It is commonplace for defined benefit pension plans to be required by law to have an actuary determine plan financial condition and the contribution rate. It is also common for the law to require such plans to be represented by legal counsel and to have an independent audit. However, rarely is there a legal requirement for the use of an investment consultant (or professional money managers or a custodian for that matter). Yet the majority of defined benefit pension plans in general and the vast majority of public pension plans (85%+) use investment consultants. Who are these people, why are they hired, and what do they do for MOSERS?

A Brief History

A Post-World War II phenomenon that had its roots in the Great Depression, the defined benefit pension plan quickly became part of the compensation structure of the American worker in the 1950s and 1960s. In exchange for one's efforts, an employer compensates a worker in two ways. The first is a periodic paycheck. But events like the Great Depression, in which many people's life savings were wiped out overnight, highlighted the need to worry about the future as well as the present. Consequently, the federal government allowed employers to set up tax-sheltered pension plans for employees, so that a stable retirement income could be assured. Under this type of arrangement each employee receives, in addition to their take home pay, a contribution into a trust to be held until paid out during retirement. This accumulation of each employee's deferred compensation quickly grew into a very large industry and billions of dollars held in trust.

The Employees Retirement Income Security Act (ERISA) became law in 1974 – the congressional objective was to codify a level of professionalism, objectivity and legality to the quickly growing pools of assets being accumulated by these defined benefit pension plans. ERISA attempted to do this by requiring those who had oversight responsibility, the Trustees, to act and behave in very specific ways. For instance, regardless of the day job held by each trustee, when wearing the trustee hat they must look beyond their personal interests and make decisions based on the sole best interests of the plan and its participants. Trustees must use skill and prudence in arriving at decisions about how, where and with whom the assets are invested. The standard by which a trustee is judged in the decision making process is known as the “prudent expert” rule, which requires trustees to be knowledgeable regarding all of the relevant issues associated with the decisions to be made. While public pension plans are exempt from this portion of ERISA, it is clearly recognized as the standard by which all pension fund trustee behavior is judged.

The Investment Industry Begins to Take Shape

In 1974, the investment community was in its infancy. Large bank trust companies ruled the landscape. Until 1974, and for some time after that, the typical pension plan was invested in a balanced fund at the local bank or a large New York-based trust department. The review process was typically an Ivy League-
educated trust officer inviting the trustees to the bank's oak-paneled conference room for a catered lunch during which he assured them that everything was fine and the investments were doing "smashing"! But with the passage of ERISA, trustees were obligated to do more. For example, they had to develop policies on allowable investments, performance goals and expectations and a requirement to assure themselves that what the bank considered "smashing" on its self-graded report card was in fact competitive. In other words, an obligation materialized that required trustees to assure themselves and others that the investments were prudent, thoughtful and competitive. From this "new paradigm" of trustee obligation, the investment world that you see today began to take shape.

It turns out that with closer scrutiny the large banks that dominated the pre-ERISA investment era many times fell short of the new standards that were now being imposed on them. As trustees began to consider alternatives to this structure in pursuit of better results, individuals from these large banks saw the opportunity to establish specialized firms. The message of the day became "no one is good at everything" (attacking the banks' "one-stop" shopping approach) and the solution became "hire specialists who concentrate on doing one thing very well" (the new investment boutique's sales pitch). And so as pension fund trustees began pursuing more relationships with more investment firms segregated by asset class, style, capitalization emphasis and other metrics, a very simple investment world started getting very complicated very quickly.

In the middle of this whirlwind sat a group of trustees, in most cases made up of individuals who offered their services on a volunteer basis and who were by in large not investment experts. As the investment world became increasingly more complicated at the same time that the fiduciary requirements placed on trustees became stricter, many trustees saw the need to seek outside expertise to help them navigate the challenging scene being created in front of them. Thus the investment consulting industry was born.

**The Evolution of Investment Consulting**

Like every other aspect of the industry, the consultant's role started off pretty simple and has become more complex as the industry has done the same. Originally, the Board hired an investment consultant to help them determine what the asset mix (percentage in stocks versus bonds) should be, what asset classes within stocks and bonds to invest in or avoid (international stocks, for example), which firm from a growing list of investment managers should be hired for each mandate and what yardstick(s) should be used to measure whether each of the selected firms performed as expected.

Typically, asset allocations were set at or around 60% stocks and 40% bonds, the consultant combed through manager-submitted proposals, summarized these findings in a search book, invited 3 “finalists” to make 30 minute presentations and the Trustees would select the victor. This was done for every asset class, but since the world was a stock and bond world, the number of managers was typically 10 or less. In this environment, especially on the public fund side, there was rarely if ever an internal investment staff and so the consultant was the investment expert, the provider of all investment-related information and the person who essentially ran the investment segment at board meetings.

![The MOSERS Evolution](image-url)

The evolution of the Missouri State Employees Retirement System's investment program very much followed the practices just described. In 1990 when our current investment consultant was hired, MOSERS had just hired its first investment staff member, the first such hiring in Jefferson City. The investment portfolio was 50% in stocks, all domestic, all large cap, all actively managed and 50% in bonds, all with Missouri banks. This was considered advanced versus two other state-wide public funds, where the portfolio were dominated by fixed income run entirely by a single bank provider. LAGERS, at that time, was the most advanced in asset allocation, diversification and the use of manager specialists.

Monthly Board meeting consisted of a brief report by the consultant followed by 20-minute presentations from half of the managers. The next quarter, the other half of the managers made presentations. All manager hiring, either into a new asset class such as international stocks or a manager replacement, began with RFP's sent to 50 to 150 firms and culminated with 3, 30-minute presentations followed by a trustee motion to hire one of the firms. Results were consistently 1.0% to 2.0% below the total fund policy benchmark.
But the good news was that all pensions plans - the good, the bad, and those in-between - were being carried along by the greatest Bull Market in history. Stocks were delivering annual returns in the high teens and low twenties. Bonds generated double-digit returns for an entire decade. Even cash generated a return thru the 1980’s that exceeded the system’s actuarially assumed rate. In other words, no matter how effective the governance model was or was not, how effective the manager hiring and firing process was or was not, no matter how creative or innovative the investment consultant was or was not, the Bull Market carried us all along on its coattails for almost two decades of fabulous actual returns, actuarial success, and benefit increases.

2000 and Beyond

It is universally accepted in the financial industry that the fabulous Bull Market in both stocks and bonds that ran from 1982 until March 2000 cannot repeat itself in the next 10 years. Broad stock market advances alone will not be sufficient to achieve the returns needed to meet plan funding requirements. Therefore, greater importance must be given by all investors to alternative asset classes and strategies, achieving greater and more consistent implementation success, and being nimble in a more rapidly changing investment world.

In this environment MOSERS has established itself, not just in Jefferson City, but around the country as a leader in innovative implementation of public fund asset investing. The number of investment-focused staff has grown along with the number of specialist managers employed, the asset classes to which the fund has exposure, and the methods and metrics used to monitor and evaluate the risks and rewards of the program.

The MOSERS Board recognized the need for investment innovation in the low absolute-return environment described above. They also recognized that many of the practices of the past were not possible in the “new world” of investing. The sheer number of evolving investment categories, like hedge funds, distressed debt, inflation-protected bonds, timber, oil and gas, to name a few, made it impossible for a Trustee meeting quarterly, or weekly for that matter, to maintain the knowledge base necessary to be a “prudent expert” in each and every one of these categories. Manager selection and on-going due diligence effort become a logistical challenge if nothing else. To adjust to this new environment, MOSERS Governance Policies were put in place, delegating many of these decisions to the Chief Investment Officer. However, with delegation comes the responsibility to assure that a strong system of checks and balances is in place to monitor the implementation decisions. This role is fulfilled for the Board by the investment consultant.

Summit’s role at MOSERS

Early in this document we discussed the historic role of consultants. In that role the consultant’s main contribution was to serve as data gatherer and reporter on fund results. As MOSERS evolved, it was extremely important that Summit’s role evolved as well. The Board addressed this need by making the following points clear in the governance policy:

- Summit Strategies is hired by the Board. The Board views Summit’s primary role as being the external investment expert hired to evaluate the investment program and the various decisions made within the policy the Board has established. Summit is an acknowledged fiduciary charged with using its investment expertise to assure the Board that the decisions are prudent, consistent with sound investment fundamentals and that staff is operating at all times within the boundaries the Board’s Investment Policy.

- Summit Strategies, and specifically its president, Steve Holmes, is required to review and approve of every hiring and firing decision brought forth by MOSERS CIO, Rick Dahl. This requires Summit to be closely involved with staff in the selection and on-going due diligence effort of every investment management, custodian, and securities lending firm with which MOSERS contracts. If a decision does not receive Summit’s approval, the Board governance policy states that the hiring/firing cannot occur. In addition, the Executive Director must also certify that investment implementation decision of the CIO and the consultant conform with the Board’s Governance Policy.

- Summit Strategies is charged by the Board through its Governance Policy to serve as its agent in assuring that internally managed portfolios are managed prudently, efficiently and in accordance with each portfolio’s implementation manual. Summit must affix its signature to all internally managed portfolios’ implementation manuals and must present semi-annual findings of its review of the internal asset management program.
At any time that Summit uncovers an issue that is not resolved with staff in a timely manner, Summit is required to notify the Board Chair of the issue, of Summit’s concern regarding the issue, and a recommended resolution to the issue. While Summit must work very closely with staff to have a detailed understanding of all investment issues regarding the portfolio, this provision specifically acknowledges Summit’s role as the fiduciary agent of the Board.

As with the evolution of the investment industry in general and the MOSERS investment program in particular, so too has the role of the investment consultant undergone significant changes and evolutions in the past several years.