

External Fund Management

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The views expressed in this presentation are those of the author and do not necessarily represent the views of the NBC.

Agenda

- 1- An Overview of EFM
- 2- EFM Selection Process
- 3- EFM Monitoring and Evaluation



1-Why Do We Need EFM's?

Investment Management: Decision Tree



Why Do We Need EFM's?

- Diversification
 - Fund management: passive, active, investment strategies, etc.
 - Asset classes: government bonds, supranationals, government agencies, corporate bonds, equity, etc.
 - Financial markets: developed, emerging, US, Europe, etc.



Why Do We Need EFMs?

- Enhance return and mitigate risk: investment diversification brings this expectation.
- Learning by doing:
 - learn investment strategy and analysis
 - onsite training and seminars
 - use EFMs' portfolios as benchmark to compare with the internally managed portfolios



Why Do We Need EFM's?

	No. of managers in portfolio								
	2	3	4	5	6	7	8	9	10
Max alpha	4.0%	3.7%	3.3%	2.9%	2.6%	2.5%	2.3%	2.2%	2.1%
Min alpha	-1.8%	-1.4%	-1.1%	-0.9%	-0.8%	-0.6%	-0.6%	-0.4%	-0.4%
Avg alpha	0.81%	0.81%	0.81%	0.81%	0.81%	0.81%	0.81%	0.81%	0.81%
P(alpha>=0.81%)	46.7%	47.8%	48.5%	48.8%	49.1%	49.4%	50.0%	50.0%	50.0%
Std. Dev.	0.87%	0.70%	0.60%	0.53%	0.47%	0.43%	0.40%	0.37%	0.34%
Avg IR	0.45	0.50	0.53	0.56	0.58	0.60	0.62	0.64	0.65



What to Know about EFM

- i. Strategic Asset Allocation (SAA)
Result**
- ii. Selection of the Right One(s)**
- iii. Legal Documents**
- iv. Custodian Service**
- v. Costs and Benefits**



SAA Result

- Available fund?
 - Using needed fund or ample one?
- Understanding of benchmark
 - Eligible asset classes (investment policy and guideline)
 - Only liquid asset classes for liquidity need or illiquid one for ample fund or mix of both?
 - Available benchmark index? Standard or Custom?
 - Meet expected risk and return objective?



2-Selection of the Right One

- Active or passive manager?

- The bottom line is that Active Management can add value to a portfolio

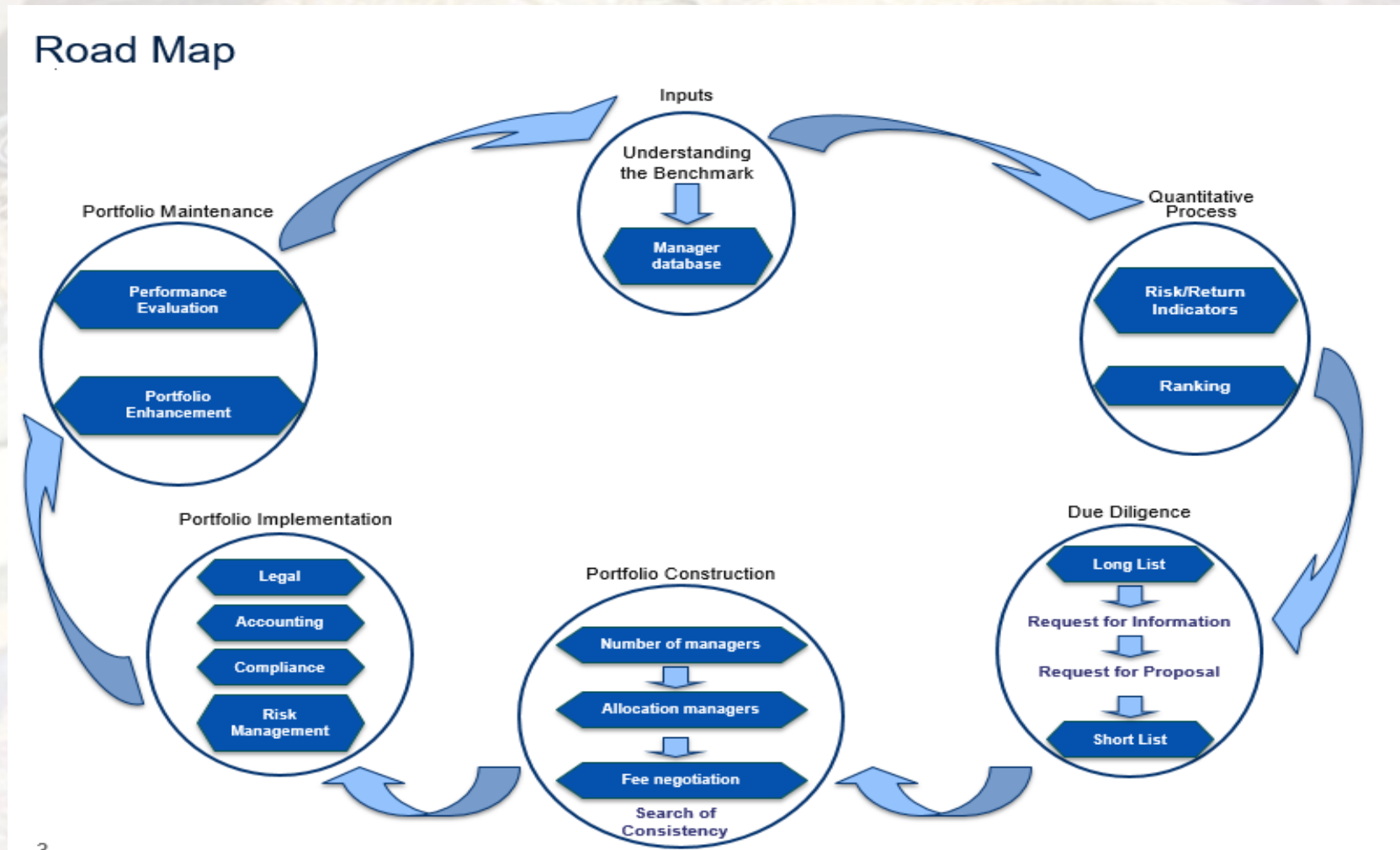
- However, it does require an ability to identify external managers who can generate future excess returns over the benchmark

- Absent this ability, Active Management can detract from performance



Selection Process

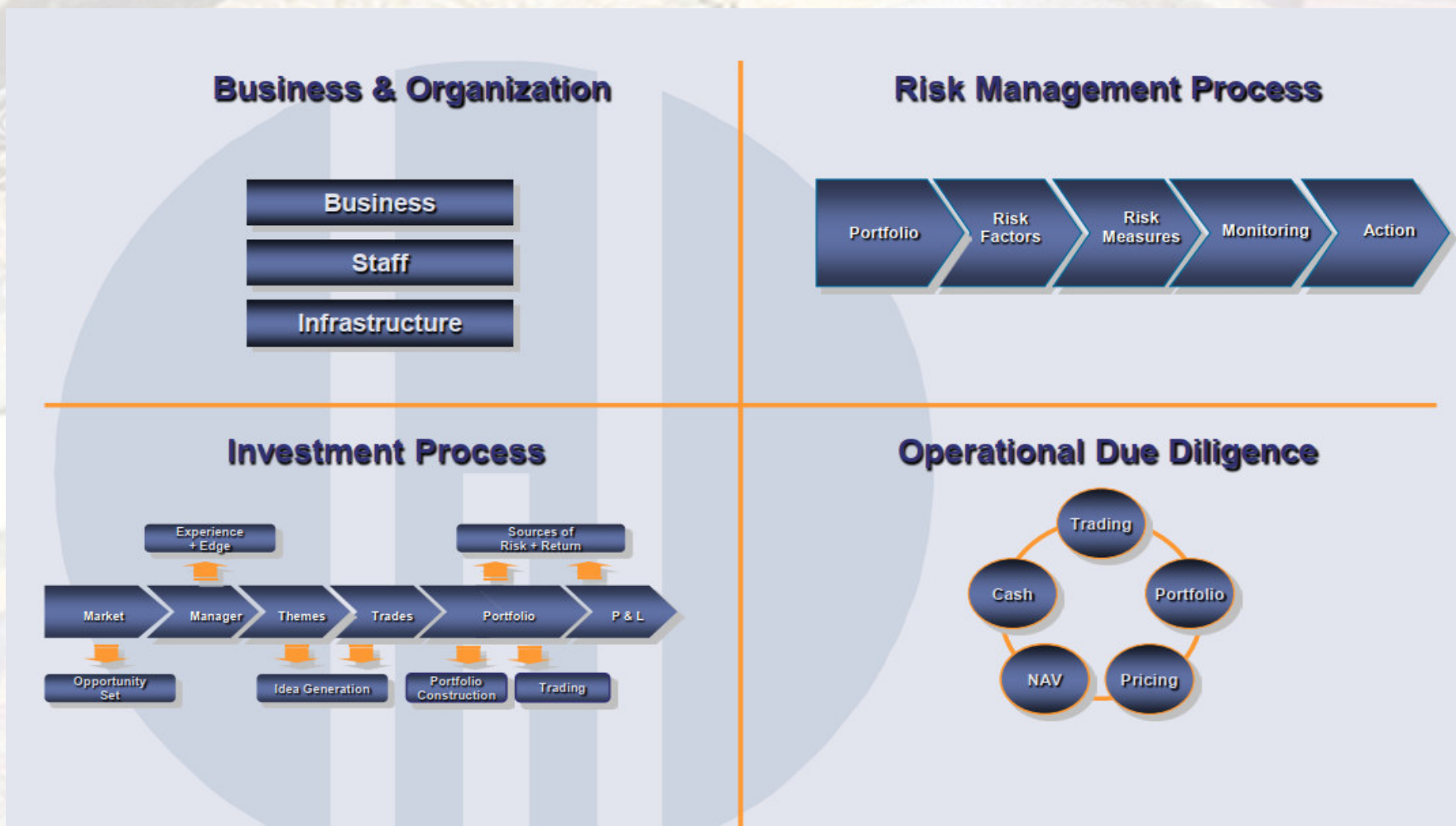
Selection lifecycle:



3

Due Diligence

Off-site Due Diligence (Request for Proposal (RFP):



3-Monitoring & Evaluation

Performance Evaluation Overview

□ Portfolio Evaluation encompasses 3 components:

1/ Performance Measurement: computing the portfolio's total rate of return and **return in excess** of its stated benchmark

- *Cone Analysis, Monthly Excess Return Analysis, Summary Statistics Analysis, Portfolio Evolution Analysis*

2/ Performance Attribution: examining **why** the portfolio performed as it did

- *Performance Attribution Analysis*

3/ Performance Appraisal: determining how well the manager did based on the results of the performance measurement and **performance attribution** analyses, as well as with respect to his/her **peers**.

- *Cone, Monthly Excess Returns and Summary Statistics Analysis, Performance Attribution Analysis, Universe Comparison Box plots*



Performance Evaluation

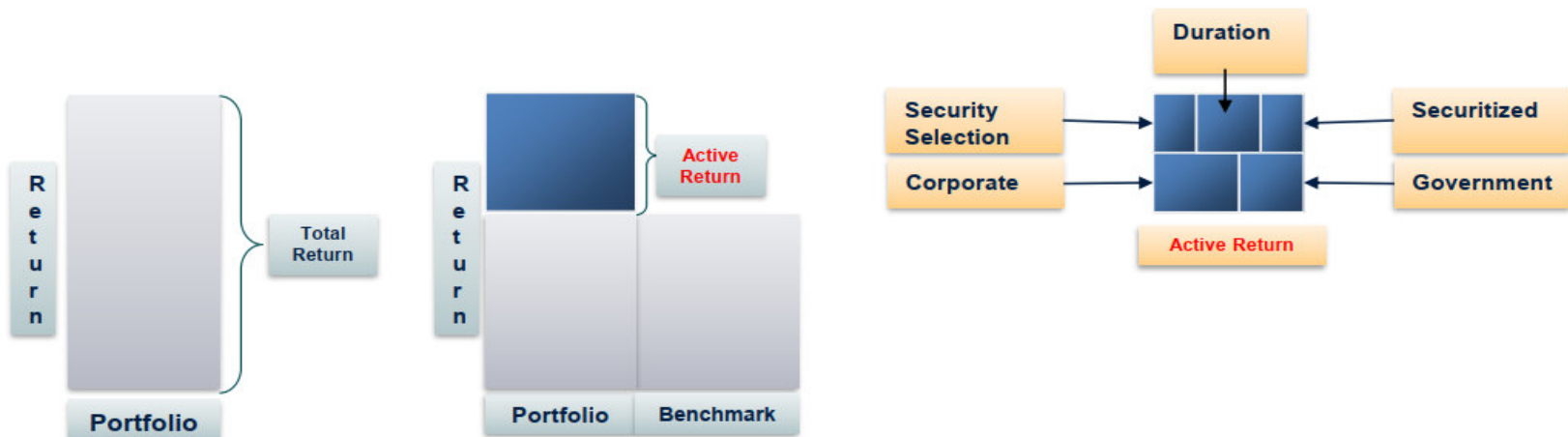
Performance Monitoring Tool and Analyses

Performance Attribution

Sources of active return may include:

- Portfolio **Duration** – Allocation along the yield curve to take advantage of anticipated changes in interest rates
- **Allocation** in different **types** of fixed income securities, e.g.: Treasuries, Corporate, Quasi government, Securitized etc.
- **Allocation** across different bond **ratings**, reflecting the credit worthiness of the bond issuer

- ❑ *Cone Charts*
- ❑ *Monthly Returns*
- ❑ **Attribution**
- ❑ *Universe Comparison*
- ❑ *Portfolio Evolution*
- ❑ *Summary Statistics*



Compliance Monitoring

- Daily check is required to ensure EFM's compliance with the given Investment Guideline.
- Sample checklist:
 - Eligible asset classes
 - Duration deviation band
 - Minimum credit rating
 - Outstanding issue size



Reporting to Management

- Follow Investment Policy and Guideline for the reporting content, frequency and the level to be addressed to.
- Sample content of monthly report in written format:
 - Performance result
 - Risk data
 - Compliance issues and solutions
 - Official data is available on monthly and annual basis



Legal Documents

- Investment Management Agreement (IMA)
 - Agreement: assignment, responsibilities, warranty, obligations, indemnification, immunity, reporting, and other necessary clauses.
 - Investment Guideline: benchmark, flexibility of investment (deviation from set benchmark), target return objective, risk tolerance, eligible investments and restrictions, etc.
 - Relevant schedules or appendices: training, fee, and specific term.



Custodian Service

Role of a Master Custodian

Core services

- Settlement
- Safekeeping of securities
- Income collection
- Cash management
- Corporate actions mgmt
- Funding
- Tax management
- Reporting – the info chain – SWIFT etc
- Banking facilities

Value added services

- Investment accounting
- Master custody/record-keeping
- Securities lending, equity repos and collaterals
- Trustee services
- Portfolio valuation
- Collateral mgmt
- Performance reporting
- Compliance monitoring





Cost and Benefits

Benefits of Using External Managers

- Access to resource-intensive investment strategies
- Access to best practice in the market
- Reduce staff turnover risk
- Minimize infrastructure costs
- Minimize the overall staff requirement

Costs of Using External Managers

- Portfolio's risk profile more difficult to control
- Requires significant experience in managing external managers
- No build-up of technical competence in selecting the single investments
- Slows down the possibility of implementing changes in the portfolio
- Higher cost



A portfolio managed by a wide enough set of managers has higher stability and better risk/return than a portfolio managed by only one manager. In an active portfolio, an internal management team can complement a set of external managers.

Conclusions

- Is there available fund for new portfolios?
- Cost and Benefits comparison
- Diversification, new asset class, capacity building
- Other related tasks/services ready for EFM's?
 - Custodian service, compliance, risk & accounting, reports
 - Internal or external consultant on legal issues
 - Internal monitoring team
 - Risk management team
 - IT system
 - Internal management structure



Thanks for your attention

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