manager strategy that has been previously agreed to

3) initiate a search for a replacement manager

4) identify and estimate the costs in changing managers and develop strategies for minimizing those costs.

Actions when administrative problems arise

When administrative problems arise which may include failure to report information, inaccurate accounting of funds, difficulty in making allocations and redemptions with the manager, and failure to complete documentation required, both the Investment Policy Committee and the Fiduciary and Administrative Committee may make recommendations. Some of the actions that may be considered include:

1) meet with the manager to clarify the reporting and documentation required

2) request an external audit of the accounting procedures

3) determine the implementation costs associated with the manager in comparison to alternative managers

4) discount the expected value added by the administrative aggravation to judge whether the manager should continue to be retained

5) request fee forgiveness or reimbursement of expenses if the administrative issues are clearly the result of the manager's actions

Replacement of Investment Managers

Ranking the concerns of committee

Since the concerns of the committee may be based on varied information, there is a need to rank the issues that are of greatest concern. For example the committee may have concerns about the organizational stability, the investment performance, or the administration of the funds, however the investment consultant may continue to recommend a ARETAIN@ for the manager. In this situation, the committee needs to identify the relative weighting of each of these issues in their decision to retain or replace the manager.

The governing principles of the board are helpful in this situation. In particular, the committee needs to use prudence and perform due diligence in reviewing the manager. All discussions must be well documented and all responses from the manager must be discussed by the committee. If the organizational stability or poor performance of the manager increases the risk such that the board could be judged to be imprudent prudent with the funds, these issues may have greater weights in the replacement decision.

The principle of cost effective administration must also be considered. If the retention of the manger dampens the ability to provide cost effective administration then administrative issues may have a greater weight in the decision.

The principle of fairness may cause the asset allocation, portfolio construction and security selection concerns to hold greater weight in the replacement decision.

Choice, Liquidity, responsiveness to member=s preferences, and the ability to educate members will be principles applied when considering the alternative manager arrangements.

Setting out the steps in replacement

Once a manager replacement is recommended, the committee takes certain actions:

1. Depending on the direction of the board, cash flow to the manager may cease or a back up management plan may be invoked
2. Research is initiated to identify the best alternative manager candidates
3. The short list of alternatives are selected and managers interviewed
4. The manager being replaced is notified; the new manager is notified
5. Transition actions are agreed upon and documented
6. The change is communicated to pension plan members

Identifying back up and replacement managers

The purpose of identifying and documenting back ups is to demonstrate that the committee has thought through short term solutions to issues that may need to be dealt with immediately. In general, the committee will be patient and prudent in the replacement of managers, which may not require implementing back up plans. When the capital investments are judged to be in jeopardy and there is insufficient time to research and appoint alternative managers, the back up provisions may be invoked, depending on the level of transition costs. In some funds, back up managers may be easily identified, particular in a multi-manager fund. In the case of single manager funds, the back up provisions are more difficult to assign. It is important to note that the act of identifying a back up does not imply that the committee will allocate funds to the back up manager in every situation. In identifying these back ups, the committee has considered portfolio managers that could easily and quickly assume the management with minimum transition costs. It is the goal that most back up portfolios are index funds, to minimize the transaction costs. The committee will research the availability of index portfolios as they review each mandate to identify the particular index fund they would consider as back up.

As of December 31, 1999, the following back up provisions apply for the UWO Pension assets:

Elliott & Page Money Market Portfolio:	Management of Short Term securities with assistance of our custodian.(STIF with Northern Trust)
Baker Gilmore Canadian Universe Bonds:	TAL Universe Bond portfolio
TAL Canadian Universe Bonds:	Baker Gilmore Universe Bond portfolio
RT Capital Canadian Large Cap Equities:	GWL Canadian Index Fund
GWL Canadian Large Cap Equities:	RT Capital Canadian Large Cap Equity portfolio
Mulvihill Capital Canadian Small Cap Equities:	RT Capital Canadian small cap equity pool
TD Quantitative Canadian Bond Portfolios:	TAL Institutional Management
Newcastle US Equity Index Fund:	State Street Global securities synthetic US Index fund
Newcastle EAFE Equity Index Fund:	SCB International Equity Portfolio, subject to foreign content restrictions
SC Bernstein International Equity Fund:	Newcastle EAFE Equity portfolio
TAL Long Term Bond Index	TD Quantitative Capital
State Street Global Bonds	Newcastle Capital synthetic global bond fund

Communication of change to members

It is important to remember that member's make their investment decisions among the available options, they do not make specific decisions on investment manager for the funds. It is within the board's responsibilities to appoint, review and replace external investment managers and the approval of such decisions by pension plan members is not required. However, the board is open to member input in the decision and may choose to survey members or request such input before the final replacement decision is made.

When a manager replacement occurs, in general the members will not be notified of the change until after the replacement manager is identified. The pension board may choose to report to members that they are in the process of researching replacements in either the newsletter or during oral presentations to members. Individually addressed notifications of changes in the investment structure of the fund will be sent to members once the new manager has been appointed and the new investment objectives are effective.

Transitions of assets

When a management agreement is terminated, the assets selected by the manager prior to termination must be dealt with in some way. If the replacement manager intends on selecting similar securities, it may make sense that the assets are held rather than liquidated. In the case of a pooled fund, the termination provisions may specify that payment may only be made in cash. If this is the case and the UWO funds represent a large percentage of the pool, the transaction fees for liquidating the securities may be charged to UWO. If assets must be liquidated, the committee may request that the divesture occur slowly so not to effect the sale prices and to spread out the market exposure during the sale.

In general, decisions on the transition of assets from one manager to another will be made on a case by case basis, based on the need for both continued asset class exposure and low overall cost.

Expense control

When the transition between management arrangement occurs, it is important that processes and monitoring is in place to control the expenses. The visible costs include commissions, taxes and custodian fees. The hidden costs are the bid/ask spread and the market exposure. To control these costs, the committee should consider the urgency of the transition and review the cost/benefits analysis before making the change.

Follow up Research on Manager Replaced

Once a manager has been replaced, it is reasonable to expect the committee to look back periodically, judging whether their decision making process was effective and appropriate. The pension board meets annually to review past decisions and replacement of managers are included in these reviews.