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Session 4PD
Managing the People Who Manage the Money

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Moderator: ELIZABETH A. WARD
Panelists: THOMAS J. HUGHES†
PATRICIA W. WILSON‡
Recorder: ELIZABETH A. WARD

Summary: As insurance companies reassess their asset allocation profile and consider changes, they must determine whether they have the necessary resources in-house to invest in the targeted areas. A natural trend that has been emerging is the increasing employment of outside money managers, at least for certain subsets of the insurer's portfolios. There are a host of issues that insurers must address when considering how to manage the money managers.

Ms. Elizabeth A. Ward: I've seen more than one manager of insurance assets talk at length about the necessary sensitivities to insurance concerns, regulatory constraints, et al. Then they trot out their firm's comparatively unconstrained ERISA fund performance. Managers should be put on a short lease with respect to the degree they can depart from the liability patterns if that's critical to you or the potential profitability of your business, and if these items are important to your company, the investment manager should also be assessed and chosen on that basis.

It's not enough to know that your funds have had an additional couple of hundred basis points of return in the first quarter of 1998 by being in the Korean market. It's not enough to say that your tenfold leveraged mortgage position has yielded several hundred basis points above all market indexes. It's not enough to measure only return. Risk is the important second dimension.

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†Mr. Hughes, not a member of the sponsoring organizations, is Vice President of Morgan Stanley Asset Management, Inc. in New York, NY.

‡Ms. Wilson, not a member of the sponsoring organizations, is Assistant Vice President-Investments of Allstate Life Insurance Company in Northbrook, IL.

Note: The chart referred to in the text can be found at the end of the manuscript.

Strive for your performance benchmark to reflect not only the risk realized but also the risk assumed. We at Charter Oak recommend choosing a benchmark that reflects contribution to the firm's value; that is, don't reward your investment manager for beating the Lehman aggregate index if the resulting investment performance forces you to drop out of your most profitable annuity line and lose your sales force.

After you pick a benchmark you need to be able to assess the quality of the performance. While it may seem relatively easy to identify a particular result, it's less easy to decipher who exactly is responsible for the effect. So, while we can calculate return in a pretty straightforward way, how do we parse out that performance by source such as duration, industry, sector, and selection? Whose result was it? Was it the portfolio manager? The credit analyst? The trader? Or the client himself? It might have been due to a sale requested by the client. There are many sources of information and traditional methods for attribution of return. My favorite primer on the subject is *Bond Performance: Analyzing Sources of Return*.

Performance information should be used to cycle back to the beginning to validate strategy and to recast plans for the portfolio. Whatever set of statistics is chosen to watch, the progress must be tracked. Compensation should provide incentives for proper strategy, risk-taking, and implementation. Rewarding dumb luck may seem fair, but it hardly supports the long-run health of the business. Finally, performance analysis by source of return can help to adjust expectations.

By understanding the components of performance and their driving forces there's much we can say about the future expectations. This is important for both the manager and the client to adjust expectations to reasonable levels if better was expected. At this point I'm going to turn it over to T.J. He'll describe why you should consider hiring an outside manager and what to consider when starting your search. Pat will then follow with a discussion of how you might manage your investment managers.

Mr. Thomas J. Hughes: As Betsy said, I'm with Morgan Stanley Institutional Investment Management, and my role is to work with insurance industry participants on matters related to investment management. While a substantial portion of our business is, indeed, working with insurance clients on the general account side, I wanted to point out too that we do provide investment management products in conjunction with separate accounts working with product managers for variable annuities (VAs) and the like. Interestingly, the theme of outsourcing investment management is not only a discernible trend in the industry right now but one that brings along with it all of the challenges we are facing in the consolidation of the financial services industries. Pressure to optimize shareholder value through

enhanced financial performance requires strong risk management and strong investment skills. The merger and acquisition (M&A) activity on my side of the business presents you with the challenge to ensure that the manager who you'll be hiring is one who will be with you for the long haul and one who can bring value-added in the relationship that you hope to forge for the future.

With that as a backdrop, the obvious question becomes why should you hire an outside manager to outsource your investment portfolio? Certain themes have emerged within the past couple of years that may argue for a mix of inside versus external expertise. You could break the list of reasons down into objective reasons, some of which may be quantitative, and subjective or qualitative reasons. The obvious aspects that come quickly to light are to gain investment experience. You can rent the expertise that an outside manager has in certain areas of the market where your in-house skills or competency may not be sufficient to capture the returns and the opportunities from certain market segments. You can also make comparisons or, in fact, create competition with other managers who you've hired or, indeed, against performance of your own internal portfolio management teams.

There are also new market opportunities: the areas of alternative investments, private equities, venture investing, commodities, and hedge funds. This all ties directly to the next point which is diversification—diversification of styles, diversification of managers. These new markets may bring about increases in risk at the margin, but the benefits of diversification on a risk return basis are significant. Then there's what I'll call the generational shift. I can't provide to you any empirical proof that this exists, but it's something that I have observed in my travels, especially within the last year. Perhaps it's a function of the consolidation in the industry. Nevertheless, the retirement or departure of certain key investment personnel causes companies to take a strategic look at how they should replace those skills that have been accumulated over the tenure of some person's career. Should a company use this as an opportunity to hire an outside manager? And from a practical point of view, how likely is it that you're going to be able to hire new personnel from the outside when the economics right now may, in fact, favor paying an outside investment manager? Consider the fees associated with hiring an outside manager and compare those to the cost of running an inside staff. Also, geographically many companies don't seem to be able to attract the type of talent they're seeking simply by virtue of the location or the region within the U.S. where they're located.

You also benefit from the insurance expertise of people who come to work with you in dealing with regulators, rating agencies, the idiosyncrasies of taxes, and the like. Those with dedicated insurance expertise not only can generate alpha or excess returns but truly can work with you as a client in strategic and tactical aspects to

achieve your objectives. I'm going to come back to this and develop this point a little bit further in just a couple of minutes.

One of the more compelling aspects of optimizing investment performance is probably best illustrated in Chart 1. The base case here is that if you have $100 million of surplus with a balance sheet that's leveraged 4 times, over time merely generating benchmark returns of 6% produces a surplus of $560 million, but by investing more strategically and focusing on generating excess returns of 75 basis points and factoring in balance sheet leverage of 4 times in this assumption, you've increased surplus by 72% over the life. Another way of stating the essence of building shareholder value is by generating excess returns of 75 basis points. The ROE in a moderately leveraged firm increases by 30%.

The question that probably comes in your mind now is one of, "Ah, yes, that sounds great, but at what price? What are the risks that are introduced when you go for excess returns on the order of 75 basis points or higher?" One of the key considerations in evaluating managers and their ability to generate excess returns is the risk factor associated with these returns—risk as measured by volatility of returns or standard deviation of monthly excess returns. Ask the managers who you're hiring or, in fact, even the ones who you may already have on board to provide a quantitative analysis of the volatilities of their excess returns. Then discuss with them the investment efficiency of their returns. We found that the information ratio is the most effective measure for analyzing risk management investment performance.

Coming back to the advantages of hiring a manager with dedicated resource to cover the insurance industry, we find that adding alpha, generating excess returns, is not all that our clients are looking for from an outside manager. The knowledge and ability of service, the insurance industry, is a key requirement. GAAP and statutory accounting issues, regulations, risk-based capital treatment, and rating agency issues all are areas where a thorough understanding of the industry is required.

This expertise can then be leveraged to the client's unique requirements in providing more customized analysis and ultimately a portfolio approach that achieves your objectives. Of paramount importance in this process is asset/liability modeling (ALM) and the asset allocation decisions that come from this analysis. ALM and asset/liability analysis and cash-flow testing and the like are areas of technical expertise best left to actuaries and industry consultants. However, taking that output and the results of this work and applying it to structuring of an optimal asset allocation framework, which then translates into portfolio management, is incumbent upon the investment manager to comprehend and execute. The ongoing

dialogue with the client and subsequent portfolio refinements that may take place are critical in this case.

Clients are constantly asking us about the numbers of managers that they should hire and the relative size of the firms that they're contemplating dealing with. I would venture to say at this point that managing managers has become a new functional skill within investment divisions of insurance companies large and small. I don't feel that there's a magic formula that you can follow in terms of the type of company that you should hire relative to size of assets under management or any other hard-and-fast rule. Let's at least consider asset managers by size themselves.

The larger firms this is all relative, I can't say whether it's in terms of assets under management of $75 billion or higher and below, but let's just say that if you have some arbitrary cut bring about benefits of scale and a wide range of products and expertise. This might enable you to deal with fewer managers, scale providers, and make managing the managers much more efficient. You also find that there are benefits from pooling assets with those managers so that you can negotiate more favorable fees overall. This is an area of negotiation that varies by firm, but one where scale is a definite benefit.

Smaller firms, on the other hand, bring benefits in providing more of a boutique-style atmosphere. This is especially true in dealing with firms that are highly specialized in selective asset classes such as hedge funds, venture and private equity, and private equity investing. The other obvious benefit is that boutiques tend to have fewer clients and may provide the feeling of better focus on a client's specific needs. I'd venture to say, however, that this may be misleading, as smaller firms may not always have the infrastructure for customized reporting, client service, and things that are unique to your situation.

Let's get to the essence of the subject. How do you actually pick the manager? The most important qualities to measure are the philosophy, the process, the performance, and the people. A firm's organization and history is also a very critical element to this equation. I'm sure you've all heard the disclaimer that past performance does not guarantee future performance. I actually have to say that I agree with that; that past performance is of marginal use in the manager selection process. It may be part of an initial screening process, but beyond that the due diligence that you have to perform with an outside manager, whether it's in your office or in their offices, is much more important to the selection process than prior history performance. A high quality organization with superior personnel will outperform over time. This is the only predictive power that I can offer you at this point, but that is indicative of future results.

Looking at each of these qualitative and quantitative measures let's talk about the manager's philosophy. What is their stated investment philosophy? It's a question that you must ask, and it's one that you should hear consistently and continuously articulated at all levels of any organization you're considering and evaluating. You want to make sure that the firm is aligned with whatever strategy they're articulating and ensure that the firm supports the philosophy with research, technology, and quality personnel to ensure depth, competency, and consistency of performance over time. If that strategy's changed, you'll want to know why. You'll want to know what the reasons have been and how they've impacted performance. Did they select a new philosophy just based upon some breakthrough in one of their research methodologies?

Turning to the investment process, again, ensure that it's very clearly and consistently articulated by portfolio managers, analysts, traders, and anyone else who you're going to come in contact with that constitutes the investment team handling your portfolio. Have there been any tactical changes to the process? Tactical changes aren't necessarily a bad thing, and, in fact, they're sometimes quite good because continuously you're looking for enhanced risk controls over time to make sure that there's always an evolution of improvement in the investment management process. Then there are strengths versus limitations, or in this politically correct world, developmental needs. I'm always wary of a firm that suggests that they have the best and the brightest but can't really identify areas for potential improvement in process. There should be continuous exercises to keep you at the leading edge of research so that new investment ideas are constantly coming forth. Do these firms stick to their convictions, i.e., stick to their knitting? Is there style drift that you've observed?

I'm constantly reminded that right now we're in one of the longest bull market phases in history. All we ever hear about is when's there going to be a bear market? Are we going to go through a sustained correction? And how's that really going to test the mettle of portfolio managers? I think right now you'll find some frayed nerves in value investment style managers in these markets. Whereas valuations in the market continue to climb, cyclical investors, for example, are finding pretty slim pickings in the market, and it's testing their ability to stay focused on a certain style and strategy.

Next I want to talk just a little bit about the process flow. If you take the client's objectives, benchmarks, and guidelines into consideration first, it's always important for the manager to focus on those and clearly understand and mutually agree upon where those stand. It's not a good thing to back into those just because of a style preference that you may have or a performance observation that you may have for a certain manager. The portfolio structure should follow this top down process. It's

where interest-rate risk is defined and quantified whether it's using duration as a measure or other methodologies. It's where quality constraints and guidelines should be set in terms of credit (especially if you're dealing in high yield or emerging markets or other high-octane markets to ensure that the quality guidelines are set and clearly understood); any foreign exposure that you might have, whether it's by country risk or currency exposure, as set at that time; and other customized guidelines such as no tobacco or gaming that may be unique situations because of board of directors' preferences and so forth.

Portfolio composition, in terms of sector selection and the absolute security selection that takes place, is on a bottom-up basis. All of this comes together to construct the portfolio for the client, whether this is being built from scratch or cash that's allocated to a new manager or the construction is taking place from a portfolio that currently exists either with another manager or perhaps is being moved from the inside to an outside manager intact. It's then up to the manager to reconfigure that portfolio.

I want to talk just a second about the importance of biographies or people's backgrounds. It's very important to understand whether a manager operates for his or her clients on the basis of a star system or a team and what impact each of those styles has upon the decision-making process and the depth of the bench and the backup that they have. That's especially important where there's a team approach, but obviously it's even more critical in a star system. What type of leadership process do they have within their teams to allow for the best ideas to come forth and not be so cumbersome as to oppress people's ideas and thinking in terms of adding value to the portfolio? What is their stability and continuity of personnel and what incentives do they have to perform their best for you as a client? Their backgrounds are very important as well in terms of the various pedigrees that they show in terms of their resumes and the practical experience they may have had in other firms where they've worked in the past. Turnover is critical. Most requests for proposals (RFPs) that we've seen are asking for a complete list of people who have come into the firm and who have left and for what reasons. That has an especially important impact right now because of all the M&A activity we're seeing today. What is the impact of some of these changes taking place, and does that really have a direct effect on performance?

Once you've made that decision to hire, you've screened all the managers you're considering, and you've selected one of them, where do you go from there? This is a bit of a transition into what Pat Wilson's going to talk about, but I wanted to give you some points of view that I have on this first. I think that the importance of communication can't be overstated. Whether it's written, verbal, in terms of market reviews, cash statements, whatever, the frequency of that, especially in the early

stages of a relationship, when you're going through portfolio composition, is critical. You want to be sure that the investment manager's sticking to the guidelines and following any gain or loss constraints that you may have set for them. It's interesting how clients who come to us as a manager saying that they want to manage to total return frequently come back to us needing to raise cash right away because of unforeseen circumstances. Those types of surprises aren't good for the client. They're not good for the manager either.

That type of communication and that type of expectation in terms of managing expectations is very critical in the early stages, as well as the ability to work with the client's infrastructure, whether it's with their custodian bank, operations, or internal accounting staff. What kind of data feeds are you going to get in terms of management information coming back. If you have highly customized needs, are those going to be able to be fulfilled and sent in the right electronic format?

What's your impact or what effect can you really have on the manager's performance? The impact of guidelines and changes in guidelines can be beneficial. It can also be a negative. But it's something that I believe is a two-way street. Guidelines are designed to manage return objectives as well as to set risk tolerances. Changes in guidelines are good, especially if they're driven from the client as well as from the manager and they're mutually agreed upon. Changes in guidelines can reduce costs. They can diversify risks and, indeed, increase the range of eligible assets in which the manager can invest.

Just a word on performance attribution. I think performance attribution is something that oftentimes is overlooked, especially in the fixed-income market. It seems to be something that is perhaps a little bit more akin to equity investing. But you want to be sure that performance attribution is something where you're able to measure key contributors or detractors from performance, whether it's in terms of the amount of interest-rate risk or duration that's taken in the portfolio; the impact of credit risk, foreign components, country and currency exposure, sector concentrations, security selection, and overweighing and underweighting; and the effect of strategic bets by industry, by sector, and by security selection.

I also want to say that I think tracking errors are something that, again, perhaps are more unique to equity investment but, indeed, are an area where tracking error must be reconciled to the satisfaction of the client in every instance. Pat and I may get a chance later on to talk a little bit about a real-life experience that we've had together in terms of a manager search that we were involved in, and we'll be happy to share some comments and thoughts on the impact of tracking error and the outcome of that search. The volatility of returns. What impact does this actually have in terms of your operations, whether they're pluses or minuses? No one likes

surprises. The objective from the manager's point of view is to minimize the surprises, positive or negative, and always maximize the benefit and the impact of an investment manager in terms of value-added to the client.

Ms. Patricia W. Wilson: I think one of the things that we all think about when we go to hire an external manager, in particular, or even when you think about what the capabilities are of your inside investment department is the drive for excess returns. I think one of the things that at least many of you in the audience can relate to is that the components of those returns, whether that fits the definition of operating income or something that if you're a stock company your shareholder can value or is excess returns really a cloak-and-dagger name for capital gain? We don't want any more capital gains because we have so many of them, and from where we sit we're going to keep getting them, even if the market goes down, particularly if the stock market goes down 10–15%. That presents a very robust challenge when you're hiring a manager.

The other thing that I want to reiterate is what T.J. said—history does not repeat itself. However, when you go through the selection process you are looking for a repeatable, winnable process. Do these people understand what it takes to succeed, and do they understand how to adapt to the marketplace? People who use a very methodical approach or have some skill at adapting quickly to changing market conditions will win. One of the debates that you're going to run into as you look at small and large firms is, who's going to be quickest to react? That is a very serious question because being able to move quickly to changing market conditions is very, very important.

What I'm going to do is cover our experience. We hired managers. We kind of got into this by accident. We changed our strategy in public high yield, and the employees who were working in there didn't like it, so they all left and got better jobs. Unfortunately, it's really true. We changed our strategy, and that forced us to hire an outside manager. I have to say that it was a very good thing for the senior management of Allstate to go through that process because all of the sudden an area that was a very small part of our balance sheet took on, I would say, even more focus as to what we wanted and why we wanted it.

Recently, we've become a manager, and that has really taxed our systems area. A comment that T.J. made earlier, it's one thing when you go out and you ask for a ton of stuff, it's another thing when somebody comes to you and says this is what I want. This should be ordinary and routine, but all of a sudden you're sitting there wondering, "Whoa, what are we going to do?" All of a sudden you find yourself getting very creative.

I'm going to spend most of my time, though, on the management issues. What happens when they're there? This stuff, at least to me, is a little boring—administrative matters, compliance, benchmarking, evaluation. Last, I'm going to spend some time talking about cost. Management issues can kill you if you don't do them well because they will show up in your returns.

As I mentioned earlier, our first manager was hired in 1994, and one of the benefits that we found is that it gave us a lot of flexibility and a faster way to enter and exit a market. We entered emerging market equities and hired an outside manager. Nine months later we were out. In this labor environment we wouldn't have been successful hiring a manager had we decided to build that internally. We got in, and we got out. We're now sitting on the sidelines. It's hard to explain to your own employee that you'd like him or her to go out and do nothing. People don't really understand that very well.

Our results thus far have been very good. However, it's not because we've necessarily achieved out performance. It's because we got exactly what we asked for, and we also got the flexibility and the other things that we wanted. So, you may find that are some little pearls that come out of this—some unintended consequences that make your whole investment operation better. The trend is for more of these relationships, I would say, not less. However, they may be in entirely different asset classes. As you'll see when you look at ours, they look like a boutique, but I think that will force most investment departments in most insurance companies to identify what they want to be good at because the things that you are really good at will drive your product creation. Having that as a day-to-day resource that's available to you is going to be one of the more critical things that your organization is going to have to think about over the next three to five years.

As I mentioned our Allstate-hired managers include TCW for our public high yield, Brenson for emerging market debt, State Street for emerging market equity, and IB Management for hedge funds. We have just entered a relationship with Pittsburgh National. And we are the manager for Sears Life. That's a lot of work.

Most of you come from pretty big corporations. If your cash projections are off by $5–10 million, it really doesn't matter. If they're off in some cases by $50 million, it really doesn't matter. In most of these, being off by a million dollars does matter. All of a sudden the investable cash thing becomes important. Process is the trade. Do they enter it in Blumberg and then get it electronically? Do they have to fax you a trade ticket or do you set up a special terminal to allow them to do that? Trade clearing. That in and of itself is a specialty area. Reconciliation. Your manager's going to keep separate records, so you have duplication going on. It's very easy for things to get off because of accruals or prepayments and various things that are

going on in the portfolio. Those need to be trued up because they are making decisions on your behalf based on that information.

It's important how they report their results, what's in those results, how those get aggregated in your GAAP financial and your statutory financials. It's also important to the people who are still in your main office. Let's say you're running public high yield, and we have other high yield assets. They don't want them commingled. They want their own performance to stand on its own. Last, pricing. Everybody has a different pricing convention, and there's tremendous error in security prices today. It's a given that most of the assets that we all manage and care about are really traded over the counter. That means there's a lot of subjectivity in the pricing process. Prices, particularly in mortgage-backed securities (MBSs), can be off by 100 basis points. That's not an unusual error, but that type of error, if it's on 5% of the portfolio, can make the difference between overperforming and underperforming in any given month. You have to understand the pricing convention and how that pricing convention that's going to be employed there compares to yours. That's really important when you get into some compliance issues because securities that drop in price below a certain level automatically in most organizations today go on your compliance problem list. You have to pay close attention to that.

This is the process that we use, which is pretty straightforward. For our public high yield, since they get regular cash, it's a weekly process. For our emerging markets, both debt and equity, it's a quarterly process. And for the hedge funds it's also a quarterly process with the emphasis really on the June 30 and January 1 kickoff dates. When we give an allocation to an outside manager they get it in writing. So, this Allstate authorization is basically a written directive saying you have this amount of money to put to work under your strategy, and that is when the clock starts ticking. It's important that you be able to document that, on Monday, June 17, you gave the manager $22 million because at that point he's sitting in cash, and that's in his performance. You have to execute the investment transactions. In some cases, we like to have the manager enter the trade into Blumberg, and then we get electronic notification through the Blumberg system. However, that doesn't work too well in MBSs, asset-backed securities (ABSs), and CMBS. You can't really do that. That leaves you with the charge of making sure you get their trade ticket. Do you use their trade ticket or do you ask them to fill out your trade ticket? That seems kind of mundane, but these trade tickets come in, and in an organization our size we're processing probably a couple hundred trades a day, and if we have special responsibilities for these trades, how do we make sure that it happens each and every time it's supposed to?

Trade affirmation. In some cases we have the outside manager affirm the trades because they have a special bank account, and it's easy for them to do that. In other cases we do it, but if there's a transaction problem, we need somebody who is involved in their trade execution process to verify. Was this purchased at x price? And if the price is off by five cents, that's a matter that usually somebody has to clear because that will affect your yield. For the accounting data update, we are trying whenever possible to get everything we can electronically. We want people to be able to give us that information on a statistical basis and on a GAAP basis so we can minimize the amount of keystrokes that are required to enter that data. Some managers can do that; a lot cannot. It's a little detail but an enormous headache because your accounting records have to be in and they have to be done, and depending on what your reporting time period is, a trade that's not in at the right time disrupts your returns and your normal reporting process. I don't know about you, but I don't really want to mess around with accountants if I can.

Relevant processing. In addition to processing things, you have to process returns. You have to make sure that those returns don't get commingled with another manager's return. More importantly, I think you have to look at it and ask, "OK, from a risk management perspective where's my risk? How are we doing versus limits?" I'm going to get into some of those compliance issues in a little bit. Management reports. You do not want your managers to have their returns commingled or the assets to blur into one asset class versus another. In our case I will tell you that our portfolio managers see themselves as competing against TCW. Their mission is to beat them. The last thing they want to see is any asset that TCW did or any asset that they purchased ever crossing, and they want complete freedom from what TCW is doing. That becomes a very fun conversation when you have issues like that.

Pricing. I know I'm kind of beating on pricing, but pricing in most cases determines what you have. The volatility that comes from the pricing process is critical, particularly in the more esoteric asset classes. When you get into small asset classes, the pricing error in a public bond might be a couple basis points. You get into some of these other asset classes, and it's somebody's best guess. Yet, you are making decisions on those prices. I can't emphasize how important that is.

Evaluation. One of the things I think that T.J. talked about is philosophy. Did they do what they said they were going to do? Did they beat their benchmark? When ideas or things change how good were they at communicating that change to you? How do they integrate into your overall process? And how well do they understand your business problems? That's really an important thing because as you try to particularly in today's environment design and sell products in a low interest-rate environment, finding a manager who understands the difference an extra 10 basis

points can make is important, and if a manager's kind of looking at it and saying "I'm going into the excess return of 75–85, no need to call until I have something that's worth 25 or 35 basis points," they may have won the battle but lost the war.

Compliance is an area of growing importance at Allstate, and I'm sure it's of growing importance everywhere. One of the things—from a guideline perspective that you need to pay attention to is when you get a manager you have to really closely define security type. If you look on the first line of 144A, private and public, all those could be used to describe corporate securities, in addition to quality levels and maturity requirements, you get into the definition, for example, of a 144A. If you look at all our filings, you will find that most of you classify a lot of your traditional private placements as 144A. Want to tell your manager that? I don't think so. Instead, you get into a definition of saying minimum size has to be underwritten. There has to be a tight bid offered spread, perhaps, let's say, five basis points for our traditional private placement might be more like 25 basis points. It forces you to think about those things. It also forces you to think about wanting payment-in-kind bonds. You can buy payment-in-kind bonds and straight-up corporate bonds. Do you want your manager to have the flexibility to buy those things?

No market sits still, whether it be structured notes, convertibles, zero coupon, nondollar, and even new security types or variations of security types. New security types are a part of life. How do you want that to work with this outside manager? They're going to be coming at you again and again and again if they're paying attention with these new security types. If they're coming to you with a new security idea, you have to be responsive, and by responsive that means a response back—if they feel they need a response back in a week, you've got to be there in a week. Typically, for most insurance companies, responding to new security types is a very slow process. This is really one area where I think as an industry we tend to go in two extremes. There's half the companies that study these things to death, and then there's the other half that goes ahead and does it. In both cases, when you have an outside money manager involved neither process works too well because you need to think about the unintended consequences. That manager's going to say you gave me the ability to do that, and I took the risk, and the fact that you have an accounting problem over there is really your issue. They will tell you they feel bad about it, but that's as far as it goes.

Probably the state of the art five or six years ago was that you had an overall position limit; that you could only own so much of Ford. But, as we've evolved and others have evolved, we understand that a flow limit really goes to not only position limits but how much you can put to work in any one given year because then you're taking on a little bit more of the market risk that's in the market at that time.

That's important, and you need to think about that in terms of your outside money manager.

The next one, inside or outside other enterprise limit structures, is very tough, and I would suggest that before you even talk to an outside manager you need to think about how that would work. For example, let's take public high yield. In our case the other relevant asset class would be bank loans. Does the TCW have a separate limit structure that rolls up or do they share a limit? You don't want to leave anything on the table. How should that work? Particularly in Allstate's case, our flow and limit structures run to each legal entity. We have two, big companies who invest in taxable securities, Allstate Insurance Company and Allstate Life Insurance Company, and together at the top we have an enterprise limit. How does the outside manager fit into that structure? In our current process when we have a debate on investment grade securities I'm usually the final arbiter. Are we getting more value owning Ford in the private market or more value in the public market? If we get close to the flow limit, I get to decide. As a practical matter, nobody really wants me to decide, so they figure it out amongst themselves. But it's a little harder to come to that logical conclusion when you have an outside money manager involved. They don't know the personalities inside your organization the way that you do. They don't understand that they have to know this person, this person, and this person to resolve those issues. So, you do find yourself getting more involved in those things. In addition, most of us have foreign basket limitations. For some of us it's more onerous than others, but how do they fit into that? You also have baskets, and then, last and I think of growing importance for most portfolios, is derivative usage. You can really change the look and feel of your portfolio through derivative usage. In most cases that can be risk-reducing or risk-seeking depending on how you look at it and at what level you look at it.

I can't emphasize enough how important it is to understand the benchmarks and the trade-offs. With benchmarks, do you get what you ask for? What you will frequently find yourself doing when you've hired an outside manager is asking yourself, "I did ask for that, didn't I?" You will either say, "Wow, was I lucky" or "Man, I blew it this time." The problem with benchmarks is that there really aren't very many benchmarks out there that are applicable to the life insurance industry. What's even further aggravating is that for the asset classes that you tend to generally buy, the benchmark selection's even poorer. You have no benchmarks in Collateralized Mortgage Obligations or floaters for that matter if you buy a lot of them, which we do. You just take a shot and select London Interbank Offered Rate plus and go from there. You have limited benchmark capability in MBSs, ABSs, bank loans, private placements, and commercial mortgages, which are the newest entrants. Even there they operate on a quarterly delay. The private placement benchmark, which was set up by the ACLI, has actually become a pretty good

benchmark. However, it is still more volatile than the corporate benchmark. In any given month returns should generally move in the same direction. Occasionally, due to pricing error they'll be 50–60 basis points in the opposite direction for no apparent reason.

Bank loans. Banks loans are set off the A tranche of a bank loan where typically as institutions we're buying the B, C, and D, so you have an inherent mismatch in the whole process. This is a problem because when you go to do attribution or any other type of work, to get at attribution you're better off having a benchmark that allows you to do that. A published benchmark will allow you to do attribution. A customized benchmark will require that you create the attribution model in your own shop. You can ask your manager to do that. I think many of them would be happy to do it, but that's very expensive, and it's also one of those things where you'd want to prove it out. Most of you I think in reality will probably also want a duration adjustment.

Last, the measurement period in and of itself. You will find that returns are pretty volatile from month to month. When you look at total returns, the longer the measurement period, the better. I think Betsy referred to the fact that we don't have anybody on 11-year benchmarks rolling measurement periods. I think it would be very difficult to keep people under those benchmark conditions, but we do have a number of people who do have rolling five-year benchmarks because at that point realized return and expected return from total return start to actually merge, so you can actually get some positive benefit from that.

Benchmark limitations. I mentioned earlier that we really don't want any more capital gains. That means that when you look at a benchmark you naturally want to constrain people on the amount of capital gains. You'd want it to show up particularly in the life insurance industry as income. Income, income, income. That's pretty easy to do in public high yield. It's more difficult to do in some of the more traditional asset classes, where price return plays a much more significant role in return.

Value at risk (VAR) tracking error. We use VAR tracking error concepts almost exclusively in Allstate Insurance Company. We use them less so in the life company. But these are, I think, wonderful tools to help you to understand the amount of risk that you're taking versus the marketplace. From our perspective, when we evaluate a manager and we look at a manager using these tools what we're looking for is how they optimized? We like to look at these types of statistics because they give us a lot of information. We find them a lot more valuable than how well the asset fits from an ALM perspective because we want to understand absolute risk, and that doesn't necessarily give us that dimension. It's also

important to understand that VAR, while it tells you about market volatility, is not really a complete measure when it comes to credit risk. It does capture some of it, but it can't really capture all of it, and you need to take that into account.

Whatever benchmark you select there's a good, if not excellent, probability that it won't be necessarily a great ALM fit, and that will force you on an enterprise basis to look at what your derivative strategies are. The reason for that is that you must have to have something that's out there on a constant basis for that manager to target. If you start changing it from week to week and month to month, you set the manager up for failure. You need to have it as constant and as streamlined and as straightforward as possible. That way you're giving them a chance to succeed. You also are setting yourself up for when they say they couldn't outperform because of X, Y, and Z. You have it covered. You really want to focus on their real performance.

You do get what you ask for, and it will show up in the performance. I emphasize again this business of measurement period because, quite frankly, most managers are hired with 30-day notice. If I don't like you, I can send you a letter and say you're out. However, the reality is if you believe that this manager has a good, repeatable process, you really want him or her to hang around for a lot longer than 30 days or even a year. You want them to be in that three-plus-year range, realistically. That's when you'll start to really reap the benefits from having an outside manager. It takes at least three years before you start to see some true payoffs from that.

I think you also need to think about, as you look at this, the range of performance versus top quartile managers. Back when we started in 1994 the range of performance between a top quartile manager and a bottom one could be measured in 75–80 basis points, at least. Today, the difference between a top quartile and a bottom quartile can be measured in basis points, which means that had you looked at statistics from Frank Russell, Piper, and others, when you look at those statistics and you see how tightly they are bounded and come, as we have, to the conclusion that, in a low interest-rate environment, getting top quartile performance may not be achievable you are actually forced to pay as if you got it which is kind of strange, but I think the reality is that getting somebody to come in and not having disruption in that business is better for your shareholders.

The other thing to understand is when you go through this process of mapping what you expect their returns to be and what you're going to pay for, as we've talked about some of these adjustments, every time you make an adjustment you can just adjust down the excess performance. There is no such thing as getting excess

performance based on one of the constraints that you might put in front of a manager. You are taking away their flexibility every time you put in a constraint.

For transparency of returns, it's really important to understand where the returns came from. As we said earlier, we like to believe that we've invested in somebody who has a repeatable process, but we want to be able to see that through tracking error, the information ratio, in particular, that we're starting to get what we thought we were going to get. We like to also pay attention to turnover because of the cap. The more turnover you have, the more capital gains you're going to have. We want people to be as efficient as possible in generating those excess returns. If it's a credit market, we really want to understand the sector bets they were making. Were they overweighted in cable? Underweighted in health care? We really want to understand that. We also want to see over time how they shifted that into some of these other sectors. Did they do a good job or a bad job?

I don't want to pay any public high yield manager to take duration bets. I'm paying these guys to take credit bets. I don't want any duration bets in any high yield portfolio for that matter. I want to be sure that they are mapping that as carefully as possible. One area that I think has dogged us is that everybody who is interested in the investment returns is really very interested in the spreads, and I think one of the things we've kind of learned the hard way is that it is a hopeless cause to ask outside managers to give us what they think the spread on is. First of all, most systems in most companies don't really track spread. First of all, I don't think any of their inside managers probably believe the numbers that are on the trade ticket anyway because there's too much noise in the system to begin with. You really need to hone down that process quite a bit. Do you want spreads at the end of the day based on the price? Do you want spreads at the time of trade execution? Do you want them independently verified, in other words, that whoever's executing the trade has to preclear it through somebody else with a screen and you get a double initial? Having bought and sold bonds myself, I can tell you I can make up five to ten basis points of spread just like that. All I have to do is tell you I priced it at 210 versus 205, and that works for me. You don't want to put yourself into that particular spot.

I think there are two myths out there about outside managers. One is that they're very expensive, and the other is that they're very cheap. If you listen to your investment people, they will tell you they're very expensive, and if you listen to people coming in to sell you on the concept, they will tell you it's very cheap. The reality is that it's really somewhere in the middle. You have to pay an investment management fee, and for the most part investment management fees can vary quite a bit. You also have your administrative fee. What's it costing you to process that

business? Because even if you have electronic fees, somebody has to be watching that stuff and making sure that the compliance process is really working.

The third one, I think, is having an investment professional oversee the relationship. For smaller firms the recommended choice there would probably be to hire a consulting firm, but if you are a firm our size, you put an investment professional in charge of that, which can get kind of sticky. Do you pay these people an investment bonus? When we made the decision that we were going to do that because they were in a position to influence the portfolio manager, we didn't really want an administrative person. We wanted somebody who could really get in there and be ahead of the curve. Our investment professionals inside Allstate asked the question, How is this person at risk? What decisions are they making that put them ever at risk? It's a good question. At the time I thought it was kind of lame, but it has grown on me that over time they can greatly influence what the manager's doing, and if they can't, then they really aren't suitable to that role.

In addition, how does this foster a professional career for the individual you asked to do this for? Is this good resume material, in other words? I don't think it really is at this point. You have to have a seasoned, dedicated person do this. Over time that will change, but today, if you ask somebody to do this, you don't ask somebody who's been there five years and is a hot commodity. You ask somebody who's been there 15–20 years who has a vested interest in the community and is rotating through the management ranks. A young person with a limited amount of experience wants to live in a world where he or she is doing, not overseeing. Their view of the corporate good is lost. They're saying what's in it for me? and I don't see much.

Soft dollar cost. From time to time we rely on a lot of the people we do business with, whether that's with Merrill Lynch, Lehman Brothers, or Morgan Stanley, to provide us with new ideas. Yet one of the things that happens when you transfer the business out is that you can lose control over soft dollar relationships, so, as a result, your ability to tell somebody to direct trades to a certain firm to get certain types of information is diminished, and you can see why, as in our case, this is an important issue because the high commission assets, whether they're hedge funds, public high yield, or emerging markets, are outside. Those are the high commission businesses for Merrill and Morgan Stanley, and we've got to have a say in who the outside manager does business with to support the overall corporate good. That's one that, to be real honest, we kind of overlooked. We didn't understand the significance of that going in, and we're only now beginning to understand its significance and its impact on our overall investment results.

In conclusion, we think that having outside managers give you a lot of flexibility. They force an investor to understand what they really want. This has helped our inside people as well because when they see what an outside manager gets they want it too, and it gives them a greater chance to succeed. Quite frankly, most people, whether they're inside or outside your firm, just want the opportunity to outperform. That's really what they want. All of the other stuff is kind of nice, but that's what they really want. So, as you go through this process of figuring out what you really want, it forces you to be sharper on the other aspects of your business, and that's a good thing.

Last, the costs, depending on how you manage those costs, can in your own personal circumstances, be either high or low, but I think it's important to understand that as you evaluate your costs you have to look at it in the context of what you got for them, and that means, in addition to excess returns, assigning value to things such as insurance knowledge, flexibility, and a willingness to come up with innovative, new ideas that help support your business. All of those things need to be factored into that equation. This is an ongoing process for us and for those of you who have the joy of working with outside managers, this is really where the relationships can become very, very exciting and very, very rewarding for your firms.

From the Floor: I appreciate some of your insights on impact operations because I've always thought in this investment area the investment manager doesn't care about the backroom at all. That's the impression I've gotten when I've had to work with them. It seems to me that the more you go outside, the less there is managed. What's your thoughts on that, Pat?

Ms. Wilson: The more that goes outside, the more important what's left inside becomes.

From the Floor: But also from a pricing standpoint you now have given away most of what you're allowed to price on your products.

Ms. Wilson: Absolutely.

From the Floor: And you have so little left for the inside operation.

Ms. Wilson: Yes. I think what you're getting at here is when you give away that flexibility for excess returns, if you get those returns, can you really factor them into the pricing of your product? I think that gets into the character of the returns that you have asked the manager to give you. If you've asked the manager to give you a total return with an operating income focus and you somehow constrained it to do

that, in a realistic way, you probably shouldn't be any worse off. In fact you might be better off because if the manager brings new expertise, you may find that instead of getting excess returns from your inside management of, let's say, 15–20 basis points, you may find yourself in the category of getting 30–35 basis points. However, you're not going to get to use those in front of pricing. You're going to have to use them behind pricing. By that I mean that you may have to either price your products in anticipation of those excess returns or you may have to wait and see how those realized returns come in and then factor them into future pricing.

From the Floor: How about the variable product of today?

Ms. Wilson: What you're asking, is how does the cost aspect impact your VAs, particularly for business if that has already been sold? Well, one of the things I would just suggest to you is that these relationships will put a lot of pressure on costs initially, and that's because you're asking people to do new things. There's a certain amount of duplication in what you're doing. Initially, it will put some pressure on the cost structure. You really have to look at your pricing issue and ask yourself, can I really price my product without taking into account the expense and the excess returns of generating that? Look at that as a dynamic tension. That's not something I think most of us are particularly good at, but I think as these relationships point out that's probably where the opportunity really arises—understanding that dynamic tension between what you paid for versus what you got—because it will put pressure on those points.

Mr. Robert E. Rachlow: What are your thoughts on how you measure the performance of derivatives and your derivatives asset manager?

Ms. Wilson: We use derivatives at the enterprise level— at the Allstate Life level and the Allstate Insurance Company level-and we evaluate their effectiveness at that level. We are looking into whether it makes sense for certain types of derivatives to allow our asset managers to use them, and the reason we're looking into that is we think that there may be an opportunity to get sharper execution on things we want. I'm specifically thinking of swaps to get to duration. I think the better execution is more likely to be made on the asset side of the equation rather than waiting for it to build up on the liability side and then execute, but that would be a rather significant departure, so that's under evaluation, and, like every derivative's initiatives, it'll take six months or more to figure out whether we want to do that or not.

Mr. Hughes: From the point of view of an investment management firm I wouldn't consider derivatives something that you have to measure the performance of in a discrete sense, and I think it's part of the overall measurement of duration risk that you take or in the sense if you're using mortgages or MBSs and so forth. You want

to adjust to the optionality or the convexity risk of certain instruments. I don't think that you can say that we have outperformance of 16 basis points because of our derivatives' positions. I think it's more appropriate to say that derivatives as part of the overall duration measurement are part and parcel of the duration aspect of performance attribution, or, if you're very active in mortgages, derivatives enabled us through execution and efficiency of market practices to achieve our ability to generate 20 basis points of excess returns due to 35% weighting and mortgage-backed risks. Thirty-five percent maybe is an arbitrary number, but the Lehman aggregate has somewhere usually between 29% and 34% mortgage exposure. In order for you to be able to maintain that same sector allocation you should factor in the ability to use derivatives actively and successfully. But to ask how do you measure performance of derivatives, I don't think that in and of itself is an asset class, per se. The only exception to that perhaps may be in hedge funds, where derivatives are in and of themselves perhaps an asset class in a hedge fund.

From the Floor: One follow-up on that. I have a portfolio manager who has some caps and floors in his portfolio, and you have so much cash, but then this cap or this floor drags on his performance because some of the cash went there. So, I'm curious how to explain to my portfolio manager how that cap or floor was good for him.

Ms. Wilson: You want to explain to your asset manager why something that he can't manage is good for him?

From the Floor: The portfolio manager, right.

Ms. Wilson: Yes. You'll never be able to do that. It goes back to your benchmark. Your caps and floors need to be in your benchmark. Then your asset manager's indifferent to them. If you've made them into an active bet, then you're forcing him to be accountable for them, but then you're telling him he can't manage them. So, put them in your benchmark, and he won't care.

Mr. Thomas Neal Taylor: In line with that derivative, one of the concerns I see is that the industry is thinking of it as an asset group instead of insurance. About two years ago I remember companies were announcing their losses, and they were treating derivative losses as if they had made major mistakes. It would be as if saying your fire insurance on your building lost you money because your building didn't burn down, but major companies were quoting it that way. Have you seen the change in the last two years in treating derivatives more like insurance rather than its own profit source?

Ms. Ward: It's very much a function of how the derivatives were put on to begin with because I've run across managers who have stellar performance and are in the top tier, but if you really look underneath, you can see that there they're taking mortgage leverage bet, absolute bet. I heard a couple years ago that they actually had been taking bets in some situations. There are others where absolutely it was a hedge, perfect or imperfect, usually imperfect, and that's what helped cause the losses. In the case of a true hedge where you're looking at an actual currency hedge, those have worked rather well, and, in fact, when I'm talking to companies in Chile or wherever I'm concerned if they don't have some of their currency risks hedged.

From the Floor: I'm not familiar with the term information ratio. Could you give a brief description of what that means?

Mr. Hughes: The information ratio, suffice it to say, is in essence a ratio literally of excess returns over standard deviation of those returns, and it's intended to be basically a risk return measurement similar to a Sharp ratio. Some people in fact refer to the information as a modified Sharp ratio. It tends to be, I think, a somewhat better measure of volatility of performance but factoring in returns as well. So, it enables you to capture not only excess returns but what the volatility of those have been over time. You want to see a decline or a trend toward a decline in volatility. The flip side of that is you want to see a continuously improving information ratio. It depends on if you're looking at volatility absolutely. You want that to be low. You want the information ratio, because of the ratio perception itself, to be continuously rising. I'm not suggesting by any means that it's going to rise over time every time, but there are ways to smooth it out and take annualized measures of monthly excess returns divided by annualized measures of monthly volatility and smooth it out, but typically what you'd want to see is a trend line improving information ratios. I might add also that from time to time we'll find clients who will screen managers not on the basis of performance but on the basis of information ratios and say that we won't even look at a manager, regardless of performance, who has an information ratio below 1 or 1.1 or something like that. I'm finding that in some screening processes when people are actually going out and trying to decide what managers they even want to interview, they're using information ratio measures as an absolute screening technique, and it's something that I think managers are having to focus on a lot more.

From the Floor: I was wondering what kind of advice you could give on operating performance?

Ms. Ward: The question, if I got it right, is how might you adjust benchmarks for operating performance? How to constrain the capital and get operating income?.

Ms. Wilson: I'm not going to give you an answer that's going to be very satisfying. First of all, I think you need to look at the asset class that you're hoping to do this with, and public high yield, for example, is a good asset class because over a 20-year period, about 85% of your returns come from the coupon and 15% come from your principal return. When you get into investment-grade corporate bonds that declines to about 55% coupon versus price return, depending on the market period that you use, it can actually flip-flop, where price return is more important than coupon return. One thing you can do is take the duration decision, for example, away from your portfolio manager. We do this in Allstate Insurance Company, our property and casualty company. We really want our credit people playing just sector bets, and it's kind of interesting. Once you take that duration bet away from people, they can focus on credit and sector plays instead. Once they are focused on that, letting those bets run is kind of critical. That helps to take that one element away.

I think the other thing you can do is look at your mix of business and say, if the Lehman index is 30%, take out the securities that you wouldn't otherwise buy. You can do that particularly if you have a tool like PC product or another product that will allow you to slice those bonds out of the index. You can, if you want, replace them with other bonds. What you give up, though, is the ability to take that tool, or any other kind of tool, and do attribution. As soon as you start to move in that direction, you have to take the attribution and move it away. I think one of the things that will surprise you as you start to use those tools is you will discover that the riskiness of particularly your investment grade portfolios is much less than you thought. That's one of the things that happens when you start to focus on returns versus spreads and operating income. You will realize that the amount of risk that you have or thought you had was probably somewhat understated, particularly in investment grade securities.

CHART 1
BALANCE SHEET LEVERAGE
MAGNIFIES INCREMENTAL RETURNS