On Benchmarking and Prudent Expert Rule

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An Address given at the annual general meeting of CFA society of Thailand, August 30th, 2011

I recalled the first year I retired from any full time job. A man who belongs to a family of wealth searched me out and offered me a job as private fund manager, managing his family wealth.

I paused, not to think of what I should put down as conditions of employment or how much I should charge him for my service but to search in my mind for a proper declining answer.

This is my answer: "O no, I am not qualified."

I saw a puzzled look on his face. I qualified my statement: "It is true, I headed GPF, the largest long term fund in Thailand (at that time), but I am not a fund manager. I am the manager of fund managers. I encouraged, I coordinated, I directed, I supported their work, and I reminded them to be professional."

Many of you are in my position I once was, and many will be there some time in the future.

Let me share with you a few thoughts on this aspect of my job.

<u>How I came to know "CFA"</u>

When I began my work as the Secretary General at the newly created Government Pension Fund, I searched for professionals to be on my team.

My accountant was my back and a few professional fund managers were my forward.

"I want to hire this person, she is young but she has a CFA level two already." My 2nd informed me.

What is a CFA?

On that day I learned that CFA (level 3) is the highest credential one can get in the field of investment profession, very difficult to get and there were very few of them in Thailand.

It was the last quarter of 1997.

I gave the job of managing fixed income to this young lady of 31. At that time she had passed level II examination. Level II was better than no level at all; this is my point of view. At least, she got solid theoretical foundation but we did not yet know her character and her performance. I trusted myself that other colleagues of mine and I could fill in the missing part.

I personally like to work with people who are professionals and I expect them to perform their task professionally.

Managing fixed income of GPF at that time meant managing over 70% of our asset allocation and the fund size was approaching 100 billion quickly. It grew by 1 to 2 billion each month.

Her performance did not disappoint me at all.

On one occasion, we went to meet CALPERS and some western states' pension fund system in the U.S. It was our first contact with them. She went along with me. By that time she was a full-fledged Chartered Financial Analyst. I found out that those funds did not know GPF but they knew CFA. A CFA helped with organizational recognition and helped put GPF professionally on equal footing with those institutional investors.

CFA may be a door opener, or a personal passport, into the world of finance and portfolio management. In my case, my CFA colleague became also a door opener for the organization.

Since then, I encouraged young people in the organization to work toward becoming a CFA charter holder. I did not give out scholarship; I just bet with my staff. I gave them back the examination fee if they passed the examination plus a transfer into investment division. Staff in any department can take this offer. I treated the CFA charter as the passport into investment division.

<u>How to obtain the CFA charter</u>

All of you have the key or the passport into the career already. You know very well, and more than I who am the outsider, the process and the program to become a chartered member of the Institute.

Let me remind you on what I think are the 2 important features of the program.

First, it is a self-study program. A self-study program is designed to combine experience with knowledge to reach “the practical knowledge”. Therefore, it implies that a candidate should not go about attending special classes with the objective of just to pass an examination, using chiefly intelligence and memory. In so doing a person gets a practical knowledge without real practice.

Secondly, it usually takes 3 to 5 years to complete the program. The 3 to 5 years period is similarly not a benchmark to try to beat with the attitude that the shorter the smarter as is often the governing attitude in this society of ours.

Therefore, if you are in the profession and you have staffs working under you who are studying to become a CFA charter member, please remind them of these two points so that they can benefit fully from the program, and you as their senior will also benefit in the future for having highly qualified colleagues to work with.

Similarly, as you advance in your career, you need also to keep yourself abreast in this fast changing world of finance, as your junior colleagues are acquiring the latest development through newly published research.

Self- study is a never ending process of learning. As a CFA charter member, you are treated as a respected individual, not a school boy or girl with scheduled classes and required refreshing courses at intervals. It is an honor to be treated as such; it is also a responsibility to live up to the honor.

<u>The duty while being in the profession</u>

Once you have entered the house of finance and investment, now what?

Here is my side of the story. In this short time, I can only relate to you an example.

I have been asked very often to be on committees to oversee and review investment policy and investment performance of funds managed by asset management companies. I have as often been told that the fund “performs close to benchmark”.

Even when the market return was negative, the presenter told committee members quite proudly that the overall performance of the fund under management was better than the benchmark. That is, it was less negative, but negative nevertheless.

When I asked why the fund under management was not invested in a longer term maturity. I was told that the fixed income fund manager could not move away to the long end under the mandate. The benchmark was, in this case, to be blamed.

I argued that benchmark is not a mandate, it is just an indication. I am sure that most people in the fund management business disagree with me, because the explanation of performance relative to the benchmark continues to persist.

“What would you do with your own money under present circumstance?” I ask.

“I personally would put it long term, say 5 – 7 years and leave my investment there.”

“Then why don’t you do that for us?”

“Committee members won’t understand when the mark to market becomes negative along the way sometime, and it will hurt our performance in the committee’s view.”

“What should be done then?” This is my next enquiry.

The answer is: “we should change the benchmark.”

What would happen if we change the benchmark and the market moves in the opposite direction when we should be investing in short term papers? Do we have to revert or to change the benchmark again?

What is your proposal for a way out in this game called “Blame it on benchmark”?

For me, benchmark is derived from the stated preference of asset owners. It is the approximation of the preference reduced into numbers for convenience and precision. It is not an absolute standard, nor a law that cannot be violated.

If the preference of an asset owner is for capital preservation, I don’t see why having a negative return is better than a positive return, although there is less opportunity for gain should the market pick up.

If it is a long term fund and one should be able to tolerate the ups and downs of the stock market, as the standard explanation goes; then why does the same argument not apply to fixed income investment as well? Aren’t the explanations given on these two asset classes inconsistent?

Benchmark should be used with care and placed in proper place. Benchmark is useful for Investors that prefer passive investment strategy with a small portion slightly active. They know what to expect. For a fund that positions itself as an active fund, however, performing slightly over benchmark is not good enough.

There was an experience in another country where an industrial average was once used as a benchmark. At that time, every fund regardless of management companies invested in quite similar assets so that their performance stayed close to the average. No fund wanted to be different. Customers had not much of a choice from such practice, but the practice continued because it was convenient and safe for the asset management industry.

The booklet on the CFA Charter said: “members of CFA Institute must place the integrity of the investment profession and the interests of clients above their own personal interests.”

The CFA Institute spells out in details the code of ethics and standards of professional conduct. I understand that these 2 topics are the focal points of the profession as they are subject of examination at every level. As you move along in your career, it should be re-visited every year by everyone, just to remind and to review oneself lest one forgets while immersing oneself in the busy world of money and profit making.

Key words are: Clients’ interests, fiduciary duty, prudent man, and prudent expert rules. I need not elaborate on these well known vocabularies for all of you who are expert and are expected to live these words in your everyday work.

Here are a few sentences just to remind.

"The Prudent Man Rule"

The Prudent Man Rule (1830) directs trustees "to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."

The Prudent Man Rule puts protection of capital ahead of chasing returns.

Prudent Expert Rule of ERISA

The Employee Retirement Income Security Act (ERISA) applies a revised and restated version of the prudent man rule to pension and profit sharing portfolios. ERISA requires that a fiduciary manage a portfolio 'with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

What does this standard of conducts have to do with benchmarking that I mentioned earlier? It is very much related. In fact, the story raises the question on conducts and ethics. By explaining away every performance with benchmarking, by not investing in things that you yourself would do with your own money, by placing concern of your own company's performance over clients' interest, are you acting in clients' interest, are you doing your fiduciary duty properly, and are you being prudent expert?

When clients do not understand benchmarking, instead of throwing away the professional knowledge and stooping to be on par with your unsophisticated customers, please teach them to understand. A CFA charter holder can do a lot more for our financial community by educating clients so they as well as you yourself can best use your potential.

Standard of works governs every action of yours.

Looking ahead to the end of a career

Everyone wants to be successful, but one defines success differently.

Whatever it is, you do not want to simply spell the word "success" or travel on each alphabet of the word. You want to taste the fruit of success.

If the CFA is the key, you have taken that key and entered the house. As time goes by your house may even grow larger to become a mansion.

Then you may wonder what should be your next move.

Living in the mansion all alone is quite lonely, and however large that mansion is, you can live in only one room at a time. Moreover, you do not just live in a mansion, you should want to get out and enjoy the surrounding as well.

For me, a mansion is not a physical mansion. It is a mansion of success based upon the job professionally done. It is a mansion surrounded with friends and colleagues. It is a comfortable mansion permeated with integrity. And recognition comes your way when you give your best to your job and your clients.

Sir Winston Churchill once said "We make a living by what we get, but we make a life by what we give."