Pension Consulting
The Early Years

By Michael J. Clowes

The investment management consulting profession is less than 50 years old and yet it has had an enormous impact on the investment practices of pension, endowment, and foundation asset pools large and small. Pension consultants have been missionaries spreading the gospel of better ways to invest those asset pools for the benefit of beneficiaries.

Pension Manager Performance
The seeds of the investment management consulting profession were sown in 1965 when the Whirlpool Corporation treasurer showed the reports of his pension fund’s managers—all of them banks—to John Mabie, vice president of sales at A. G. Becker & Co., a Chicago-based investment banking firm, and said: “Look at these results. I think they are doing a lousy job. What do you think?” At the time most corporate pension funds used trust departments at banks to manage pension assets—and usually the trust departments of the banks that provided financing to the company. Many used only one trust department.

Mabie was unwilling to venture an opinion on the basis of a cursory glance at the figures, but he agreed to look more closely at the results. Over the following week, the more he thought about the Whirlpool treasurer’s question, the more he thought it suggested a business opportunity for Becker because he realized many more treasurers were in the same position. A. G. Becker could offer a service evaluating how each company’s pension fund managers were doing. He was able to convince other executives at Becker of the value of the idea, in part because they realized they could allow companies to pay for the service by directing trades to Becker’s brokerage arm, and in part because the relationship might lead to more investment banking business. The company set up its Funds Evaluation Service and set about gathering five years of data from the major banks that were managing the bulk of pension assets. Despite initial resistance from Morgan Guaranty and a few others, with pressure from other treasurers who wanted the information Becker soon had the data it needed. Initially the performance numbers gathered and reported by A. G. Becker Funds Evaluation Service were dollar-weighted, which was sufficient when most funds used only a few managers. (The actuarial consulting firm Martin E. Segal Co., which was consulting to the Air Line Pilots Association about performance of its defined contribution plan, had settled on dollar-weighted performance as the appropriate measure, as had the National Endowment of Health, Welfare and Pension Plans [later the International Foundation of Employee Benefit Plans]).

Pension Management Business
Neither A. G. Becker nor Martin E. Segal Co. realized the pension management world was about to become more complicated. Just three years after A. G. Becker Funds Evaluation Service was started, investment counseling firms noted the rapid growth of pension assets, particularly corporate pension assets, and began to pursue the business. Some of these firms were arms of old-line mutual fund management companies such as Scudder, Stevens & Clark, Putnam Management Co., and Capital Management & Research (which established Capital Management Trust).

Others were new firms such as Battery-march Financial Management in Boston, Jennison Associates in New York, and Rosenberg Capital Management in San Francisco, which were established by experienced investors who left mutual fund companies, bank trust departments, or Wall Street research boutiques. Soon the trickle of new investment counseling firms became a flood, partly as a result of Becker’s performance reports showing that bank trust departments were, on average, doing a poor job of generating results. Allied Chemical Corporation, for example, hired Becker to examine the performance of its five bank managers from 1964 to 1970. It found the compound annual return for the period was less than 2 percent. In 1972 it hired two of the new investment counseling firms and fired one of the banks.

Investment Management Consulting Pioneers
A. G. Becker, however, did not assist Allied Chemical in the selection of its two new investment managers because it had decided early on not to offer such advice when delivering its performance reports. This left the field open for the creation of the investment management consulting profession when the need arrived, and it arrived when the banks began to lose their grip on and understanding of the investment markets. The transition away from banks was gradual. The 1971 Money Market Directory identified only 10 pension funds that used two or more investment counseling firms, but many more had hired one independent firm and had taken some money away from trust banks. Each of those earlyhirings provided an opportunity for the nascent investment management consulting industry.
George Russell

One of the first to move into the space left vacant by A. G. Becker was George Russell. In 1969 Russell learned from a Ling-Temco-Vought Corporation (later LTV Corporation) executive that the company was looking to replace the executive who internally managed the company’s pension fund. At the time Russell was managing the mutual fund company started by his grandfather, Frank Russell, and he suggested that Ling-Temco-Vought use mutual funds rather than internal management. He sold the idea to James Ling, Ling-Temco-Vought’s co-founder, and then helped the company choose mutual funds. But in trying to sell this idea to other pension funds, Russell learned that companies did not want to delegate the management to mutual funds, they wanted more involvement and control. A cold call on Paul Kaltinick, treasurer of J. C. Penney Co. Inc., led Russell to his first manager research. Kaltinick handed Russell a list of 19 money management firms he was interested in as possible hires for the Penney pension fund. Russell took the list and over the next three weeks visited all 19 managers. He reported to Kaltinick that only three of the firms were worth keeping, and named some firms not on the list that should be considered as well. Kaltinick soon hired Frank Russell Co. as investment management consultant to the J. C. Penney pension fund. He also recommended to Park Davidson at Burlington Industries that he hire Frank Russell Co. as investment management consultant to Burlington’s fund. Between 1969 and 1974 George Russell signed 38 more clients for his pension consulting service.

Edwin Callan

Edwin Callan was another pioneer in pension consulting. Like Becker’s John Mabie, Callan was selling the wares of a brokerage firm, San Francisco-based Mitchum, Jones and Templeton, in 1968 when a National Steel Corp. executive told him that the company’s pension fund was managed by trust banks and corporate management had no idea how the fund was doing. Callan knew about the work Segal had done for the Air Line Pilots Association and set up a performance evaluation unit at Mitchum to gather data and calculate returns. In 1969 Pacific Lighting Co. hired Callan to evaluate Bankers Trust Co’s performance for the company’s pension fund. Performance was poor and Pacific Lighting fired Bankers Trust. Unfortunately for Callan, Pacific Lighting generated only $15,000 in fees for Mitchum, while Bankers Trust had been doing $1 million of business a year with the company. As a result, Callan’s operation was unpopular at Mitchum and in 1973 he broke away and founded Callan Associates as an investment management consulting firm.

Bill Crerend and John Casey

Close behind Russell and Callan, Bill Crerend and John Casey (later of Rogers, Casey and Associates) built a performance measurement and consulting unit for Paine Webber & Co. Casey, then a young broker in Paine Webber’s Chicago office, had helped Consumers Power in Illinois select a money manager for its pension fund. Casey suggested to his superiors in New York that there might be a business opportunity in such a service, and management asked Crerend to look into it. Crerend soon got the go-ahead to build an operation to offer pension consulting, and by 1976 the department was causing problems for its parent: The consultants were telling pension funds to fire trust banks while other Paine Webber employees were trying to persuade the banks to buy private placements or other securities. Thus Crerend’s small group was costing Paine Webber bigger business. Paine Webber persuaded Crerend to buy the unit from them, which he and three other employees did in 1976, renaming it Evaluation Associates.

Peter Deitz, Jack Treynor, Bill Sharpe

Early consulting firms had to invent the evaluation techniques taken for granted today. Dollar-average performance was acceptable when funds used one or two banks as managers and funded them equally and steadily; but it wasn’t acceptable when funds used multiple managers hired at different times and funded them at different times of the year. The timing of cash flows had an impact on apparent performance. In 1966 Peter Dietz, a PhD student at Northwestern University, noticed that most pension funds were measuring performance based on original cost and ignoring unrealized gains or losses, and recognizing only realized gains or losses over long periods of time. For his dissertation, Deitz developed a formula for calculating time-weighted rates of return that eliminated the effects of cash flows. Two years later the Bank Administration Institute (BAI) blessed the time-weighted rate of return as the correct methodology for measuring investment performance. When George Russell realized he needed a better understanding of performance measurement for his fledgling consulting firm, he hired Deitz. Soon after BAI released its report supporting time weighting, Merrill Lynch Pierce Fenner and Smith established a performance measurement group headed by Jack Treynor offering time-weighted rates of return. Treynor, for many years the editor of Financial Analysts Journal, hired Bill Sharpe, developer of the concept of beta and later a Nobel laureate, as a consultant and offered risk-adjusted rates of return as part of the service.

Manager Selection

In 1970, as the pension consulting revolution was just beginning, manager selection was based almost solely on past performance. However, it soon became apparent that past performance was not enough. George Russell hired a staff to build a database of investment management firms and researched them as if they were common stocks. The key questions Russell initially told his researchers to answer were the following:
• Who were the owners and the other members of the staff and what were their backgrounds?
• What was their investment philosophy?
• How did they define investment value?
• What is the investment process?
• How did they construct portfolios, including how much diversification did they seek?
• What was the past investment performance?

Other early firms soon developed their own research questionnaires, often many pages long. Soon equity managers had been classified into growth or value managers, then into large-, medium-, or small-cap growth or value.

Early consulting firms often had true quants and real rocket scientists on staff. What later became Wilshire Associates began as the performance measurement division of Planning Research Corp. John O’Brien, a young MIT and UCLA graduate, was assigned to determine how the company’s profit-sharing fund was performing and, after studying the sparse literature, hired Bill Sharpe as a consultant. With Sharpe’s help he developed a risk measurement model based on capital asset pricing. When Planning Research’s efforts to market the product for cash failed, O’Brien joined Oliphant & Co., a San Francisco-based brokerage, looking for products to sell for commissions and soon was selling books of betas for all listed stocks as well as risk-adjusted performance reports. On the Oliphant staff were Dennis Tito, who had worked on the U.S. space program; Gifford Fong, who later started his own fixed-income consulting firm; and Gil Beebower, who later joined A. G. Becker and wrote a number of ground-breaking research papers on investment returns and diversification. In 1972 O’Brien and his colleagues had a falling out with Oliphant and Co. and set up their own firm, O’Brien Associates, which in 1975 became Wilshire Associates. About the same time, actuarial and benefit consulting firms such as Hewitt Associates, Kwasha Lipton, and George B. Buck added manager search and selection to their services. Barr Rosenberg, a professor of finance at the University of California, Berkeley, established Barr Rosenberg and Associates (later BARRA) to help pension executives build efficient portfolios using tools developed from modern portfolio theory.

Diversification

By mid-1974 more than a half-dozen investment management consulting firms were helping pension funds measure fund managers’ performances and select new managers to replace those lagging. Most assignments still involved selection of stock or bond managers. But the consultant’s job soon became more complicated and demanded broader knowledge than just stocks and bonds. By 1974 a number of funds had become interested in investing in real estate for diversification, and real estate separate accounts had been established at insurance companies such as Prudential Insurance, Equitable Life Assurance Society, Metropolitan Life Insurance, and New England Mutual Life Insurance, as well as at a few banks. Pension funds asked if these were acceptable vehicles for pension funds. Some public employee pension funds were selling call options to enhance income in the bear market, and others wanted to know more. Consultants quickly had to come up to speed on these topics.

In 1974, Bruno Solnik, an assistant professor at Stanford University, determined that foreign stocks could diversify U.S. stock portfolios, reducing risk and/or enhancing return. A few U.S. pension funds such as those of U.S. Steel and General Electric already invested in foreign stocks, but they were pioneers. In 1974 J. P. Morgan told pension clients that it would begin investing some assets in international stocks unless they objected in writing. Soon other managers followed, and consultants had another field in which to build expertise to meet client needs.

Conclusion

By the end of the 1970s, consulting firms were providing expertise on equity and fixed-income manager selection, indexing, diversification, options, real estate investing, international investing, guaranteed investment contracts, and risk-adjusted performance measurement. By the mid-1980s the book of required expertise had expanded to include fixed-income and stock index futures, venture capital and leveraged buyouts, and defined contribution issues (as corporations froze or terminated defined benefit plans and replaced them with 401(k) plans). By the end of the 1990s, clients looked to consultants for guidance on the selection of hedge fund managers and were beginning to look for guidance on infrastructure managers. Some consulting firms tried to provide all these services, but others chose to specialize in a few areas such as quantitative analysis or hedge-fund manager selection.

The consulting profession has grown in complexity as the investment world has grown in complexity. It has taken on the burden of learning new things and then using the knowledge to guide pension executives as they seek to protect benefits for beneficiaries. The evolution of investment management, and the spread of knowledge in the institutional investment world, would have been far slower without pension consulting professionals.

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