

Do Plan Sponsors Increase Portfolio Returns Through Manager Selection and Market Timing Decisions?

How much value is added when plan sponsors make allocation decisions? Are they able to improve portfolio returns through well timed moves into and out of asset classes? Are they able to select managers that will outperform their peers through the use of extensive due diligence processes? Despite the immense consequences of poor decisions (institutional assets total over \$10 trillion¹), surprisingly little research has been conducted on the ability of plan sponsors to make profitable investment decisions.

Numerous academic studies have concluded that individual investors make poor investment timing decisions². One would expect that institutional investors have an advantage by hiring sophisticated professionals or expert consultants, and therefore would have the discipline and insight necessary to make investment decisions that add value for their stakeholders. It is reasonable to expect that the “smart money” would be insulated from the psychological pressures that ultimately result in the destruction of wealth for so many individual investors. However, recent academic research has examined this issue and demonstrated that, in fact, the opposite is true.

In an article titled “*Absence of Value: An Analysis of Investment Allocation Decisions by Institutional Plan Sponsors*” published in the Financial Analysts Journal, the authors analyzed the PSN investment manager database from 1984-2007 to determine whether institutional plan sponsors improved the performance of their investment portfolios through manager selection and asset allocation changes. They concluded that in periods following cash flows, the performance for products that had experienced net outflows was higher than that of products that experienced net inflows.

In other words, when plan sponsors fire a manager or allocate money away from a manager, that manager has typically outperformed the new manager that was hired. Interestingly, these findings apply both to allocation changes among different investment asset classes as well as manager selection within asset classes [see Table 1].

Table 1

	Performance Difference	Attributable to Asset Class	Attributable to Manager Selection
<i>A. Subsequent one-year returns</i>			
Mean Return (1985-2006)	-1.12%	-0.27%	-0.74%
<i>B. Annualized subsequent three-year returns</i>			
Mean Return (1985-2004)	-0.86%	-0.30%	-0.59%
<i>C. Annualized subsequent five-year returns</i>			
Mean Return (1985-2002)	-0.67%	-0.20%	-0.44%

Moreover, this underperformance is not limited to difficulties in a few select asset classes. The table on the following page demonstrates the performance differential is widespread across asset classes and persists over different time periods [see Table 2].

The study’s conclusion is that plan sponsors are not acting in their stakeholders’ best interests when they make allocation decisions. This implies that the attempts by plan sponsors to time the market and select active money managers (i.e., finding the “best of breed”) typically backfire, and they end up joining with individual investors in chasing hot performance only to get burned.

Table 2

Performance Differential Across Asset Classes (1985-2006)			
<u>Category</u>	<u>Net Inflow Manager Returns</u>	<u>Net Outflow Manager Returns</u>	<u>Performance Difference</u>
<i>A. One-year returns</i>			
Domestic growth	12.87%	14.65%	-1.78%
Domestic GARP	13.75%	14.54%	-0.79%
Domestic balanced	10.67%	11.36%	-0.69%
Domestic value	12.98%	14.27%	-1.28%
Domestic core	12.94%	13.30%	-0.36%
Global equity	11.48%	12.72%	-1.24%
International equity	13.29%	14.99%	-1.70%
Domestic fixed	7.72%	8.02%	-0.30%
Global fixed	7.84%	8.58%	-0.74%
International fixed	12.56%	13.27%	-0.71%
<i>B. Annualized three-year returns</i>			
Domestic growth	12.22%	13.74%	-1.52%
Domestic GARP	12.88%	13.43%	-0.54%
Domestic balanced	10.44%	11.02%	-0.58%
Domestic value	13.05%	13.73%	-0.68%
Domestic core	12.45%	12.92%	-0.46%
Global equity	10.69%	11.99%	-1.30%
International equity	10.02%	10.92%	-0.90%
Domestic fixed	7.55%	7.84%	-0.29%
Global fixed	7.83%	7.50%	0.33%
International fixed	11.40%	11.14%	0.26%
<i>C. Annualized five-year returns</i>			
Domestic growth	12.18%	13.41%	-1.24%
Domestic GARP	12.36%	13.13%	-0.76%
Domestic balanced	10.35%	11.02%	-0.67%
Domestic value	12.95%	13.37%	-0.42%
Domestic core	12.22%	12.77%	-0.55%
Global equity	10.78%	10.77%	0.01%
International equity	8.66%	8.88%	-0.23%
Domestic fixed	7.72%	8.02%	-0.30%
Global fixed	7.74%	7.49%	0.25%
International fixed	10.77%	11.08%	-0.31%

All data is derived from the referenced article in the Financial Analysts Journal.

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¹Heisler, Jeffrey, Christopher R. Knittel, John J. Neumann, and Scott D. Stewart. 2009. "Absence of Value: An Analysis of Investment Allocation Decisions by Institutional Plan Sponsors" *Financial Analysts Journal*, vol. 65, no. 6 (November/December):34-51.

²Dalbar, Inc. 2005. "QAIB 2005: Quantitative Analysis of Investor Behavior."