An investigation of the role of trust in the relationship between pension fund trustees and investment managers: an Indonesian case study

Djoko Wintoro
University of Wollongong


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Chapter 1

Introduction

1. Background.

In the pension fund industry, the trustees typically use the services of investment managers to actually invest the funds that are contributed to members and employer. A proportion of these funds are invested in various types of securities in the stock market with the aim of obtaining returns over a long investment period. Investment managers can, and do provide, a whole range of investment services to the trustees which can range from complete administration of the total investment to one specific role, such as managing active investments. Providing investment services to trustees can be complicated because there are several layers of investment managers, several layers of investment decisions to be made, and a number of investment products on offer to trustees by investment managers. Consequently, the form of relationship established between trustees of pension funds and investment managers varies considerably, as does the number and nature of the parties in these relationships. Nevertheless, these relationships have much in common. The investment manager offers for a fee a range of investment services to the trustee. Therefore, the trustee scrutinises the investment manager’s performance past and present, and proven trustworthiness in order to obtain the maximum benefits from using the investment services on offer.
2. The Research Questions

Not much is known about a trustee’s need of trust in building and developing a relationship with an investment manager, so this study is, therefore, essentially exploratory. In this thesis, trust is defined as the willingness of the trustee to be vulnerable to the actions of the investment manager based on the expectation that the investment manager has a high degree of trustworthiness and will perform a particular action important to the trustee, irrespective of the ability to monitor or control the investment manager (adapted from Mayer, Davis, and Schoorman, 1995, p.724).

This definition of trust implies that there are three critical factors of trust: (a) the willingness of the trustee to be placed in a vulnerable situation, (b) the expectations of the trustee in the relationship, and (c) the confidence of the trustee in the trustworthiness of the investment manager (Mayer, Davis, and Schoorman, 1995). This thesis focuses on two critical aspects of the relationship between the trustee and the investment manager: (i) the key factors of trustworthiness of the investment manager which are required by the trustee to reduce risks in the relationship (Sheppard and Sherman, 1998), and (ii) key activities performed by both the trustee and the investment manager in building their relationship which can be divided into two stages: an early and a long-term relationship. This leads to two major research questions:

(1) What are the key factors of trustworthiness of the investment manager from the perception of the trustee of pension funds in Indonesia?
(2) How do pension fund trustee and investment manager in Indonesia develop their relationship?

An investment manager is defined as a qualified person, on behalf of a body corporate, appointed by the trustee of a fund to invest funds on his/her behalf (adapted from section 10(1) of the SIS Act 1993).

A trustee, in relation to the pension fund, is a person who manages the fund (adapted from section 10(1b) of the SIS Act 1993).

The major duty of the trustee of the pension fund in relations to investment management is the selection of investment managers and the evaluation of his/her performance (Brown, Draper, and McKenzie, 1997).

Key factors of the trustworthiness of an investment manager are defined as those attributes of the investment manager that enhance the confidence of the trustee to trust in him/her (Mayer, Davis, and Schoorman, 1995).

Key activities are defined as the activities agreed by both the trustee and the investment manager as important activities for building their trust relationship (Lewicki and Bunker, 1996).

3. The Purpose of the Study

The purpose of this study is to investigate the role of trust in building and developing a relationship between the trustee and the investment manager in a developing country (Indonesia) with immature but developing capital markets and a growing pension fund industry. The investigation focuses on two critical aspects of a relationship that are thought to be the most significant for building and developing their relationship. These two aspects are the trustworthiness of the investment manager, and the key activities performed by the trustee and the investment manager for building their relationship.
A theoretical model of trust developed by Mayer, Davis, and Schoorman (1995) is used to identify and investigate the key factors of trustworthiness of investment managers that are used by trustees as criteria for the selecting and hiring of an investment manager. The stages of a trust relationship development proposed by Lewicki and Bunker (1996) are used to identify the key activities performed by both the trustees and investment managers for building and developing their relationship.

4. Motivation of This Study.

The investment activities of pension funds in the stock markets showed that: (i) trustees of pension funds give mandates to professional investment intermediaries to manage their active investments (Kumples and McCrae, 1999; Jeanette, 1997); and (ii) that trustees of medium to large pension funds continue to use more than one investment manager to manage their active investment (Fant and O’Neal, 1999; Ennis, 1997). However research has largely concentrated on the performance of pension funds (Kumples and McCrae, 1999), the performance of the pension funds’ investment managers (Brown, Draper, and McKenzie, 1997), and the performance of mutual fund managers (Chevaliuer and Ellison, 1999).

Not much is known about the underlying factors which determine the building and developing of the relationship between the trustee of a pension fund and the investment manager who receives a mandate from the trustee to manage active investments. There has been some research into the relationship between investors
and mutual funds' investment managers (Gruber, 1996; and Goetzman and Peles, 1997) but an answer is still needed to the question of why investors continue their relationship with investment managers who have delivered a poor performance.

This thesis argues that trust is important for the trustee in building a long-term relationship with the investment manager for a number of reasons. Firstly, the trustee relies on an investment manager to obtain returns on the investments although it is realised that the actual returns may be above or below the returns benchmark. In such a situation, the trustee has no option except to trust in the investment manager who will provide his/her best efforts. Secondly, the trustee bears a risk in the relationship with an investment manager such as the risk of cheating. In order to reduce such a risk, the trustee must rely on the honesty and integrity of the investment manager (Sheppard and Sherman, 1998). The trustee will obtain additional benefits with the proven trustworthiness of the investment manager; these benefits include a reduction in the costs of monitoring the behavior of an investment manager, and a reduction of conflict with an investment manager.

5. Case Selection.

An Indonesian case study of the relationship between Indonesian trustees of pension funds and investment managers is selected for research. This relationship is the result of the trustees having the power to appoint investment managers, and the ability of investment managers to provide investment services and products to trustees.
5.1. The Indonesian Trustee of Pension Funds.

The Indonesian pension funds industry is in its early stages of development, in terms of the number of pension funds, the amount of regulations in relation to the services of pension funds, the total number of employees covered by pension plans, and the inexperience of trustees in managing the pension funds.

The pattern of investment of Indonesian pension funds in the stock market has some similarities to the pattern experienced by those countries with a more developed pension fund industry, such as the Australian superannuation funds industry (see chapter three). These similarities include (i) rapid growth in the amount of funds invested in stocks and bonds via an investment manager, (ii) the trustees of large pension funds hiring more than one investment manager for their active investments, and (iii) the trustees being responsible to their members for the investment performance. There are, however, some differences, these are: (i) most Indonesian trustees lack investment knowledge and experience in investing in the stock market; (ii) most Indonesian trustees select and hire an investment manager directly without using a management consultant; and (iii) most Indonesian trustees of large pension funds expect to obtain from the investment manager not only investment returns but also a transfer of investment knowledge.

5.2. The Indonesian Investment Management

The Indonesian investment management industry is also in the early stages of development in term of the number of firms, investment products offered to the
clients, and the expertise of the investment manager of managing active investments on behalf of his/her client.

The services offered by Indonesian investment managers are similar to those of investment managers in a developed stock market, such as the Australian, in dealing with the trustees of the pension funds (see chapter 2). These are: (i) the investment manager receives a mandate to manage active investments on behalf of the trustee; (ii) the investment manager offers several investment products to meet the various needs of the trustee; and (iii) the investment manager provides investment services. There are, however, some differences, these are: (i) the Indonesian investment managers’ investment experience is of a short of duration, (ii) they have limited experience in building a relationship with the trustee; and (iii) the individual investment manager’s style is unknown to the trustees.

The characteristics of the Indonesian pension funds and investment management industries indicate that the trustee bears considerable risk in the relationship with the investment manager, for two reasons. Firstly, the trustee may lack the knowledge to monitor and evaluate the performance of an investment manager. Secondly, the trustee may hire the wrong investment manager because of insufficient information about his/her performance record. This thesis explores trust further in order to establish whether the Indonesian trustees emphasis the trustworthiness of the investment manager in order to reduce their risks in the relationship.
6. Review of Previous Studies on the Relationship Between the Investors and the Investment Managers

To date there has been little research in the relationship between investors who may be individuals or institutions, and their investment manager, except for the work by DeBondt (1993); Gruber (1996); and Goetzman and Peles (1997). However these studies do not give sufficient explanation as to why some investors, such as the trustees of pension funds, continue with a long-term relationship with an investment manager who has performed poorly. They only found that investors have: (i) avoided responsibility by shifting their investment responsibility to the investment managers (DeBondt, 1993), (ii) transferred their potential regret to the investment manager (DeBondt, 1993), (iii) suffer from insufficient investment knowledge that would lead to reliance on the investment manager (Gruber, 1996), and (iv) been influenced by their cognitive dissonance as a response to poor performance (Goetzman and Peles, 1997). This evidence implies that each type of investor may have different reasons for building and developing a relationship with a chosen investment manager. Therefore, a specific detailed study of one type of investor may be useful in understanding this relationship phenomena. This thesis focuses on the trustees of pension funds as the institutional type of investor in the stock market, and their relationship with investment managers.

DeBondt (1993) reported that there is a paradox within the stock market.

The great majority of individual participants and institutional players in the stock market continue to believe that they can benefit from professional investment advice. Most troubling of all, virtually no
studies have shown that professionally managed portfolio systematically outperform randomly selected portfolios. So the question arises: why do investors continue to pay attention? (p. 121-122).

DeBondt (1993) provides an explanation to this paradox by using regret and responsibility shifting in the case of institutional investors. Firstly, the emergence of institutional investors as the dominant participants of the stock market are part of the trend of the increasing investment fund management industry. Secondly, most institutional investors prefer to shift their responsibility for risky investment decisions to outsiders, such as investment managers or investment advisers. This is because the institutional investors believe that the investment manager, for example, has expertise on investing in the stock market. Thirdly, institutional investors hire investment managers for the purpose of avoiding the psychological cost of possible regret. If the chosen investment manager performs poorly, he/she can serve as the scapegoat. The institutional investors, on the other hand, can maintain their image as reasonable and prudent investors. Finally, DeBondt (1993) acknowledges that regret and responsibility shifting are important, but it is still not enough to explain the relationship between investors and the investment manager who has a poor performance record. It will be argued here, that the relationship between the specific type of institutional investor (e.g., pension funds) and the investment manager needs detailed exploration.

Gruber (1996) explain in his article that:

The more time I spent thinking about mutual funds, the more I was troubled by a question: why do investors buy actively managed mutual funds?...I will tell you that the average actively managed fund has negative performance compared to a set of indices (p.783).
In order to understand why investors are attracted to mutual funds, he examines the average performance of 270 mutual funds from January 1985 to December 1994. The results of this examination showed that performance of mutual funds, on average, is below the risk adjusted returns of the market index used as the benchmark. On the basis of this result, Gruber (1996) proposes a possible explanation of why investors buy actively managed funds even if their performance is below the benchmark. Firstly, the majority of poor performance funds are held by unsophisticated investors, institutional disadvantaged investors and tax disadvantaged investors. Secondly, unsophisticated investors buy mutual funds based not only on performance but also advertisement and advice from others although they are aware that this fund provides negative returns. Thirdly, institutional disadvantaged investors, most of whom are trustee of pension funds, are restricted in their ability to remove their money from poor funds. Fourthly, those tax disadvantage investors who will not receive benefits from capital gains taxes if they remove their money from poor funds. This thesis argues that the Indonesian trustee of a pension fund is a typical example of an unsophisticated investor who seeks reassurance by means of building an early relationship with an investment manager which will, if successful, develop into a long-term one.

Goetzmann and Peles (1997) raised a question of the mutual fund industry when they queried:

why some investors stay with funds that consistently perform poorly (p.145).
They answer their question by using the cognitive dissonance theory proposed by Festinger (1957). His theory asserts that “individuals are distressed by conflicting cognitive elements, such as discrepancy between empirical evidence and past choice, and that they alter their beliefs to reduce this discomfort” (c.f. Goetzmann and Peles, 1997, p.146). In investment decision making, Goetzman and Peles (1997) argued that

cognitive dissonance can be considered a psychological cost that investors seek to reduce by adjusting their beliefs about the efficacy of past investment choices (Goetzman and Peles, p.146).

Goetzmann and Peles (1997) use a questionnaire to gather information from many mutual fund investors into the question of funds’ past performances. The result of their study showed that investors continue to hold onto a fund, for on average 2.15 years, even if the fund consistently performs poorly. The investors may justify their investment decision through biased belief about the fund’s past performance. This evidence implies that the cognitive dissonance effect on investors makes them stay in poorly performing funds. However, it will be argued here, that further study is required to provide key explanations as to why this is so.

6.1. Summary of Previous Studies on the Relationship Between the Investors and the Investment Managers

Previous studies on the relationship between investors and investment managers indicate that the impetus for investors in building long-term relationships with investment managers, even those managers who have poor performance records, come from several factors. These include: (i) transferring potential regret to the
investment manager as the scapegoat (DeBondt, 1993), (ii) shifting investment functions to the investment manager (DeBondt, 1993), (iii) attractive marketing of the funds (Gruber, 1996), and (iv) the cognitive dissonance of investors (Goetzmann and Peles, 1997). It can be inferred from these previous studies that among other factors, trust, might be an important component in building the relationship between investors and investment managers. To date, this has not been explored.

7. Review of Previous Studies on Trust in Business Relationship.

A risky and uncertain environment is one condition where trust is needed as a basis for a relationship (Bhattacharya, Devinney, and Pilluta, 1998; Chiles and McMackin, 1996), because trust provides the following necessary benefits to the parties in a relationship: (i) the maintenance of harmony in the human relationship (Lewis and Weigert, 1985); (ii) a reduction of fear in the relationship (Boon and Holmes, 1991); a reduction of costs of monitoring behavior (Shapiro, Sheppard, and Cheraskin, 1992); enhancing long-term orientation between parties (Ganesan, 1994); and speeding decision making and reducing transaction costs (Creeds and Miles, 1996).

This thesis argues that trust plays an important role in determining the quality of the relationship between the trustee of the pension fund and the investment manager. The quality of their relationship may be measured by the duration of the
relationship, cost of monitoring the behaviour of the investment manager, and the
degree of mutual understanding between the parties.

7.1. The Need for Trust.

There are several conditions that may lead to the necessity for trust in a relationship, these conditions include: (i) dependence on another person to obtain outcomes (Frost, Stimpson, and Maughan, 1978), (ii) optimistic expectations of the behavior of another (Hosmer, 1995), vulnerability from opportunistic behaviors (Chiles and McMackin, 1996), (iii) uncertainty in a situation which may lead to a positive or negative outcome in a long-term relationship (Chiles and McMackin, 1996), and (iv) an uncertain and risky environment (Bhattacharya, Devinney, and Pilluta, 1998). However, this last condition, it is generally agreed, is where trust is needed as a basis for a relationship because trust will provide benefits to both parties.

Moorman, Zaltman, and Deshpande (1992) propose that there are two major benefits to trust. Firstly, by trust in another, the mutual understanding between the parties in the relationship will increase; for example, the empirical results provided by Shemwell, Cronin, and Bullard (1994) show that trust and commitment are important aspects of a customer-service provider relationship. Wray, Palmer, and Bejou (1994) found that trust and satisfaction are important aspects to increase the quality of a buyer-seller relationship. Fram (1995) also found that openness in communication and interpersonal trust are important factors in maintaining a purchasing partnership. Secondly, by trust in another, the
quality of the relationship will increase as measured by: increasing satisfaction, enhancing loyalty, and reducing conflict. For example, in the study of the partnership between a distributor and a manufacturing firm, Anderson and Narus (1990) found that the manufacturing firms claim trust as a basis for enhancing satisfaction, and reducing conflict. In a study of the purchasing strategy of the buyer, Chow and Holden (1997) found that trust is able to enhance the buyer’s loyalty.

The trustee may emphasis trust as an essential component for building a relationship with an investment manager because the condition of their relationship is risky and uncertain. Firstly, investment in the stock market involves risk in the form of being unable to control returns, any potential loss to the funds, or any deviation of the actual returns from the expected target returns.

Secondly, the trustee can only hope that the investment manager will be seriously concerned with the trustee’s interests. For example, the investment manager will construct a securities portfolio that meets the client’s preferences, and provide investment services that help to keep the trustee well-informed. In these situations, trustees must use trust as a guide in assessing the trustworthiness of an investment manager and in performing activities that are needed for building and developing their relationship. It can be concluded therefore that the expectation of the trustees of obtaining benefits by hiring investment managers indicate their willingness to take risks in the relationship.
7.2 The Key Factors of Trustworthiness of an Investment manager.

Many studies indicate that the relationship between the trustee and the investment manager are determined not only by the ability of the investment manager but also some other factors of trustworthiness. For example, if the investment manager does not perform well within the stated period, but he/she demonstrates his/her honesty and acts with integrity, the investors may continue the relationship. However, if the investment manager does not consistently perform well over a long period and although he/she is still honest, the trustee of the pension fund will discontinue the relationship. This means that the relationship between the trustee and the investment manager may be based on various elements of trust which persuades the trustee to trust in the investment manager or not.

The level of trust which a trustee of a pension fund has in an investment manager tends to depend upon the key factors of trustworthiness exhibited by investment managers. These factors may include intention and competence (Cook and Wall, 1980), reliability and honesty (Johnson-George and Swap, 1982), goodwill (Ring and Van de Ven, 1992), competence, consistency, openness, integrity, loyalty (Butler and Cantrel, 1984; Schindler and Thomas, 1993), ability and value congruence (Sitkin and Roth, 1993), reliability and integrity (Morgan and Hunt, 1994), ability, benevolence, and integrity (Mayer, Davis, and Schoorman, 1995), competence, openness, concern, and reliability (Mishra, 1996), ability and intention (Nooteboom and Noorderhaven, 1997), consistency, integrity, sharing, communication, and concern (Whitener, Brodt, Korsgaard, and Werner, 1998), and loyalty and competence (Dooley and Fryxell, 1999).
7.3. The Stages in Development of a Trust Relationship

Trust appears to have the characteristic of gradual development over time when it goes through a number of definable stages (Rempel, Holmes, and Zanna 1985; Shapiro, Shepard, and Cheraskin, 1992; Lewicki and Bunker, 1996). This gradual development implies that the essence of trust is not static but dynamic within the stages of a relationship (Lewicki and Bunker, 1996). It is, therefore, important to explore the activities performed by both the trustee and the investment manager in establishing and building an early and later a long-term relationship that reflects the stages of a trust relationship.

Lewicki and Bunker (1996) divide the stages of trust development into calculus-based, knowledge-based, and identification-based. They give two reasons for this. The first is that trust has two major dimensions: cognitive and emotional. The cognitive dimension is the one most responsible for maintaining the balance in calculus-and knowledge-based trust but the emotional dimension is critical in identification based trust, because the feelings of personal attachment toward the other increases. The second reason is that the degree of trust is developed gradually and evolves from one stage to the other, such as calculus-based to knowledge-based, and knowledge-based to identification-based.

According to the Lewicki and Bunker's (1996) work on the stages of trust development, this thesis argues that a long-term trust relationship between the trustee of a pension fund and the investment manager may have an emotional dimension which is higher than the cognitive dimension of trust. This may be one
of the reasons why an investor, such as a trustee, stays with his/her chosen investment manager even though he/she has performed poorly. Firstly, a long-term trust relationship between a trustee and an investment manager can be in the stage of a knowledge-based or identification-based trust. At this stage trust elements such as honesty, integrity, and regular communication are more important than investment performance. Secondly, an early trust relationship may be at the stage of calculus-based trust where investment performance is more important than other elements of trust, such as benevolence. Using these stages of a trust relationship, this thesis will explore how trustees and investment managers develop their trust relationship. The aim is to find the key activities performed by both Indonesian trustees and investment managers for building this relationship.

8. Study Approach.

Since the development of the Capital Asset Pricing Model (CAPM) in the mid-1960s, a number of finance researchers have used risk adjusted performance to measure the performance of professionally managed funds by conducting quantitative research (Blake, Elton, and Gruber, 1993; Malkiel, 1995; Grinblatt and Titman, 1993; and Daniel, Grinblat, Titman, and Wermers, 1997). However quantitative approaches tended to neglect qualitative factors in the long-term relationship between the trustee and the investment manager. This is a major issue which this thesis will investigate by conducting qualitative research, in the form of a case study.
According to Frankfurter and McGoun (1996), qualitative research enables researchers to examine the behavior of market players in conjunction with cultural and social issues. They also suggest several qualitative research methods that are appropriate for studying the stock market: grounded theory, ethnography, and case study.

In this thesis, a case study is used to explore the key factors in the trustworthiness of an investment manager, and the key activities performed by both the trustee and the investment manager in building and developing their relationship. There are three reasons for this. Firstly, the case study is a rigorous research method for exploring the relationship between individuals (Orum, Feagin, and Sjoberg, 1991; Hamel, 1992); and uses primary and secondary data in answering the research questions (Yin, 1994). Secondly, the case study is a relevant research method to use in the early stage of research on a particular topic (Hill, 1993). Thirdly, the relationship between the trustee and the investment manager can be considered as a business relationship. The case study has been used to explore several business relationships, for example, Kozak and Cohen (1997) use it to explore distributor-supplier partnering relationships, and Lewin and Johnston (1997) explore the marketing relationship.

9. The Contribution of This Study.

The first contribution of this study is expected: (i) to add additional variables of perceived trustworthiness of model of trust developed by Mayer, Davis, and
Schoorman (1995), (ii) to add additional key activity of trust development proposed by Lewicki and Bunker (1996), and (iii) to combine these two models into a model of trust relationship between the trustee and investment manager.

The second contribution of this study is expected to be confirmation that the relationship between an Indonesian trustee and investment manager can provide: (i) empirical evidence of the factors of trustworthiness of a person as proposed by Mayer, Davis, and Schoorman (1995) in their model of trust, and (ii) empirical evidence supporting the argument of Lewicki and Bunker (1996) that trust in a relationship develops gradually through several stages.

The third contribution of this study is expected to provide useful information for: (i) the regulators of the Indonesian stock markets who issue regulations for the relationship between the Indonesian trustee and the investment manager, (ii) the trustee of a pension fund who may hire an investment manager by evaluating the degree of trustworthiness of an investment manager, and (iii) the investment manager who will demonstrate his/her trustworthiness by building a relationship with the trustee.

10. The Limitation of This Case Study.

The limitations of this research are related to the Indonesian case study, and the data collection methods. First, in the case study, the relationship between the trustee and the investment manager is very specific. This is because, firstly the Indonesian pension fund industry, the Indonesian investment management
industry, and the Jakarta stock market are all in an emerging stage of development. Therefore, the findings of this research are too limited to be generalised. Secondly, the primary data is only gathered through the conducting of semi-structured interviews with trustees, and investment managers. The researcher obviously could not observe at first hand, the actual relationship between the trustee and the investment manager, because the information discussed between them is confidential and unavailable to outside persons. Therefore, the researcher must accept the statements made by them and the data analysis must be limited to the results of interviews.

11. The Structure of This Thesis.

This thesis consist of 11 chapters, these are:

Chapter 1: Introduction
Chapter 2: The Roles and Function of Investment Manager in the Stock Market.
Chapter 3: The Duties and Power of The Trustee of Superannuation Funds in Managing Investment Funds.
Chapter 4: A Trust Theory Approach to the Relationship between The Trustee of Pension Funds and the Investment Manager.
Chapter 5: Research Method: Case Study
Chapter 6: The Development of Indonesian Investment Management
Chapter 7: The Development of Indonesian Pension Funds
Chapter 8: Case Analysis Part 1.
  The Trustworthiness of Investment manager: The Perspective of Trustee of pension funds.
Chapter 9: Case Analysis Part 2.
  The Key Activities Performed by The Trustee and The Investment Manager for Building and Developing Their Relationship.
Chapter 10: Research Findings and Conclusions.
Chapter 11: Research Contributions, Limitations, and Implications