dual. consulting.

Investment consulting models in South Africa still lag behind the international governance trend which insists on absolute independence of the investment consultant. This article explores the reasons for this lag and looks at the emerging concept of a dual-consulting model.

The role of the investment or asset consultant is well entrenched and accepted in the South African retirement fund industry by now. Boards of trustees need expert advice in developing complex strategies around asset allocation, life-stage models and asset manager selection. Yet investment consulting models in South Africa still lag behind the international governance trend, which insists on absolute independence of the investment consultant.

Paving the way for a new approach, a few of the larger retirement funds in South Africa have now adopted a dual-consulting model. This involves appointing two investment consultants, who are independent of each other, to provide investment advice. The dual-consulting model could act as a peer review mechanism.

The concept of peer review is well established in academia, the sciences and the actuarial profession, so why not investment consulting? When applied to complex retirement fund investment decisions, peer review should deliver the same quality of thought process, leading to better outcomes for all retirement fund stakeholders including members, the regulator and government.

How does it work?

The investment consulting companies can either have overlapping or non-overlapping service level agreements with the retirement fund. In the former, the retirement fund effectively receives two opinions on the same matter. This allows greater debate of complex investment matters to improve overall investment decision-making and may also instil confidence in the board of trustees in the decisions that they have taken.

Where the retirement fund awards separate and non-overlapping service level agreements to the investment consulting firms, the fund recognises the strengths (and weaknesses) of the two consultants and seeks to use their respective and complementary areas of strength. A degree of healthy competition between the two investment consulting companies should lead to better service levels for retirement funds.

By: Shainal Sukha
Managing director
Shainal Sukha & Associates

What of existing single-consulting model?

Writing over several years on potential conflicts of interest in investment consulting, former 'Personal Finance' editor Bruce Cameron stated that investment consultants are meant to act as 'watchdogs' for retirement fund trustees. They should retain some distance from other service providers (rather than receive remuneration from or build business relationships with them) in order to remain as objective as possible. Investment consultants should only generate fees from providing independent investment advice to align themselves completely with the interests of their clients. However, this is a challenging business model and as a result there are only a few truly independent investment consulting companies in South Africa that fit this mould.

The primary challenge is that investment consulting is a low-margin industry. As a result, many investment consulting companies have offered additional services to retirement funds to generate additional revenue. There is nothing wrong with this, especially if the additional services add value. However, with each additional service there is a real risk that explicit and implicit conflicts of interest develop between the investment consultant and its retirement fund client, thereby creating a non-alignment of interest and, possibly additional costs, both explicit and implicit. Two examples of such additional services are multi-management and transition management.

Some investment consultants offer their own multi-manager products, charging asset-based fees for specialist manager research and selection services. This not only adds an additional layer of fees but also places the investment consultant in a conflicted position as it acts as both adviser and asset manager to the retirement fund. In addition, manager selection is already one of the services usually provided by investment consultants so there is a risk of 'double-dipping' or charging twice for the same service.

Some investment consultants have set up transition management businesses that charge a (more preferred) basis point fee per transition. There is therefore an incentive, even if only at a sub-conscious level, for the consulting division to recommend asset manager or product changes (based on short-term performance) more frequently than necessary to generate business for the transition management division. In this case, retirement funds not only suffer from unnecessary transition costs and the negative effects of short-termism, but also from the opportunity cost of changing asset managers or switching between products at, more often than not, the wrong times.

When applied correctly, these additional services can and do add significant value to retirement funds. However, the multiple roles described do risk moving the investment consultant's interests further away from those of the retirement fund and its members, creating conflicting incentives.

The dual-consulting model seeks to address these issues and offers additional benefits to trustees:

- the model tends to have a more comprehensive audit trail of decision-making, which improves transparency to various stakeholders and confidence in the decision-making process. Often there is no wrong or right answer when dealing with investment issues. Therefore the decision-making process in arriving at a particular outcome must be robust. This is particularly important within a defined contribution environment where members and trustees bear the risk of failed investment strategies, as opposed to an employer or sponsor.
- it allows trustees to grasp complex issues and make more informed investment decisions by allowing different perspectives on an issue to be actively debated between the two informed and professional investment experts.
- it allows investment issues to be prioritised more effectively and assists with managing the board's governance budget, including time allocation. Trustees may develop greater conviction in decisions in instances where both investment consultants agree. On the other hand, in instances where the two consultants disagree, trustees may exercise greater caution or allocate more time to investigate the matter further.
- it allows trustees to tap into the collective expertise of both consultants or utilise the strengths of each consultant as they see fit or as is appropriate to different situations.
- Investment consultants have different 'styles' or methods of operating and different skill sets and experience. Some companies may be more quantitative in their approach whereas other companies may be more contrarian.

Downside potential disadvantages

There is a risk that the dual-consulting model could delay decision-making, especially if the two investment consultants differ with each other for the sake of differing. This model therefore requires the investment consultants and the trustees to create an environment of mutual respect. However, some would argue that any decision-making delays will be in areas where a delay is actually warranted. And in any case, long-term decisions require an additional layer of scrutiny and research, so spending time on these decisions is entirely appropriate for long-term investors.

Retirement funds will need to spend additional time managing the two consultants, especially where the level of competition is fierce. The arrangement is more complicated than the single consulting model but this complexity does seem to be warranted given the complexity of the tasks and decisions involved.

The dual-consulting model may lead to an increase in investment consulting fees. Costs are important as they impact significantly on members' net replacement ratio on retirement. However, this is limited if the investment consulting budget is essentially split between the two appointed investment consultants. Even where there is an increase in combined consulting fees, this should be marginal relative to the improved decision-making, resulting in investment returns and risk outcomes that better match the fund's requirements, as well as the governance and other benefits associated with the dual-consulting model.

In conclusion, the dual-consulting model effectively builds in an expert alternative opinion at every level of the investment decision-making process at little or no extra cost and addresses some of the shortcomings of the single investment consulting model. This can only improve outcomes for all retirement fund stakeholders over the long term, and is more able to deliver the sustainable long-term, risk-adjusted returns required by retirement fund members. ∞