Worst Practices in Institutional Asset Management

The Wall Street Journal published a story last week about the investing program for the foundation of the Financial Industry Regulatory Authority (FINRA). FINRA is a nonprofit that's tasked with regulating the broker-dealer industry to ensure investors aren't getting taken advantage of.

FINRA itself has a $1.6 billion investment portfolio that leaves much to be desired based on the description in the WSJ. The performance of the fund has been severely lacking since it was funded in the early-2000s with annual returns that are roughly half that of a simple 50/50 globally diversified stock/bond portfolio.

Whenever an institutional portfolio runs into trouble it's typically a governance issue more than investment strategy that causes the problems. What follows is a list of worst practices in the institutional asset management space along with an example from this article.

Chasing peer performance. The herd mentality is strong in the institutional investment community. Everyone wants to mimic the Ivy League endowment funds and FINRA is apparently no different:

Finra decided in November 2003 to mimic the investment strategies of university endowments, such as those at Harvard and Yale. It didn’t widely publicize the decision, which was opposed by some smaller brokerages that wanted Finra to distribute the Nasdaq payout to member firms. “Finra’s investment portfolio is governed by a policy based on best practices of endowment funds,” it wrote in its 2007 annual report.

Of course, everyone says they use "best practices" but very few institutional investors have the best people or organizational structure in place to accomplish those best practices.

Fighting the last war. The number of institutions who de-risked in 2009 right near the time the markets bottomed is larger than most people could imagine:

Finra tripled the share of its portfolio parked in bonds and cash in 2009, and yanked money from hedge funds and stocks, a decision that hurt its performance as riskier assets rebounded that year. The organization since then has kept about 12% in cash, according to Finra officials, which also hurts returns.

There's nothing wrong with making an asset allocation change per se, but the timing of these moves couldn't have been worse. This is a classic panic move where you realize you really had no plan of attack for a downturn in the first place. Buy high, sell low...repeat until broke.

Unrealistic expectations. Hope, as they say, is not an investment strategy. Most investors found this out the hard way during the financial crisis when asset values fell far below where many were projecting in their range of outcomes. In FINRA's case that meant losses that were 3x bigger than anticipated:

After losing $576 million in the 2008 downturn, triple its worst-case estimates, Finra piled much of its portfolio into bonds, missing out on much of the subsequent stock-market rally.

I'm not sure what they were using for return expectations but someone dropped the ball here in terms of being prepared for a market crash and what that means for asset prices.

Complex benchmarking. I'd venture a guess that 99.9% of the time when a money manager or fund changes their benchmark or creates a custom benchmark, it's because they're trying to mask poor performance. Moving the goalposts is a time-honored tradition. I'm not sure what benchmarks FINRA is using but I'm guessing they are low hurdle rates made up of conveniently difficult to understand metrics:

Finra's returns since 2009 have met a custom benchmark that Finra executives use to judge whether their outside money managers beat lower-cost alternatives, Ms. Condon said. But Finra's annual reports don't disclose the benchmark's performance or report how it is calculated.

Investment results impacting the organization's mission. The only thing that really matters for a nonprofit -- or any investor for that matter -- is meeting your end goals. Once your investment results begin to impact your mission as an organization, that's when you know the problems are real:

The returns have real ramifications for the brokerage industry. In years when Finra's fee revenue exceeds forecasts and investment gains are strong, the regulator can rebate fees paid by firms it regulates. It hasn't done that since 2014.

FINRA is not alone in in these mistakes. While most people assume this space is filled with the most sophisticated investors in the world, the sheer amount of money involved invites politics into the equation, which can lead to poor results. Even the most brilliant investors in the world will have a hard time if the correct governance structures aren't in place at the organizational level. The biggest issue for most investors that run into these types of problems is having no clear vision or philosophy to begin with.

Obtaining extraordinary performance in the institutional asset management industry is not easy. But obtaining sufficient performance should be, assuming you avoid huge mistakes. Avoiding mistakes isn't a flashy strategy but it's the right one for the majority of investors.

Source:
Wall Street Regulator Is Also an Investor -- With Meager Returns (WSJ)

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