



This presentation was originally given by:

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Investment Management for Institutional Investors
Boston, MA

WHAT YOU NEED TO KNOW ...
TO BE AN EFFECTIVE FIDUCIARY OF
INSTITUTIONAL FUNDS

Presented by:

David J. Kudish, President

Advocate Investment Advisors, LLC

May 13, 2003

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INVESTMENT LESSONS FROM
HISTORY



SEVEN INVESTMENT LESSONS

What are the lessons from 200 years of investment history?

1.) PAYOFF versus RISK:

To make really big money, one has to take large-sized risks.

- You need to adapt a very different Asset Allocation policy than the typical fund.
- You need to have a strong “stomach” to be a “Contrarian”... and to stick with it.



SEVEN INVESTMENT LESSONS

(continued)

2.) PAYOFF versus PATIENCE:

While there is usually a big payoff for taking “risk”...

- ... you can go five to ten years without a “Bull Market.”
- *Do YOU have the fortitude to wait this long for a “payoff”?*



SEVEN INVESTMENT LESSONS

(continued)

3-A.) “Risky” assets usually outperform “less-risky” assets.

- This is the “payoff” we’ve been discussing.

3-B.) Stocks beat bonds:

- IF you take the long-term view
- IF you invest regularly.

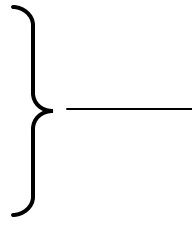


SEVEN INVESTMENT LESSONS

(continued)

4.) Diversification works.

- Pennsylvania Railroad
- Xerox
- Enron
- Garbage.dot.com



← Formula for Failure (*unless you are Bill Gates*) :
Concentration = Decimation of Wealth



SEVEN INVESTMENT LESSONS

(continued)

5.) Compounding of returns really works.

- Small differences in returns are important
- “Time” is a huge factor
- Patience is an investment virtue



SEVEN INVESTMENT LESSONS

(continued)

6.) Preservation of principal is paramount.

- At certain levels of losses, recoveries are difficult
- At certain levels of losses, recoveries are virtually impossible



SEVEN INVESTMENT LESSONS

(continued)

7.) Pay strict attention to the first six lessons!

- It may not make you the richest person alive...
but you will retire in dignity.

INVEST WITH REASONABLE EXPECTATIONS:
Understanding Compounded Rates of Return

COMPOUND RATES OF RETURN: The “good times”

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NEW YORK STOCK EXCHANGE SEAT

<u>Elapsed Time</u>	<u>YEAR</u>	<u>VALUE</u>	<u>Growth Factor</u>
213 years	1787	\$ 25	40,000
	2000	\$1,000,000	

$$\begin{aligned} \text{Annual Rate of Return} &= ? \\ &= 5.1\% \text{ per year} \end{aligned}$$

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A MONET MASTERPIECE

Elapsed Time = 100 years
 Current Value = \$20 million

COST	Growth Factor	Rate of Return
\$10,000	2,000	7.9%
\$ 2,000	10,000	9.6%
\$ 200	100,000	12.2%

50 times!

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LOWER MANHATTAN

Elapsed Time	YEAR	VALUE	Growth Factor
371 years	1630	\$ 20	???
	2000	???	???

Assumed Annual Return = 7.0% per year

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LOWER MANHATTAN

<u>Elapsed Time</u>	<u>YEAR</u>	<u>VALUE</u>	<u>Growth Factor</u>
371 years	1630	\$ 20	80 billion times !
	2000	\$ 1.8 trillion	

Assumed Annual Return = 7.0% per year

Next year's interest = \$128 billion

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LESSONS LEARNED

Small differences in Rates of Return have a huge difference in terminal wealth... over long-term holding periods.

Expectations of many investors to achieve Rates of Return in excess of 15% are wildly unreasonable.

- *10% would be fantastic!*
- *7% would be pretty terrific!*

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COMPOUND RATES OF RETURN: The “bad times”

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1929 STOCK MARKET CRASH

<u>Market Decline</u> ¹	<u>Subsequent Appreciation Required</u> ²	<u>Recovery Time Period</u>	<u>Annual Return Required</u>
89%	910%	10 years	24.7%
[\$100 to \$11]	[\$11 to \$100]	20 years	11.7%

¹ Inflation adjusted

² To make up the loss (ignores the time-value of money)

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MARKET LOSSES AND RECOVERIES

Market Decline	Appreciation Required to Get Even ¹	Likelihood of Recovery
10%	11%	Likely
20%	25%	
25%	33%	Possible
33%	50%	
50%	100%	Very Difficult
65%	300%	
80%	500%	Virtually Impossible!
90%	1,000%	

¹ To make up the loss and equal the terminal wealth of an investor who did not suffer the loss (and earned a simple 4% per year).

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LESSONS LEARNED

Preserving capital during hostile periods is THE most important activity of a professional investment advisor.

- Possible to make a “comeback” from a 33% loss.
- Virtually impossible to make a “comeback” from a 80% loss.

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IMPLICATIONS

Notwithstanding the past 20 years, it is very difficult to earn even a 10% compounded annual rate of return.

Investment success is a result of several factors:

- ∇ Be skeptical about what the “in crowd” *really* knows.
- ∇ Hold down investment costs (fees and commissions).
- ∇ Reduce turnover...and greatly reduce taxes.

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FIDUCIARY RESPONSIBILITIES



DEFINING A “FIDUCIARY”

What is a “Fiduciary”?

A Fiduciary is a person in a position of trust who has a control responsibility for a Fund.

Who is a Fiduciary?

YOU are likely a Fiduciary if you make decisions and control the investment or disposition of money.

What do you need to know to be an effective Fiduciary?



WHAT YOU NEED TO KNOW...

- ▽ Pre ERISA*: Mandate was for Fiduciary to “act prudently.”
- ▽ Since 1974: A higher standard was established.
- ▽ Must act as a “prudent expert.”

* Employee Retirement Income Security Act of 1974



PRUDENT EXPERT

Permitted to use outside experts.

- ▽ Investment management firms (“Managers”):
 - Investment advisors
 - Banks
 - Insurance companies.
- ▽ Investment Consultants
- ▽ Bank trustees
- ▽ Attorneys
- ▽ Accountants.



PRUDENT EXPERT

(continued)

Delegation

- ▽ Can delegate authority to outside experts
- ▽ Cannot abrogate all responsibilities
- ▽ Must maintain oversight responsibilities.



PRUDENT EXPERT

(continued)

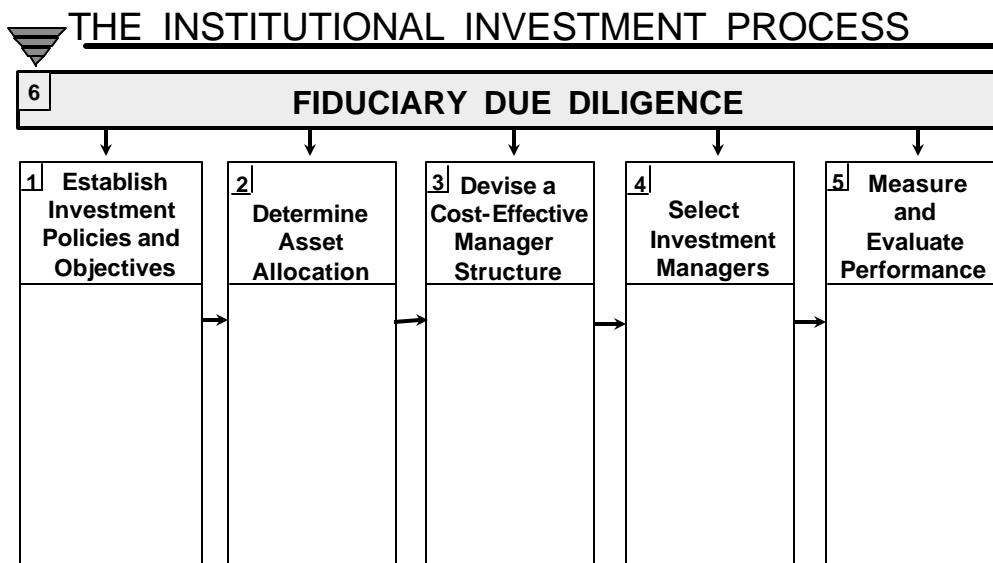
Conflict Free

- ∇ Must avoid “party-in-interest transactions” (“PITs”)
- ∇ Must report others’ (Fiduciaries’) PITs
- ∇ Must attempt to remedy others’ PITs.

THE INSTITUTIONAL INVESTMENT PROCESS

1

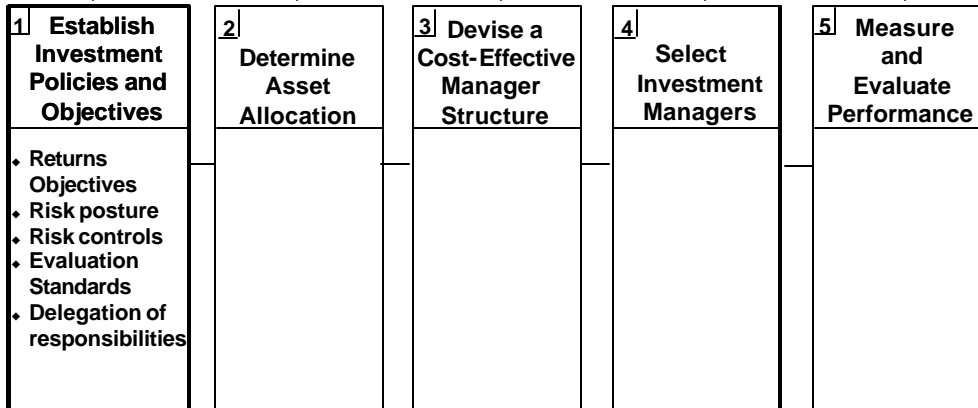
ESTABLISH INVESTMENT POLICIES



INVESTMENT POLICY

6

FIDUCIARY DUE DILIGENCE



RISK PREFERENCE

(continued)

- ∇ The Fiduciaries need to "feel" comfortable with the performance "consequences" of their Asset Allocation Policy decisions — the percentage allocated to stocks, bonds, alternatives, and cash.
- ∇ The worst situation would be for the fiduciaries to alter the Fund's asset allocation after an extended market decline .



SIX DIMENSIONS OF RISK

- ∇ Flexibility in asset allocation (static *versus* dynamic).
- ∇ Primary goal (capital preservation *versus* capital growth).
- ∇ Income *versus* growth trade-off.



SIX DIMENSIONS OF RISK

- ∇ Market volatility (“acceptable” volatility; benefits of asset-class diversification).
- ∇ Relative performance pattern (in rising markets; in declining markets).
- ∇ Collective ability to “stomach” market declines; take losses.

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DETERMINE ASSET ALLOCATION

THE INSTITUTIONAL INVESTMENT PROCESS



6 FIDUCIARY DUE DILIGENCE

1 Establish Investment Policies and Objectives

2 Determine Asset Allocation

- Stocks
- Bonds
- International
- Alternative investments
- Other

3 Devise a Cost-Effective Manager Structure

4 Select Investment Managers

5 Measure and Evaluate Performance

2-A

DETERMINE ASSET ALLOCATION Issues and Considerations



ASSET ALLOCATION

- ∇ Why is “Asset Allocation” important?
- ∇ Why is diversification important?
- ∇ What is the “Efficient Frontier”?
- ∇ How have various asset classes performed during other market periods?



“EFFICIENT FRONTIER” MODELING

Concept:

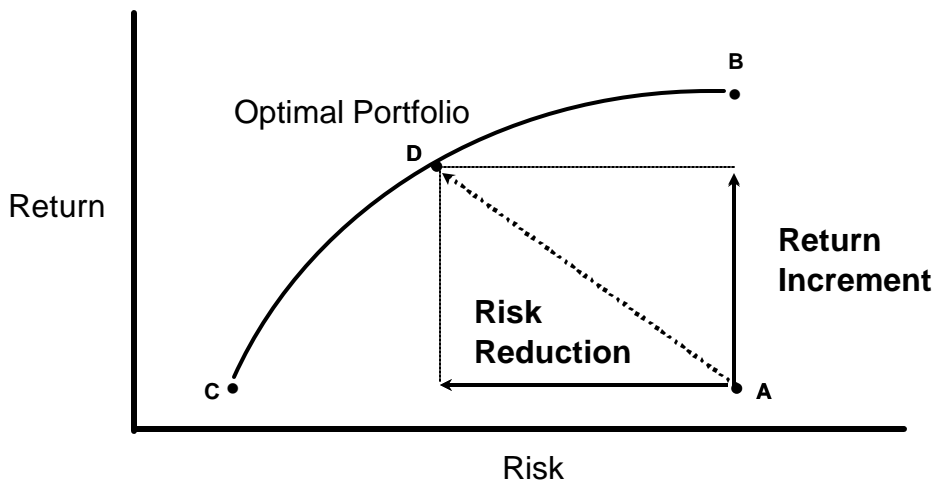
By blending properties of different asset classes, one can lower risk... and enhance expected returns.

Corollary:

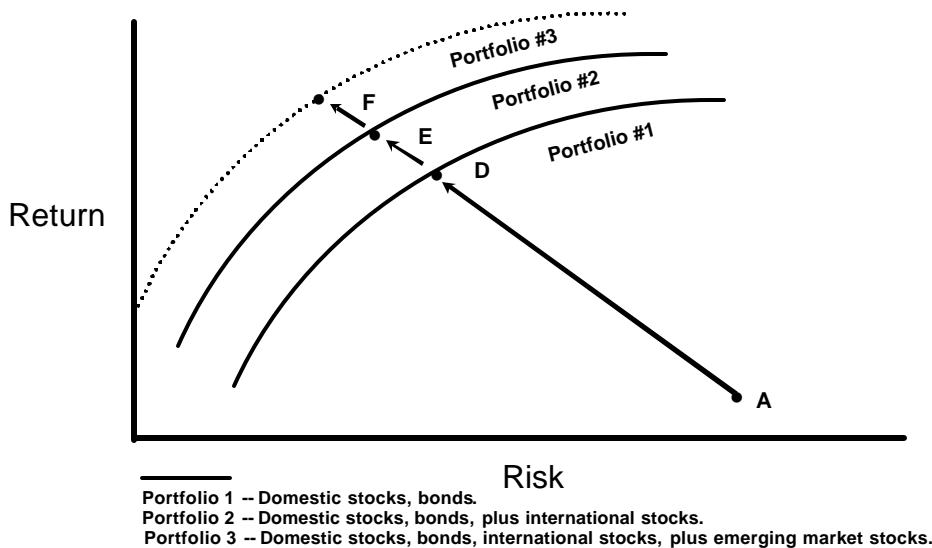
Certain blends are more “efficient” (more beneficial) than other blends.



BENEFITS OF DIVERSIFICATION Optimizing the Portfolio Tradeoffs



BENEFITS OF DIVERSIFICATION Adding Asset Classes



ADDING ADDITIONAL ASSET CLASSES TO YOUR FUND'S PORTFOLIO

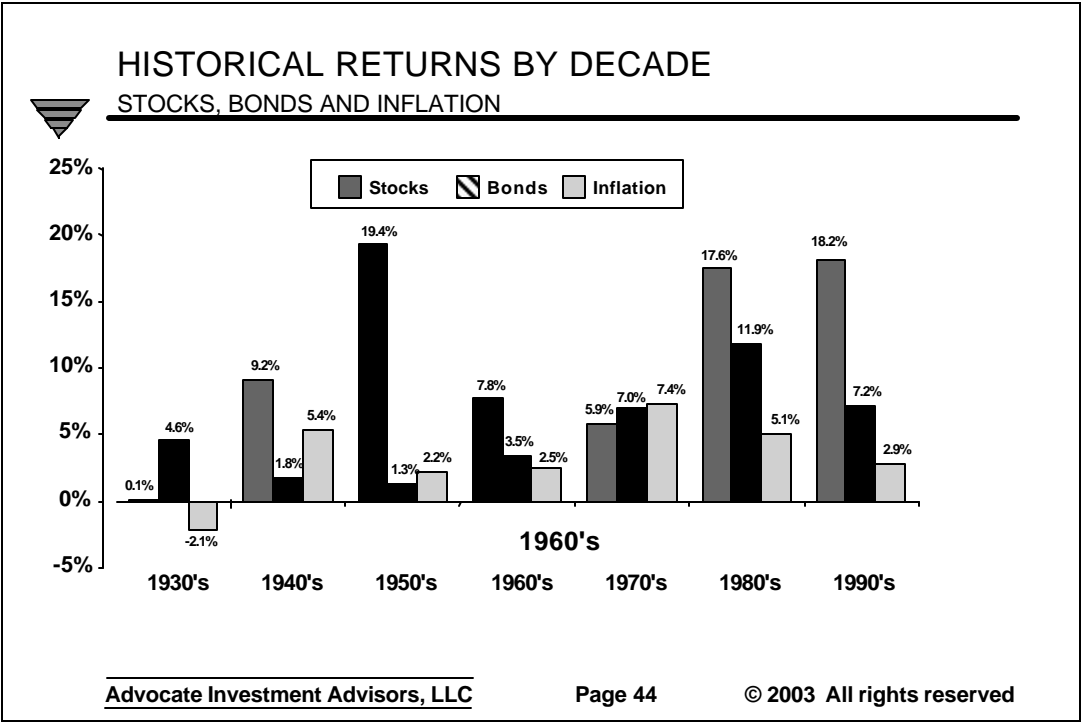
(continued)

- ▽ Portfolio diversification benefits are the driving force behind the use of additional asset classes...and investment styles.
- ▽ BUT, be aware that over-diversification results in higher costs.. that can, inadvertently, REDUCE long-term returns.

2-B

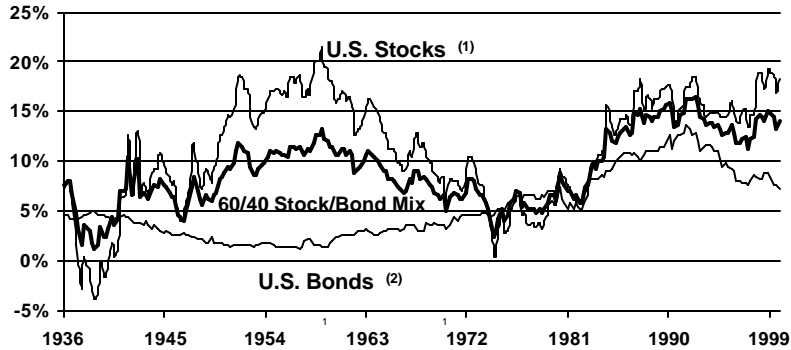
DETERMINE ASSET ALLOCATION

Capital Markets History



STOCK and BOND MARKET RETURN PATTERNS

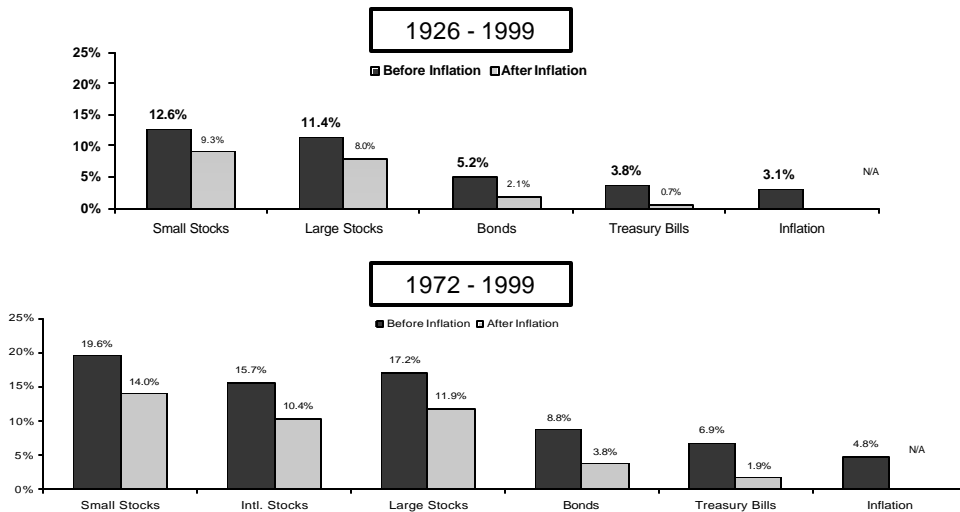
ROLLING 10-YEAR CUMULATIVE ANNUALIZED RETURNS (1926 - 1999)



The return patterns from stocks and bonds vary markedly. But over virtually all long-term periods, stocks outperform bonds. A combination of stocks and bonds preserves much of the upside from stocks while reducing volatility.

Source: Ibbotson Associates.
 (1) Stocks represented by the S&P 500 Stock Index.
 (2) Bonds represented by the Ibbotson U.S. Intermediate-term Government Bond Index.

RETURNS OF DIFFERENT ASSET CLASSES

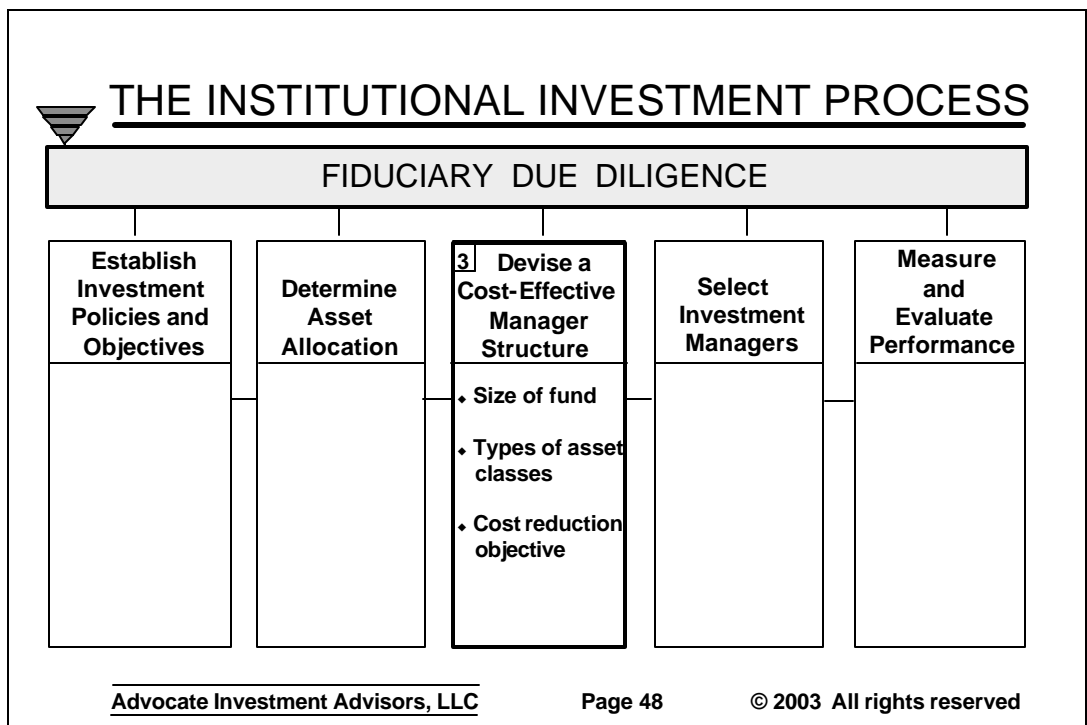


Source: Ibbotson Associates.

3-A

MANAGER STRUCTURE

Defining the Issues





WHAT IS “MANAGER STRUCTURE” ?

- ∇ The number of Managers used
- ∇ The types of Managers used
- ∇ The investment vehicles used.



WHY IS THIS IMPORTANT?

A well-designed Manager Structure leads to:

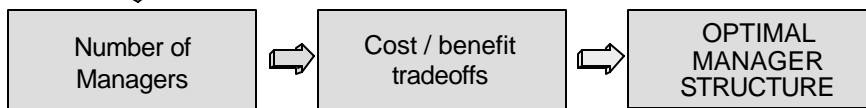
- ∇ Reduced costs
- ∇ More effective fund administration
- ∇ Enhanced flexibility to make changes.

ESTABLISHING A DIVERSIFIED MANAGER STRUCTURE



Key Factors to Consider

- ◆ Separate accounts *versus* Commingled / mutual funds
- ◆ Active *versus* Passive (“ Indexed ”)
- ◆ Specialists *versus* Balanced
- ◆ In-house *versus* External Manager



3-B

MANAGER STRUCTURE: Separate Accounts *versus* Mutual Funds

THE BENEFITS OF USING SEPARATE ACCOUNTS



For larger fund allocations, separate accounts make sense:

- ▽ Fees are lower.
- ▽ Control: can impose specific investment policies.
- ▽ Tailor-made portfolios.
- ▽ Possibly benefit by directed brokerage commissions.
- ▽ No restrictions on timing of withdrawal from Managers.

BENEFITS OF USING MUTUAL FUNDS



For smaller fund allocations, mutual funds make sense:

- ▽ Gain access to Managers with high minimum account-size restrictions **(beyond your capability)**.
- ▽ Typically, portfolio holdings are very similar to that Manager's separate accounts.
- ▽ Spread assets--enhance overall fund diversification--among a more varied group of Managers.
- ▽ Capture cost advantage of "block trading."
- ▽ Preserve exit privilege without transaction costs.

3-C

MANAGER STRUCTURE Asset-size Guidelines



MANAGER STRUCTURE: ASSET-SIZE GUIDELINES (per Manager)

<u>Asset Class</u>	<u>For Assets "less than..." use Commingled / Mutual Funds</u>	<u>For Assets "more than..." use Separate Accounts</u>
--------------------	--	--

NOTE: These are rough "rules of thumb."

**MANAGER STRUCTURE:
ASSET-SIZE GUIDELINES (per Manager)**



<u>Asset Class</u>	For Assets "less than..." use Commingled / Mutual Funds	For Assets "more than..." use Separate Accounts
U.S. - Large Cap	\$ 15 million	\$ 25 million
U.S. - Small Cap	\$ 5 million	\$ 10 million
U.S. - Bonds	\$ 25 million	\$ 50 million
International Equities - Developed Markets	\$ 30 million	\$ 50 million
International Equities - Emerging Markets	\$ 40 million	\$ 60 million

**MANAGER STRUCTURE:
ASSET-SIZE GUIDELINES (per Manager)**



<u>Alternative Asset Classes</u>	For Assets "less than..." use a Fund or a Fund-of-Funds	For Assets "more than..." can buy individual deals
Real Estate	< \$100 million	> \$100 million
Venture Capital	< \$ 50 million	> \$ 50 million
Hedge Funds	<i>Depends on specific approach of fund; usually \$1.0 to \$5.0 million</i>	

3-D

MANAGER STRUCTURE Observations and Comments



OBSERVATIONS AND COMMENTS

▽ More different types of asset classes and managers:

- Improved Diversification.
- Less concentrated risks.



OBSERVATIONS AND COMMENTS

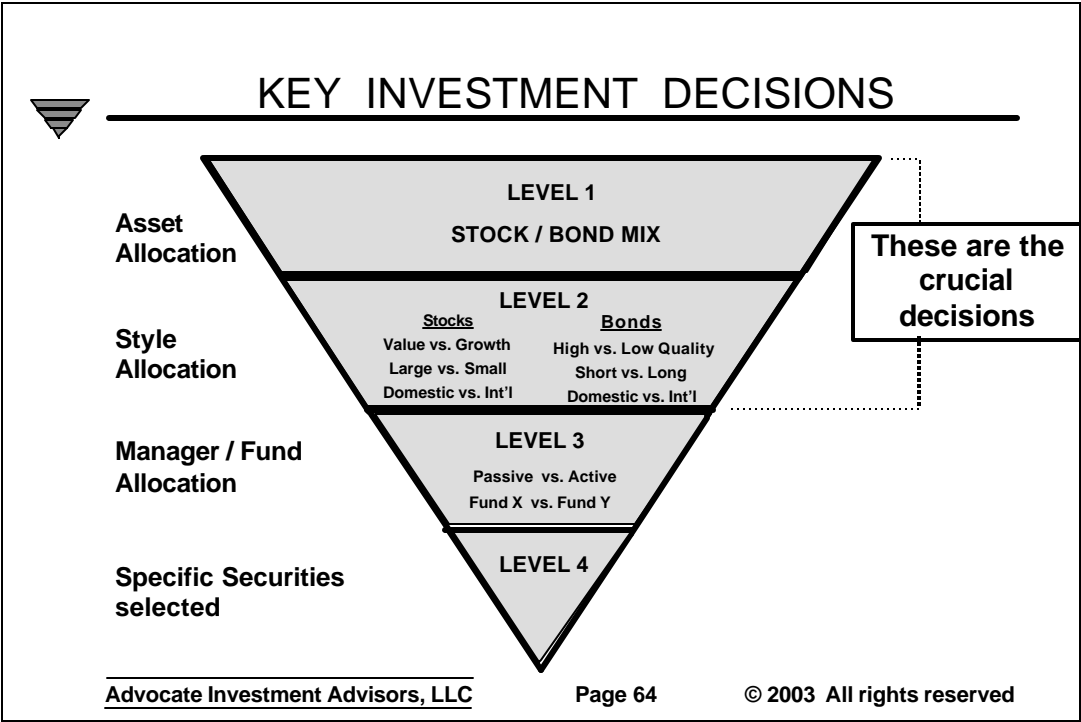
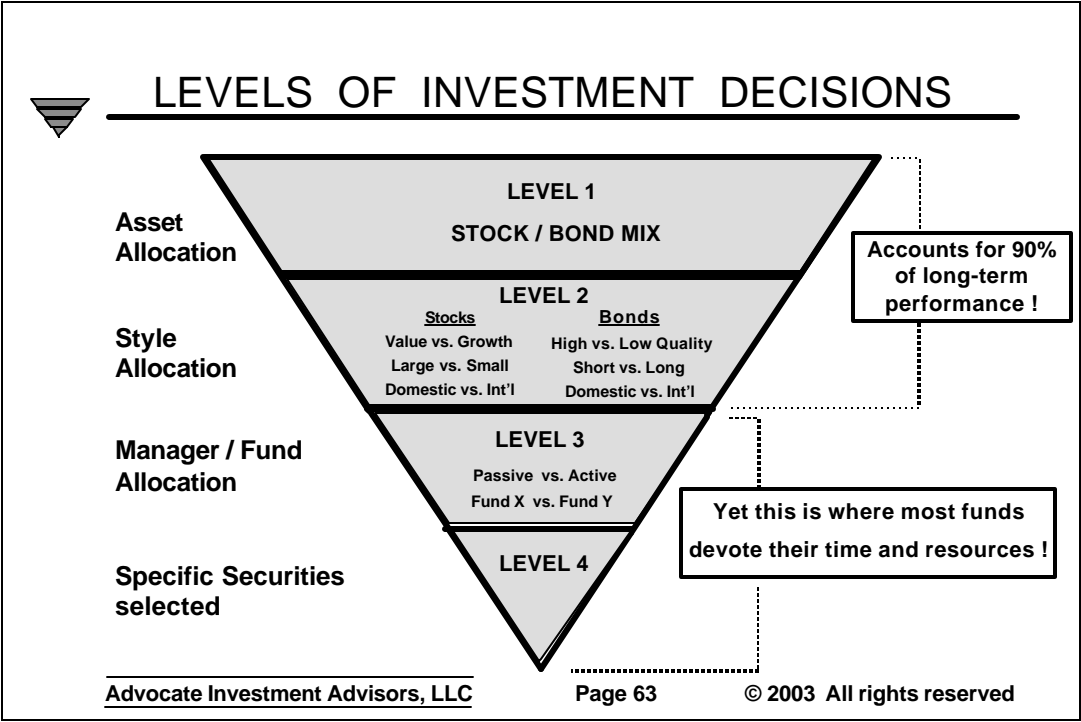
But...

▽ Marginal cost of adding Investment Managers:

- Higher Manager fees.
- Higher Consultant fees.
- Higher performance measurement fees.
- Higher custodian fees.

4

SELECT INVESTMENT MANAGERS





AN INVITATION...

If you would like to learn more about this...

I invite you to attend my talk tomorrow,
Wednesday, May 14th, at 11:00 AM

"Improving Manager Selection"

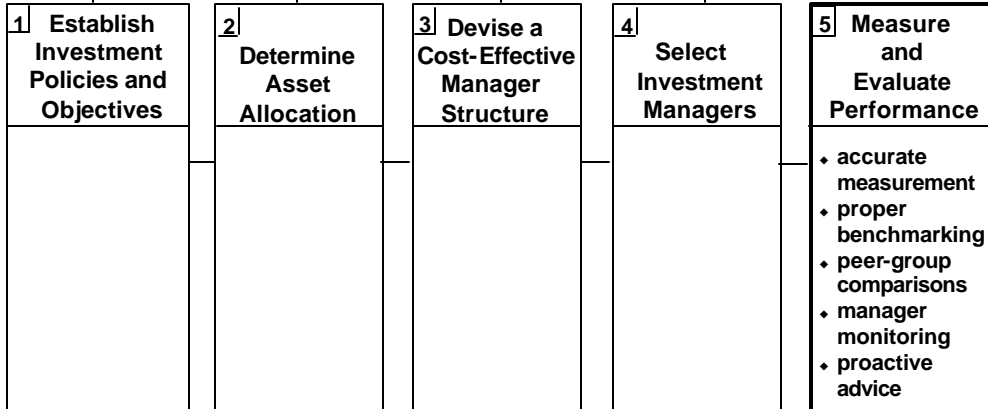
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MEASURE & EVALUATE PERFORMANCE



THE INSTITUTIONAL INVESTMENT PROCESS

6 FIDUCIARY DUE DILIGENCE



5-A

MEASURE & EVALUATE PERFORMANCE

Performance Measurement Universes



DETERMINING A PERFORMANCE "UNIVERSE"

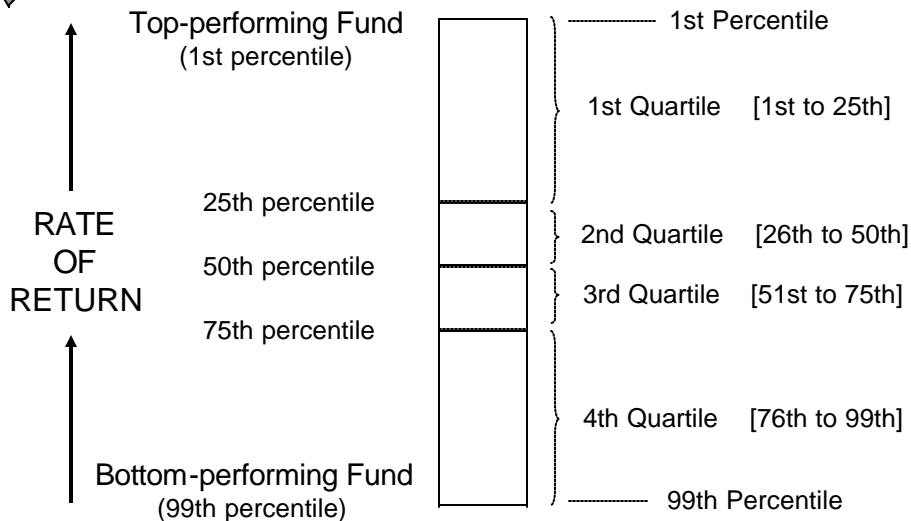
Step 1: Set a time period

Step 2: Select an asset class or investment style

Step 3: Rank order funds' returns from high to low.



QUARTILE RANKINGS





PERFORMANCE MEASUREMENT

ANALYSIS

Various Time Periods

- Periods ending.
- Annual periods.
- Rolling time periods.

Market Cycle

- Rising periods.
- Declining periods.

Risk Adjusted

- Sharpe Ratio.
- Modigliani Ratio.



PERFORMANCE EVALUATION & COMPARISONS

COMPARISONS

To the Market

- Market indices
- Benchmarks

To Other Funds or Managers

- Universes
- Peer groups.

5-F

MEASURE & EVALUATE PERFORMANCE: The Need for Proactive Advice

PERFORMANCE EVALUATION: ONLY FOUR POSSIBLE ACTIONS



- ∇ No change in Manager or allocation.
- ∇ Add assets.
- ∇ Remove assets.
- ∇ Dismiss Manager.



ADVOCATE'S ADVICE

- ∇ Avoid Manager changes, if possible:
 - Give Manager time to perform.
 - Frequent changes cost money !
 - Conduct a more intensive Manager research effort up front.
 - *pay for outside expertise*

- ∇ But, don't avoid changes, if required!



A THOUGHT FOR REFLECTION...

In considering taking action to retain or dismiss a Manager:

Your Consultant's total independence (or lack of independence) is (or should be) a crucial factor !

6

SELECTING A CONSULTANT



PRESENTATION OUTLINE

6. Select a Consultant
 - A. Consultant's strengths and weaknesses
 - B. Uncovering unethical practices
 - C. What to Avoid: The alarm signals

6-A

SELECTING A CONSULTANT: Consultant's strengths and weaknesses



DESIRED CONSULTANT'S STRENGTHS

Seven Desirable Characteristics

1. Experienced team with considerable perspective.
2. Focused objective: To achieve superior risk-adjusted long-term returns.
3. Initiate proactive, written advice.
4. Results oriented: Favorable long-term track record.



DESIRED CONSULTANT'S STRENGTHS

Seven Desirable Characteristics

(continued)

5. Tenure of senior professionals.
6. Continuity of senior professionals.
7. Stability in ownership.



UNDESIRED CONSULTANT'S WEAKNESSES

Ten Undesirable Characteristics

1. Inkling that you are not an important client
2. History of lack of continuity in firm's client relationships
3. Concentrated ownership structure
4. No succession plan
5. High turnover among professional staff.



UNDESIRABLE CONSULTANT'S WEAKNESSES

Ten Undesirable Characteristics

(continued)

6. Assignment of an inexperienced consulting team
7. Avoids giving advice; rarely initiates ideas
8. Sloppy about details...and deadlines
9. Consultant places its interests ahead of its Client's best interests. Possible Conflicts Of Interest
10. Not independent; Actual Conflicts Of Interest !



CONSULTANT INDEPENDENCE ... OR LACK THEREOF

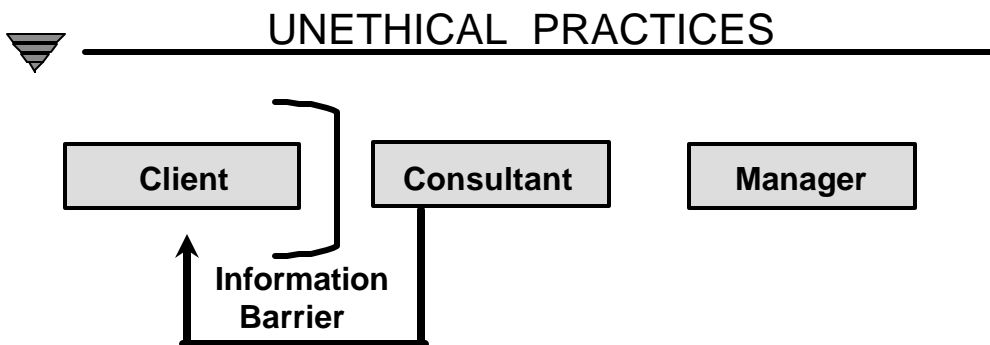
Some Consultants are totally independent.

Other Consultants are not independent. They are fraught with conflicts of interest.

Consultants' lack of independence is a very important subject... and not often discussed.

6-B

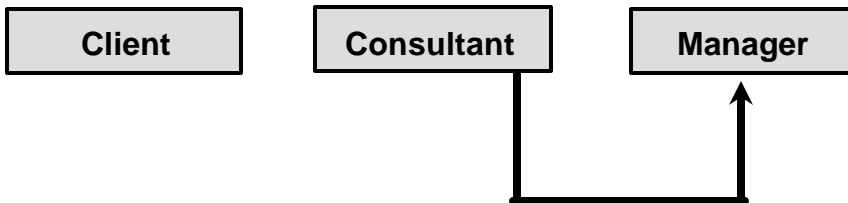
SELECTING A CONSULTANT: Uncovering Unethical Practices



- ◆ Consultant sells services to Client ... at a deeply discounted fee.
- ◆ Consultant downplays or doesn't disclose other sources of income.

UNETHICAL PRACTICES

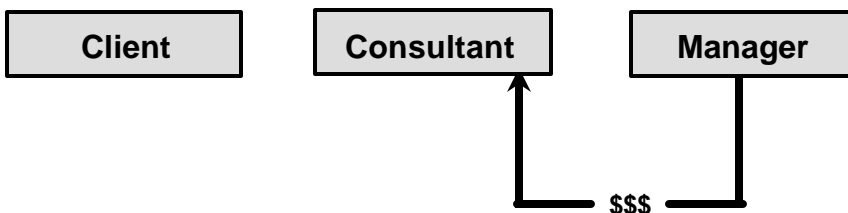
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- Consultant sells services to the Manager.

UNETHICAL PRACTICES

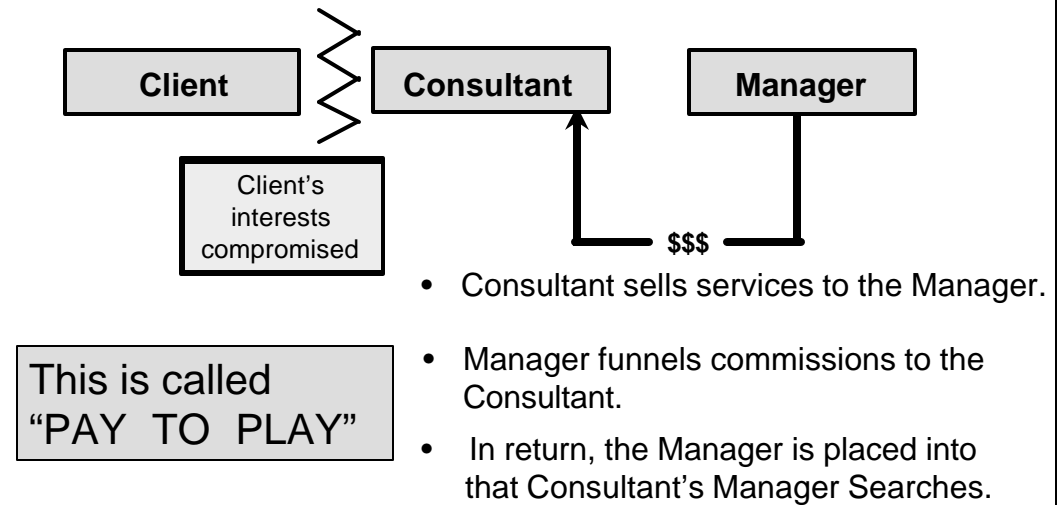
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- Consultant sells services to the Manager.
- Manager funnels commissions to the Consultant.

UNETHICAL PRACTICES

(continued)



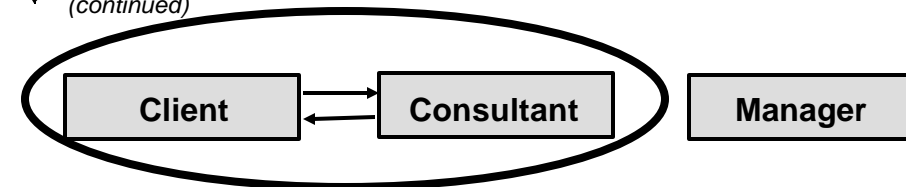
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UNETHICAL PRACTICES

(continued)



You THINK that YOU are the Consultant's Client ?

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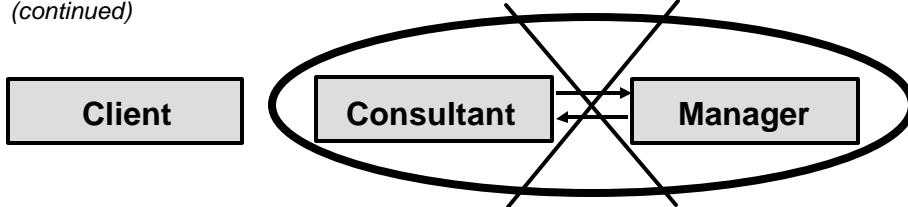
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UNETHICAL PRACTICES

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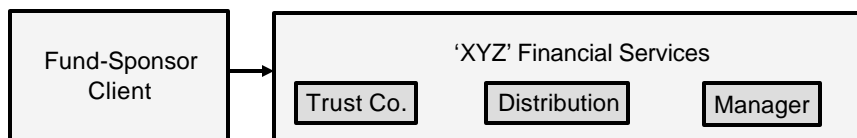


The Manager is really the Consultant's client.

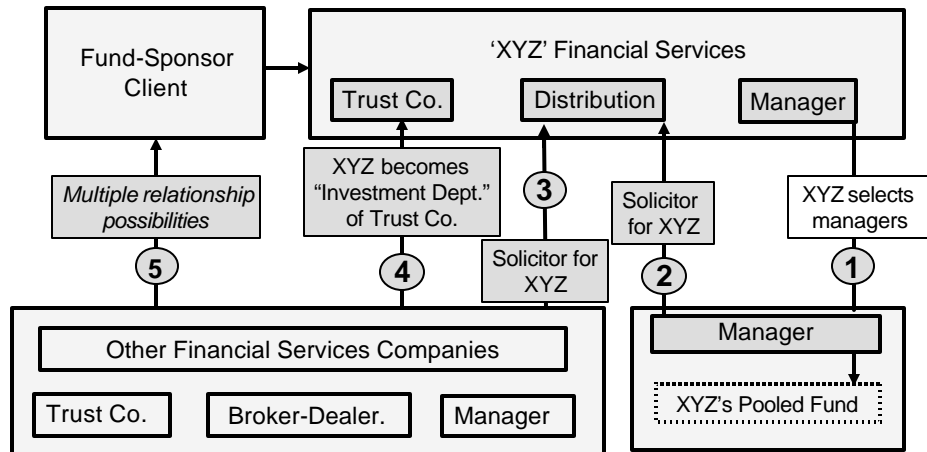
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CASE STUDY: WHAT THE CLIENT SEES



CASE STUDY: THE "FULL MONTY"



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WHAT IF YOUR CONSULTANT IS NOT REALLY INDEPENDENT ?

▽ YOU, as a Fiduciary, have the responsibility to:

- investigate ...and uncover...these abuses.
- correct these ethical violations.

RECOMMENDATION: If you find that a "Pay-to-Play" relationship exists between your Consultant and any Manager, immediately dismiss both parties !

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THE DILEMMA

How can you detect a “problem” with your current Consultant if you do not know what to look for?

6-C

WHAT TO AVOID:
The Alarm Signals



THE ALARM SIGNALS

- ▽ Your Consultant reluctantly recommends S&P 500 Index Funds

- ▽ Your Consultant has a brokerage affiliate... or is owned by a brokerage firm.

- ▽ Your Consultant accepts “soft dollars.”



THE ALARM SIGNALS

(continued)

- ▽ Your Managers attend a Consultant-sponsored conference... for \$70,000 per year !

- ▽ Your Manager sponsors a portion of the Consultant’s client conference

- ▽ Your Manager buys “marketing consulting” advice from the Consultant (getting a better sales brochure).



THE ALARM SIGNALS

(continued)

- ▽ Your Consultant sells services to Managers — for “hard dollars” or “soft dollars.”
- ▽ Your Consultant’s fees are lower than most other consultants.
- ▽ Your Consultant entertains lavishly.



ANOTHER INVITATION...

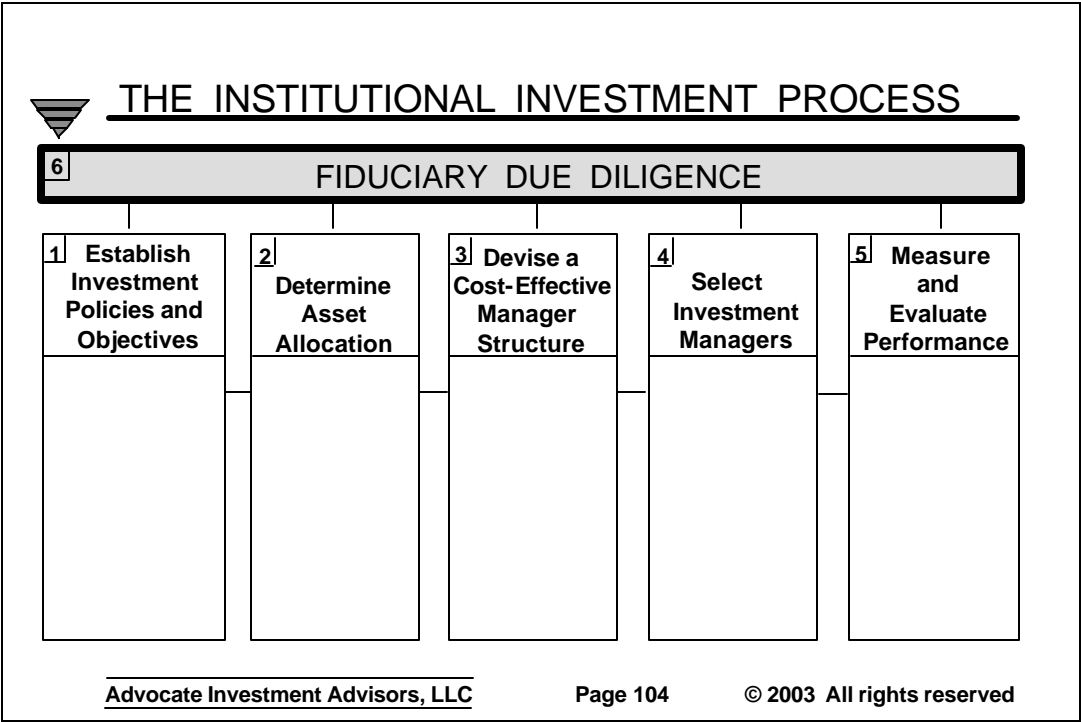
If you would like to learn more about
Consultants’ unethical practices...

I invite you to attend my talk on
Friday, May 16th, at 10:00 AM

“The Hard Truth About Soft Dollars”

7

FIDUCIARY DUE DILIGENCE





THREE AREAS OF FIDUCIARY SCRUTINY

- ∇ Fund-sponsor Fiduciaries
- ∇ Consultant
- ∇ Investment Managers.



FIDUCIARY CHECKLIST

Fund-sponsor Fiduciaries

- ∇ Is there a relationship between any Fund Fiduciary and:
 - the Consultant ?
 - the Managers ?

- ∇ Are there any financial/business/ family relationships ?



FIDUCIARY CHECKLIST

Consultant

- ∇ Does the Consultant do any business with any Investment Manager currently (or formerly) used used by your Fund?
- ∇ How about the Consultant's related entities — parent organization, subsidiary, affiliate, or joint venturer?
- ∇ Are the Consultant's fees — and sources of revenue — fully disclosed?



FIDUCIARY CHECKLIST

Managers

- ∇ Is the Manager treating your account the same as its larger accounts?
- ∇ Is the Manager a stable organization?
- ∇ Is the Manager trying to keep turnover and transaction costs low?
- ∇ Is the Manager voting your proxies with your interests in mind?



FIDUCIARY CHECKLIST

Managers *(continued)*

- ∇ How much brokerage business is done for “Soft Dollars” (which benefits the Manager)?
- ∇ At what commission rates are trades executed?
- ∇ Does the Manager buy services from the Consultant ...or its related entities?



FIDUCIARY DUE DILIGENCE OF BROKERAGE COMMISSIONS

- ∇ Fund Fiduciaries are charged with supervising and monitoring the use of brokerage commissions.
- ∇ It is the Fiduciaries' responsibility to ensure that brokerage commissions are utilized properly.
- ∇ There can be potential abuses.
This area requires constant vigilance.



MINDSET OF AN EFFECTIVE FIDUCIARY

- ▽ Know what you know... and don't know.
- ▽ Be open minded to new ideas...but seek widespread evidence (not word of mouth).
- ▽ Understand your personal investing biases...
... and be aware of their influence.



SOME CONCLUDING THOUGHTS

- ▽ As a Fiduciary, you are charged with serving the best interests of your fund beneficiaries.
- ▽ Obtain advice that is TOTALLY independent.
- ▽ Use common sense in making judgments.
- ▽ Look out for hidden conflicts of interest.
- ▽ Watch your costs!