



The Search for Investment Quality— A Survey of Investors, Consultants, and Managers

- **Investment Quality is a manager’s ability to consistently meet stated objectives.** This definition incorporates three key elements – skill, consistency, and objectives. Skill is the manager’s talent and capability to add value. Consistency is the uniformity and diligence with which skill is applied. Objectives are clearly defined and communicated.
- **We surveyed over 250 plan sponsors, consultants, and managers.** We teamed with InvestorForce to test our definition of Investment Quality and better understand how it is identified, measured, and evolving.
- **Investors and managers share consistent views of Investment Quality.** Interestingly, there is little disagreement between investors and managers about the importance of, contributors to, and measures of Investment Quality.
- **Respondents universally believe Investment Quality is critically important.** Over 70% of plan sponsors, investment consultants, and investment managers believe that Investment Quality is much more important today than it was historically.
- **Investment process, professional’s quality and experience, and stability are considered the most important contributors to Investment Quality.** Quality is not simply about performance – process, people, and environmental factors are considered essential elements.
- **We anticipate a flight to Investment Quality.** We believe that Investment Quality, and the search for it, will be a defining theme of the investment management industry over the next decade. This will translate into significant asset flows and business growth for managers who can demonstrate Investment Quality.

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Casey, Quirk & Acito (CQA) provides management consulting services exclusively to investment management firms. CQA specializes in business strategy and planning, developing and monitoring investment quality, and delivering market intelligence. CQA draws on 35 years of experience in delivering value to its clients and partners through a unique combination of deep industry knowledge and experience, solutions-oriented thought leadership, and a proven ability to create change within organizations. CQA counts many of the most successful investment management firms among its clients.



InvestorForce is an investment and technology company, which provides technology solutions to support the consultants, money managers and advisors to institutional and wealthy investors. InvestorForce helps streamline the operations of pension consultants by making available extensive analytics and search tools, as well as qualitative and quantitative information on the investment performance of the country’s leading money managers. InvestorForce’s technology allows investment managers to participate in an increased number of searches, as well as conduct competitive research on their peers.

1. Introduction

During the equity bull market, strong absolute returns contributed to high investor satisfaction. As a result, investors were less critical or aware of manager underperformance relative to peers or benchmarks. In addition, the sources of return and level of risk in portfolios received less scrutiny. However, market conditions over the past three years have exposed a widening gap between investors' expectations and investment managers' ability to meet objectives. Many individual and institutional investors were let down by managers that were unable to deliver on expectations. The biggest disappointments were with managers that lost sight of risk in pursuit of outsized returns.

Investors of all types are now reevaluating their investment managers with a particular focus on quality and dependability. With investors demanding greater levels of investment dependability, financial planners and investment consultants are reexamining what makes a good manager; and they are committing significant resources, time, and energy to identifying Investment Quality.

What is Investment Quality? How is it measured? Who exhibits it? In this paper, we will define Investment Quality, highlight contributors to it, and identify metrics that plan sponsors, investment consultants, individual advisors, and investment managers use to find it.

We define Investment Quality as a ***manager's ability to consistently meet stated objectives***. Embedded in this definition, are three underlying tenets:

- **Ability or skill is required.** The ability to meet objectives over time implies a manager has investment skill. However, meeting objectives is not enough. To build investors' confidence about the future, skill must be differentiated from luck by validating sources of return.

- **Consistency implies investment discipline.** A systematic and disciplined investment process (not necessarily mechanical) is an important contributor to Investment Quality. Consistent value-added translates into investment dependability.
- **Objectives must be defined and clearly articulated.** Clearly communicating objectives helps to set and manage buyer expectations and provide a foundation for identifying and measuring Investment Quality.

Investment Quality is the manager's ability to consistently meet stated objectives.

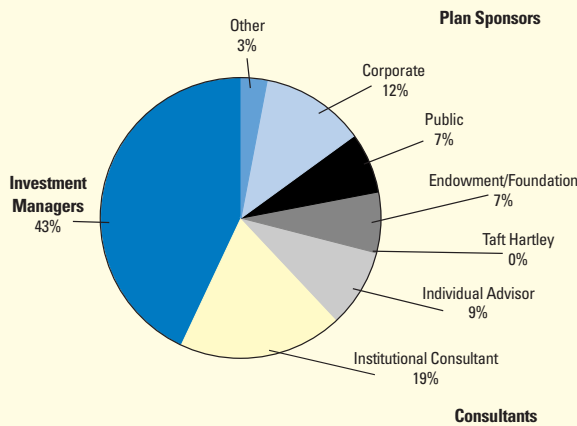
The strength of this definition is its breadth of applicability. It is both investor type and asset class neutral. It applies equally to individual investors, eleemosynary investors, and retirement plans. In addition, it is applicable to fixed income, hedge fund, and equity products.

To test our definition of Investment Quality and its importance in the market, we surveyed plan sponsors, investment consultants, individual advisors, and investment managers about Investment Quality. Our objective was to understand how the marketplace currently identifies and measures Investment Quality. The results of our survey, which follow, provide insight into investors, consultants, and managers' current perspectives on Investment Quality.

2. Survey Methodology and Participants

Our survey was conducted in the first quarter of 2003 with InvestorForce, a leading provider of technology and data to the asset management industry. The survey soliciting feedback on Investment Quality was sent electronically to InvestorForce subscribers. Two hundred fifty-six plan sponsors, investment consultants, individual financial advisors, and investment managers responded to the survey over a two-week period. Approximately half of the survey participants were plan sponsors, investment consultants, or individual advisors, and half were asset managers (see Exhibit 1).

Exhibit 1: Participants
Participant Organization Type



The respondents represented a broad cross section of the plan sponsor, investment consultant, and investment management communities (see Exhibits 2 - 4). Approximately 70% of the plan sponsor participants identified themselves as chief investment officer, pension director, or pension staff. Of the consultant and financial planner participants, 68% identified themselves as consultants to institutions, and 32% identified themselves as advisors to individuals.

Exhibit 2: Participants
Plan Sponsor Respondent Assets Under Management

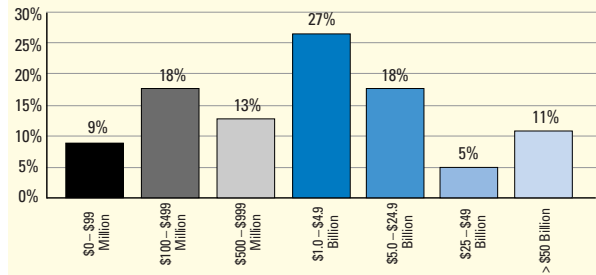
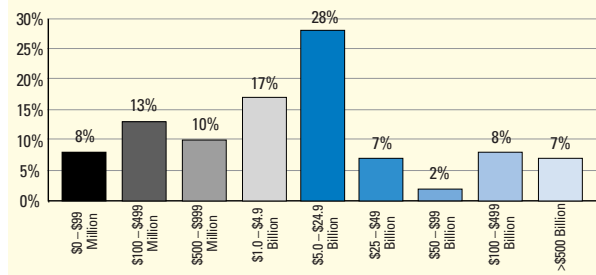
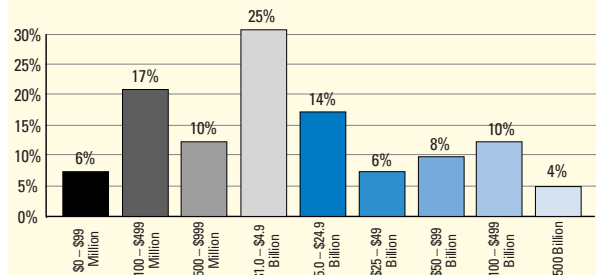


Exhibit 3: Participants
Institutional and Individual Consultant Respondent Assets Under Advisement



The investment manager respondents represented a broad range of firms from small to some of the largest. Sixty percent of investment manager survey participants identified themselves as marketing or client service professionals.

Exhibit 4: Participants
Investment Manager Respondent Assets Under Management



3. Survey Findings

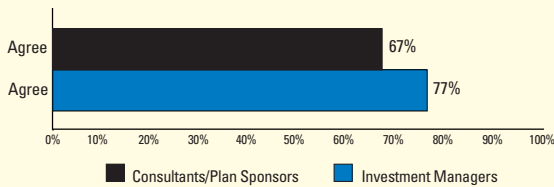
THE IMPORTANCE OF INVESTMENT QUALITY

We believe that Investment Quality will be a defining theme of the investment management industry over the next decade because investors will demand it. Plan sponsors, investment consultants, and individual advisors will continue to refine their search process to find better ways of identifying it. Investment managers will also increase their focus on Investment Quality. To be successful in an increasingly competitive environment, managers will have to build confidence among their clients and prospects that they can meet their stated objectives.

We asked the participants about the importance of Investment Quality. Over 70% of plan sponsors, investment consultants, individual advisors, and investment managers believe that Investment Quality is much more important today than it was historically (see Exhibit 5).

Exhibit 5: Importance

Q: Investment Quality is much more important today than in the past (Do you agree or disagree?)

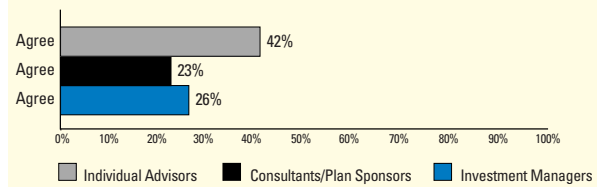


Over 70% of respondents believe Investment Quality is much more important today than in the past.

Interestingly, despite the difficult market conditions of the past three years, the broad group of respondents felt that their definition of Investment Quality had not changed significantly. However, nearly half of the advisors serving individuals felt that their definition of Investment Quality had changed significantly (see Exhibit 6). This may suggest a higher urgency among advisors serving individuals to more fully appreciate Investment Quality. This is consistent with our observation that individual advisor sophistication is increasing.

Exhibit 6: Importance

Q: My view of what defines Investment Quality is changing significantly (Do you agree or disagree?)



CONTRIBUTORS TO INVESTMENT QUALITY

In general, consultant, plan sponsor, and manager respondents have consistent views about what contributes to Investment Quality. Respondents believe that there are three primary contributors to Investment Quality: **investment process, professionals' quality and experience, and stability**.

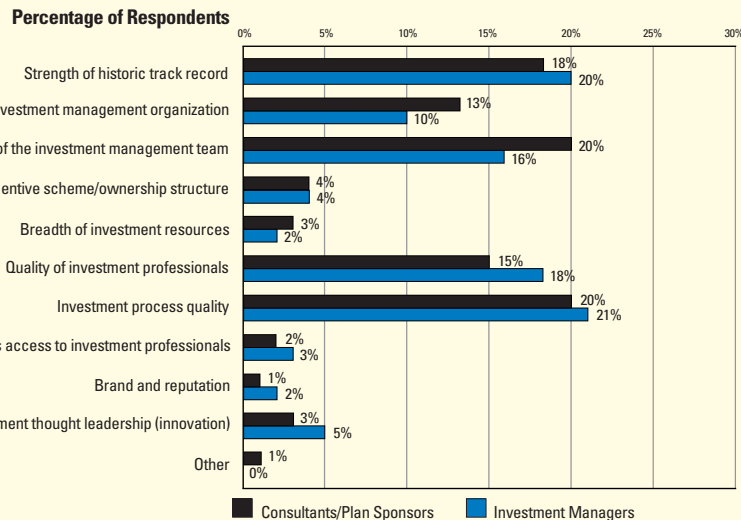
The majority of respondents believe that investment process is the primary driver of Investment Quality (see Exhibits 7 and 8). Based on our experience advising investment managers, we believe that a clear investment process inspires confidence of repeatability among buyers. Leading investment consultants have long employed rigorous investment process assessments as a means of identifying Investment Quality.

that stability is achieved through strong business management, clear firm vision, and appropriate incentive alignment. During the difficult market environment, we have observed that firms that have demonstrated Investment Quality have largely maintained stable organizations.

The quality of investment professionals and track record strength (a measure of experience) are viewed as the third critical contributor to Investment Quality by our respondents (see Exhibits 7 and 9). In the search for Investment Quality, evaluating the experience and judgment of professionals is difficult to measure but essential to consider. Importantly, experience is not just about a good track record: over 90% of the respondents believe that Investment Quality is about more than performance (see Exhibit 10).

Exhibit 7: Contributors

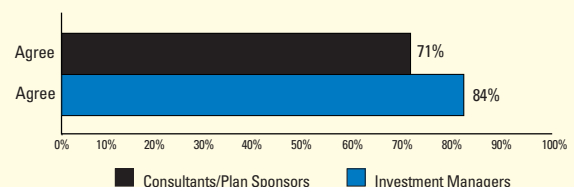
Q: Which of the following are the most important broad contributors to developing your view of Investment Quality?
(Select up to four)



Stability of the investment management team and organization is also a critical contributor to Investment Quality according to our respondents. More consultants and plan sponsors than investment managers believe that stability of the investment management team is an important contributor to Investment Quality (see Exhibit 7). Given our definition of Investment Quality, maintaining a stable organization (keeping the people who create Investment Quality) seems to be a critical element. We believe

Exhibit 8: Contributors

Q: Investment process is the primary driver of Investment Quality (Do you agree or disagree?)



Interestingly, a large research staff is considered among the least important contributors to Investment Quality by our respondents. We observed significant growth in investment staff over the decade of the 1990s. The intent, of course, was to increase Investment Quality. However, in adding staff, many organizations may have impaired their ability to deliver Investment Quality. Our respondents seem to reflect the view that a large research staff is not a critical contributor to Investment Quality (see Exhibit 9). We believe “efficiency energizes true talent”—that is, great investors

Investment process, professionals’ quality and experience, and stability were viewed as the most important contributors to Investment Quality.

can be slowed down by bureaucratic or overly complex investment processes. This belief seems to be appreciated among the respondents.

Exhibit 9: Contributors

Q: Which of the following resource characteristics are the most important contributors to Investment Quality?
(Select up to three)

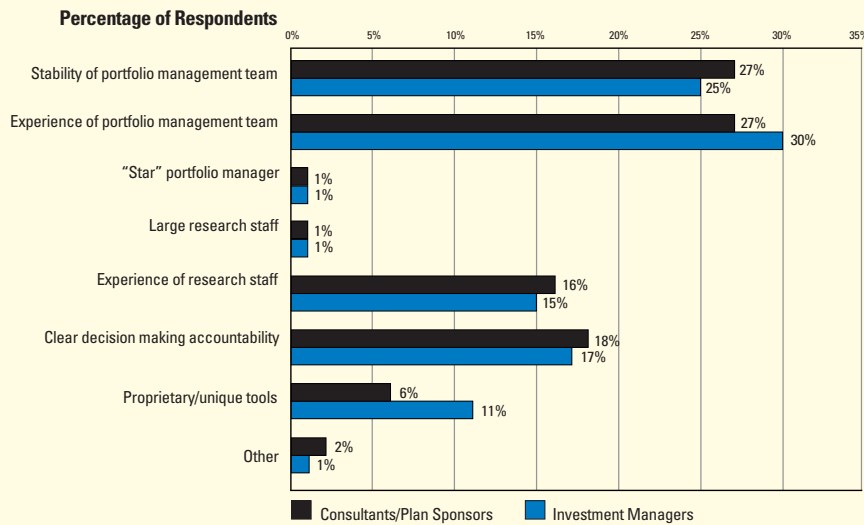
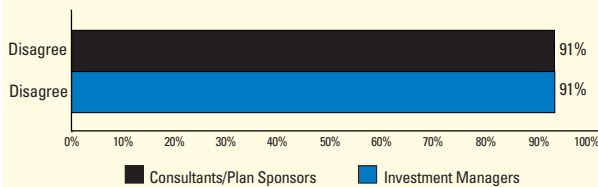


Exhibit 10: Contributors

Q: Investment Quality is really only about performance
(Do you agree or disagree?)



FINDING INVESTMENT QUALITY

Plan sponsors, investment consultants, and intermediaries have consistent views about what contributes to Investment Quality; however, most agree that identifying Investment Quality is a challenge. While it may be impossible to determine a manager's future ability to meet stated objectives with certainty, tools can be employed to increase the probability of identifying it. Quantitative analysis and metrics are used to evaluate a manager's historic skill and

consistency; investment process evaluation is used to assess a manager's potential for repeatability of past success; and understanding the investment professional's environment including firm stability and incentive schemes provides further insight into a manager's chances for future success.

In simple terms, managers are typically evaluated on the basis of qualitative (philosophy, process, people) and quantitative (historic product characteristics and track

Exhibit 11: Finding Quality

Q: In developing your view on Investment Quality, what is the relative contribution from qualitative factors versus quantitative evaluation?

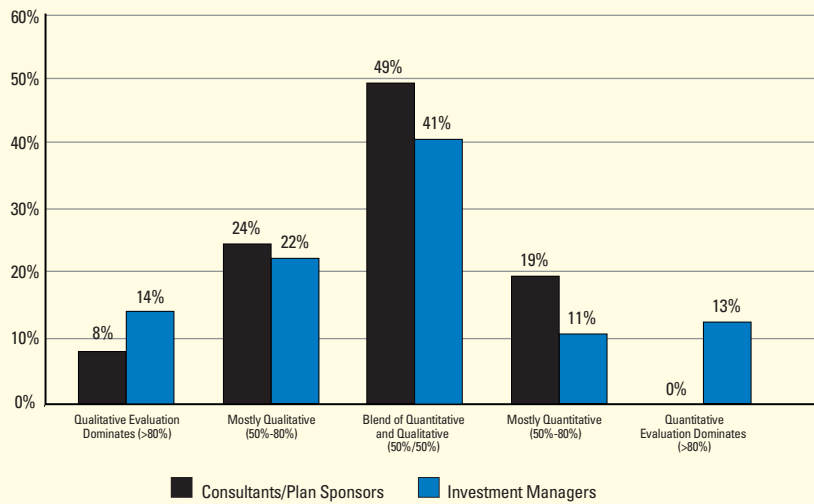
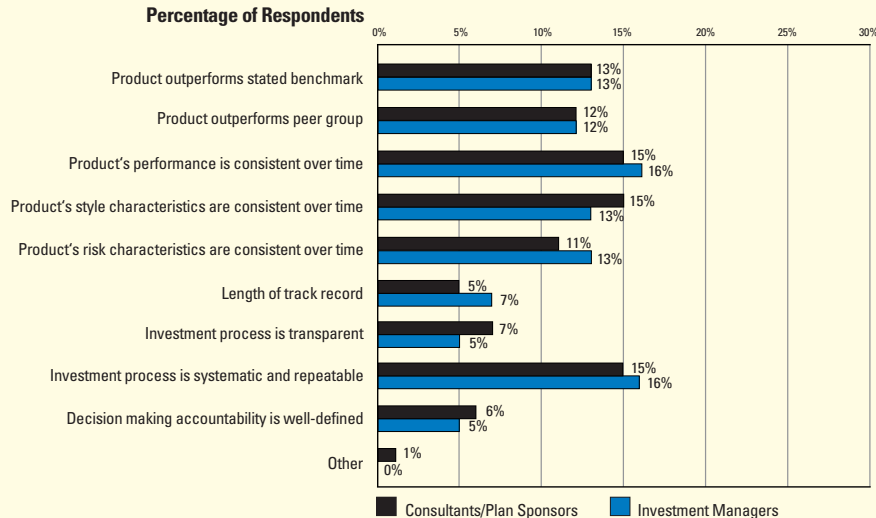


Exhibit 12: Finding Quality

Q: In evaluating equity products, which of the following are the most important contributors to your view of Investment Quality? (Select up to four)



Consultants and plan sponsors' manager evaluation process is skewed toward qualitative (vs. quantitative) techniques.

record) evaluation techniques. We asked our survey participants, on balance, which of the two techniques they employed (or perceived the market to employ). Nearly 50% of plan sponsors, investment consultants, and individual financial advisors responded that they use an equal blend of qualitative and quantitative inputs to assess Investment Quality. Interestingly, consultant and plan sponsors' process for evaluating Investment Quality is skewed toward qualitative evaluation (see Exhibit 11). This appears to be consistent with the prior findings on the key contributors to Investment Quality (investment process, experience, and stability) since those factors would be most effectively assessed through qualitative evaluation.

Remembering two key elements in our definition of Investment Quality—skill and consistency—what specific

metrics do respondents view as important? Three broad measures ranked highest: outperformance, product consistency, and a systematic and repeatable investment process (see Exhibit 12).

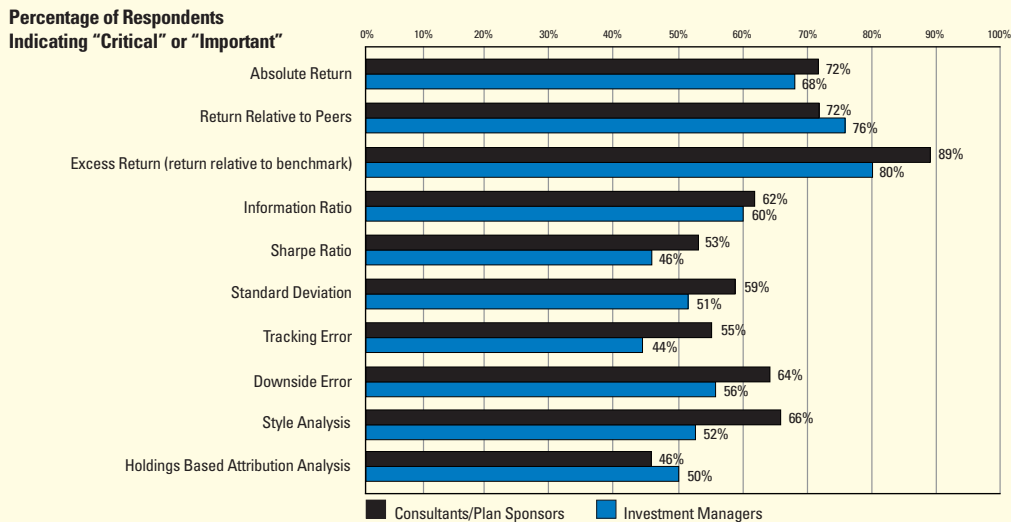
Quantitative analysis of historic information is often the starting point in the search for Investment Quality. Buyers often begin their search with widely available databases of managers' historic performance data. We were interested in what specific analyses are most important.

Although respondents strongly believe that performance is not the only contributor to their view of Investment Quality, it is certainly a critical metric in beginning their search for it. Excess return (return relative to a benchmark), return relative to peers, and absolute return were the three most often cited as critical or important (see Exhibit 13).

Risk-adjusted measures of performance, such as information ratio and sharpe ratio, are ranked as important or critical by approximately 60% and 50% of the respondents, respectively. We were surprised that the measures of risk adjusted skill, information ratio and sharpe ratio did

Exhibit 13: Finding Quality

Q: In developing confidence in a manager's future performance, rank the importance of the following types of analyses. (Categorize each as critical, important, helpful, marginal, or not important)

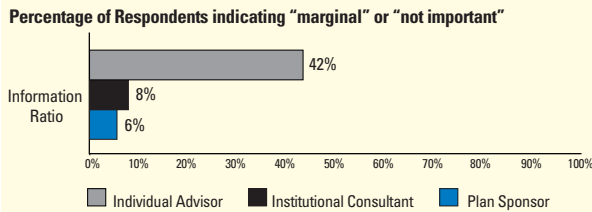


Three and five-year historic track records were viewed as the most important evaluation timeframes.

not rank higher in importance. We believe that in the future such measures will increase in importance. One interesting observation is that 42% of individual advisors view information ratio to be marginally or not important, compared with only 8% of institutional consultants and 6% of plan sponsors (see Exhibit 14).

Exhibit 14: Finding Quality

Q: In developing confidence in a manager's future performance, rank the importance of the following types of analyses. (Categorize each as critical, important, helpful, marginal, or not important)



Five years and three years are considered the most important timeframes in evaluating historic track records (see Exhibit 15). This is consistent with conventional

wisdom in the institutional market that a minimum three-year track record is required to be considered for selection. Longer-term track records obviously allow buyers to differentiate between luck and skill with greater confidence.

Respondents believe that understanding the sources of value-added is critical to understanding Investment Quality (see Exhibit 16). This finding implies that good performance is a necessary but not sufficient condition, to demonstrate Investment Quality.

Only 35% of plan sponsors, investment consultants, and intermediaries and 57% of investment managers regularly perform holdings-based performance analysis (see Exhibit 17). We believe that portfolio holdings-based attribution provides the deepest insight into the sources of value-added and that it can provide clear validation of manager skill.

Exhibit 16: Finding Quality

Q: Performance attribution (evaluating the sources of value-added) is critical to evaluating Investment Quality (Do you agree or disagree?)

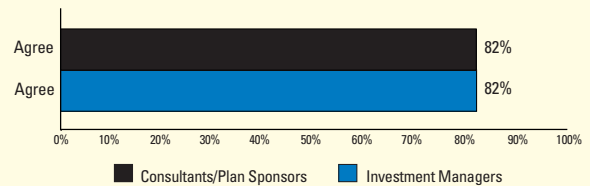


Exhibit 15: Finding Quality

Q: Which timeframe is most important in evaluating historic track records?

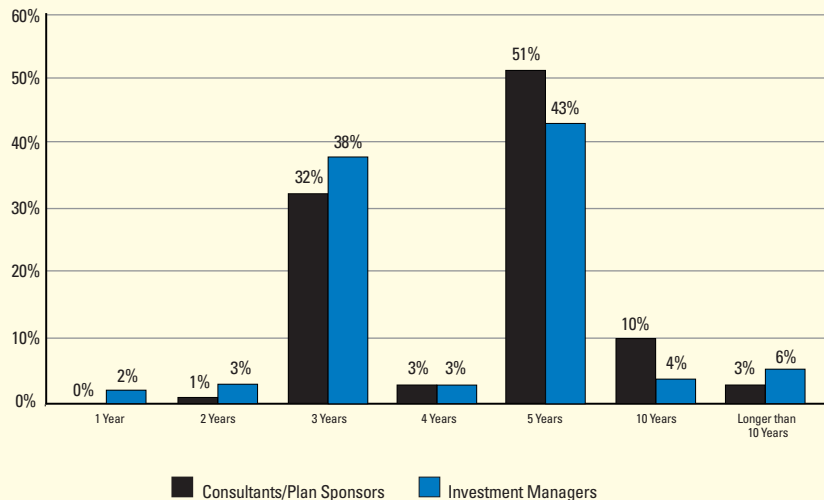
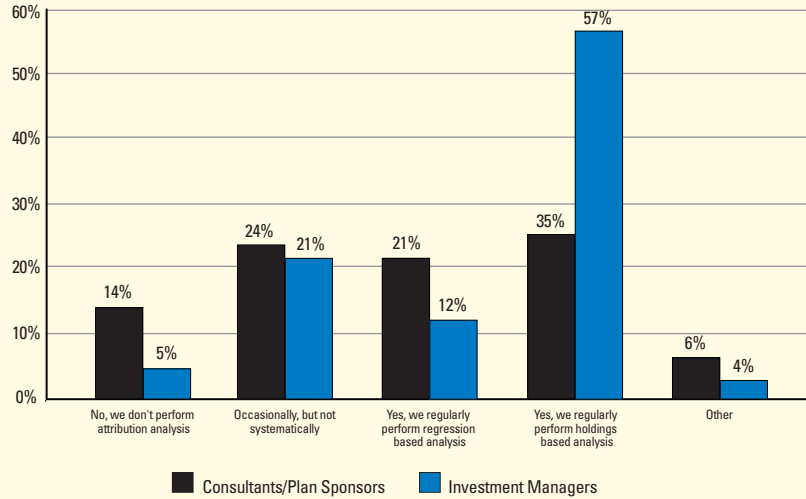


Exhibit 17 : Finding Quality

Q: Q: Do you perform or receive attribution analysis (on your own portfolios or those that are managed for you)?

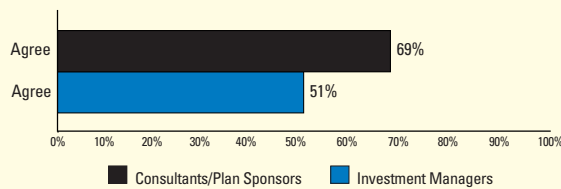


In one of the most dramatic differences in opinion, approximately 70% of plan sponsors, investment consultants, and individual financial planners, compared with 51% of investment managers, believe that differentiation

between investment styles within traditional style boxes is critical to understanding Investment Quality (see Exhibit 18). This seems to highlight the issue that many managers take with being evaluated within traditional style boxes. That is, these broad categories of investment style do not fairly represent their uniqueness. Conversely, investors require adequate tools to compare managers “apples to apples.”

Exhibit 18 : Finding Quality

Q: Differentiation among investment styles within traditional style boxes is critical to understanding Investment Quality (Do you agree or disagree?)



We believe that traditional style categories are only a starting point for manager comparison and evaluation. For example, all Growth managers do not have the same style; in fact, there are significant style differences between Growth at a Reasonable Price and Growth Momentum managers. We believe that to gain insight into Investment Quality, these differences must be understood, and their impact must be considered.

WHO HAS INVESTMENT QUALITY?

We asked the respondents which firms best exemplify Investment Quality. Eighty-seven participants responded identifying over 125 different firms. A large number of mentions included many smaller boutique firms, confirming that Investment Quality is not about size.

Exhibit 19: Who has Investment Quality?

Q: Which investment firms best exemplify Investment Quality? (Top mentions among plan sponsors, consultants, and individual advisors)

- | | |
|-----|-----------------------------|
| 1. | Capital Guardian |
| T2. | Brandes Investment Partners |
| T2. | Wellington Management |
| T3. | Barclays Global Investors |
| T3. | PIMCO |

4. Conclusions

Investment Quality will be a defining theme of the investment management industry over the next decade. Based on our survey results, it seems evident that investors, consultants, and managers have an increasing appreciation for this theme.

In the past 12-18 months, we have observed strong evidence that a flight to quality (or at least “perceived quality”) is occurring. We view this as a natural evolution and confluence of: (1) the poor recent investment experience of investors; (2) many well-known and reputable organizations performing far worse than expected; and (3) the maturation of tools and sophistication of investment managers and the people who assess them.

Flight to Investment Quality is part of a long-term shift in the future winners in the industry.

Importantly, we do not view this recent movement as a cyclical trend, but rather part of a long-term shift in the future winners in the industry. We believe that a flight to quality could be substantial as investors of all types scrutinize their current managers in their search for Investment Quality.

Consultants, advisors, and investment managers will play an important role in the emerging flight to Investment Quality. Consultants and advisors will be the primary gatekeepers and evaluators of Investment Quality. Investment managers will help shape the definition of and set the expectations for Investment Quality.

Consultants and advisors are at a critical juncture as their clients look to them for advice after a period of difficult investment results. We believe that consultants and advisors should use this opportunity to listen to and talk to their clients, reflect on their current practices, and consider making changes. The following are some specific ideas and questions consultants and advisors might consider:

- **Reconfirm your clients’ objectives.** It is a critical time to listen to your clients. Given the recent market conditions, have your clients’ objectives, views, and needs changed? Have you discussed and confirmed their objectives?
- **Reevaluate your advisory frameworks.** Long-held approaches (many built over the bull market) are being challenged. Are the fundamental underpinnings of your allocation and manager assessment/monitoring frameworks sound? Does your asset allocation approach meet your clients’ needs? Have you appropriately considered

and implemented relative return and absolute return strategies? Are you considering alternative products? Are you paying too much or too little attention to style?

- **Inventory your investment manager roster.** With the benefit of a better understanding of your clients' objectives and your advisory frameworks, how do your current managers stack up? How do they rate against your definition of Investment Quality?
- **Define and implement clear success metrics.** How do you define success in the search for Investment Quality? Have you clearly stated your success metrics for your overall investment approach as well as for your managers? Are they reasonable? What are your milestones and timeframes for success?

Investment managers are also at a critical point. Investors appear to be taking some steps toward Investment Quality. Like consultants and advisors, we believe managers should similarly use this period to reflect on their value proposition to their clients. Specifically:

- **Clarify your objectives.** If Investment Quality is tied to a manager's ability to meet stated objectives, then clarifying and having internal buy-in to those objectives is essential. Are investment, marketing, and client service professionals articulating consistent objectives to your clients and prospects?
- **Confirm your objectives with your clients.** Managers are usually terminated for underperformance. But underperformance relative to what? Clients with a better understanding of your objectives and clear performance expectations are more likely to be good

long-term clients. Do your clients have a clear understanding of your objectives? Do they understand your philosophy and portfolio positioning rationale?

- **Evaluate your investment process.** Maintaining a disciplined and understandable investment process is broadly considered a critical contributor to investment quality success. Do you understand your investment skill, and is it consistently applied? How does your investment process compare against investment quality standards? Do you understand your sources of value added?
- **Align incentives.** Investors repeatedly cite organizational stability as a critical contributor to Investment Quality. What is your organization doing to ensure appropriate commitment of key professionals? Are equity-like incentives a critical element of your incentive plan? Is the organization and investment process structured efficiently to benefit from the talent of your professionals?

While the most recent period has been a difficult one for investors, many lessons have been learned, and it has created a significant opportunity to innovate. We believe that as the industry innovates, Investment Quality will become a central theme to meeting the needs of investors.



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May 2003

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