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

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Chapter 2

The Roles, Functions and Responsibilities of Investment Managers in Managing Fund

1. Introduction

This thesis investigates the role of trust in building and developing a relationship between a trustee and an investment manager. The investigation focuses on two important aspects: (i) the key factors of trustworthiness of the investment manager, and (ii) the key activities performed by both the trustee and the investment manager for building their relationship which can be divided into two stages: an early relationship and long-term relationship. This relationship is a result of the trustee having the power to appoint an investment manager and the ability of the investment manager chosen to provide the investment services needed by the trustee. Only the roles and functions of the investment manager in managing funds are examined in this chapter but this will demonstrate that the ability of the investment manager to perform his/her roles and functions efficiently and effectively is important in building a relationship with his/her clients.

In this chapter, the researcher uses the Australian investment manager as a model to illustrate the complexity of the role and function of the investment manager in a developed stock market. This model will be used as a guide for the exploration of Indonesian investment manager's role and functions (chapter 6).
The structure of this chapter is organised around three main topics, from the general to specific: investment intermediaries, investment firms, and investment managers. The investment intermediary, which is one type of financial intermediary, performs a financial intermediation function in the stock market in the form of brokerage and asset transformation. These functions are the source of developing investment products and services provided to other types of financial intermediaries such as pension funds. Investment firms, which are one type of investment intermediary, offer collective investment to retail investors and individually managed portfolios to institutional investors. These investments are managed by an investment manager on behalf of both individual and institutional investors.

2. Investment Intermediaries in Stock Market

Investment intermediaries consist of: investment banks, brokerage firms, and investment firms (Smith, 1993). These three types of investment intermediaries perform different activities in the stock market (Madura, 1995, Smith 1993), as follow:

**Types of Investment Intermediary. The Major Activities.**

- **Investment Banks**
  - to buy and sell new stocks issued by firm.

- **Brokerage Firms**
  - to assists investors to buy or sell stocks, and to provide investment advice.

- **Investment Firms**
  - to invest in securities for their portfolio.

Source: Smith (1993) and Madura (1995)
2.1. The Function of Investment Intermediaries

Three major financial intermediation functions of investment intermediaries in the stock market are: (i) underwriting function (Smith, 1993), (ii) a brokerage function (Saunders, 1997), and (iii) an asset transformation function (Saunders, 1997; Greenbaum and Thakor, 1995). The last two functions are the basis for providing continuous investment services to investors such as trustee of pension funds.

2.1.1. Brokerage Function.

In performing the brokerage function in the stock market, the broker or brokerage firm can perform two functions: (i) to assist clients in buying or selling stocks and bonds by the executing and processing of orders, recording the transactions (Saunders, 1997; Smith, 1993), (ii) providing investment information and advice (Saunders, 1997; Yau, Ip, and Chan, 1995). The brokerage firm may perform these three functions to offer full services or only one function and so offer limited services to their clients.

There are two types of brokerage firms: pure and discount. (Saunders, 1997; Brown, 1997). A pure brokerage firm provides full investment services to its clients including: investment research, providing investment recommendations, and executing clients' orders to buy or to sell on a fee basis (Saunders, 1997). However a survey conducted by Ruth (1995), showed that full-service brokerage firms make recommendation with little knowledge of their clients, and sometimes give misleading information about risks and returns. A discount brokerage firm
offers only limited services such as executing orders to buy or sell securities but the firm does not make stock recommendation or provide analyst reports (Saunders, 1997; Brown, 1997).

In selecting a brokerage firm, the investors can used criteria proposed by Yau, Ip, and Chan (1995) these are: (i) the firm is able to execute buy or sale orders at the right time, and to provide quotes quickly, (ii) the firm has a god reputation in the industry, (iii) the firm has established a long record of good investment services, (iv) the firm is able to provide up-to-date market information and market forecasts, (v) and the firm has staff who have appropriate professional qualifications. However, Yau, Ip, and Chan (1995) argue that some investors may have a different set of criteria for selecting a brokerage firm which will depend on their risk preferences, education and experience, frequency of buying or selling, and the value of each transaction.

2.1.2. Assets Transformation Function

In performing asset transformation functions, investment firms may issue open-end mutual funds to investors who want to invest their funds in a large securities portfolio (Smith, 1993). Depending on the composition of the portfolio, the mutual fund may be in the form of equity, fixed income, or a mixture of both. For example, AMP Asset Management, a leading Australian investment management firm, issues mutual funds in Australian Shares, a portfolio which invests primarily in shares listed on the Australian Stock Exchange. This fund is designed for investors who prefer long-term returns and liquidity (AMP-Quarterly Report.
March 1999). AMP asset management also issues mutual funds in Australian Fixed Interest, a portfolio of fixed interest securities consisting mainly of Commonwealth, State and Corporate bonds. This fund is designed for investors who prefer gains from exposure to the fixed interest market (AMP-Quarterly Report, March 1999).

Mutual funds are more attractive to retail and inexperienced investors than the primary securities listed on the stock market (Saunders, 1997). This is because the investor does not need to monitor stock price movements, or seek information that has any impact on its price. The investor can resell mutual funds at any time at the current price to the investment firms so that liquidity costs are reduced. The investor not only obtains benefits from the cost reduction but also opportunities to obtain capital gains and continuous investment services provided by the investment firm.

In addition, investors with only small funds gain an advantage in terms of economies of scale by investing in mutual funds rather than investing directly in the stock market (Sharpe, Alexander, and Bailey, 1999). Sharpe, Alexander, and Bailey (1999) give as an example an individual investor with a small amount of funds who wants to invest in the stock market. The individual investor has two alternatives: to build a diversified portfolio by buying stocks in odd lots with high securities transactions costs, or to acquire a few different stocks by buying stocks in round lots with low transactions costs. Neither of these alternatives satisfy the needs of investors to acquire a diversified portfolio with low transaction costs.
There are at least two intermediaries involved in performing asset transformations functions. For example, the trustee of the pension funds (first party) wants to buy units of mutual funds directly from an investment firm (second party); the mutual funds are issued by the second party. This transaction of buying units of mutual funds creates a relationship between the trustee and the investment firm because the trustee delegates the investment function to the investment firm; and the investment firm promises to provide investment services to the trustee. The longer the trustee is a unit holder, the longer the relationship between them lasts. During their relationship, the parties must perform several activities for building and developing their relationship into a long-term one. The relationship between a trustee and an investment manager is a concern of this thesis.

2.2. The Benefits of Investment Intermediaries to the Stock Market

The financial intermediation functions of investment intermediaries provide significant contributions to the performance of the stock market in terms of market size, market liquidity, and market volatility (Demiruc-Kunt and Levine, 1996; Levine and Zervos, 1996). Firstly, market size is an important measurement for stock market development. The increasing market size will increase the capacity of the stock market to provide the funds needed by firms by issuing their new stocks on the stock market (Demirguc-Kunt and Maksimovic, 1996). The increasing market size will also increase integration with other stock markets (Obsfeld, 1994). According to Demirguc-Kunt and Levine (1996) market size can be measured by market capitalization, and the number of listed firms. These
measurements provide information about the nominal size of the stock market and its relative size compared with other stock markets. For example, financial intermediaries such as brokerage firms can issue their stocks in the primary market in order to increase their equity capital. The issuing of new stock will affect the increase in the market size as measured by market capitalization and the number of listed firms.

Secondly, market liquidity is also an important indicator of stock market development. The increasing market liquidity will provide indications to investors that they are able to trade their stock at a reasonable price and at the desired time (Schwartz, 1991). The increasing market liquidity will provide an indication to investors that the execution of small orders is not affecting the movement of stock market price significantly (Massimb and Pjelps, 1994). Market liquidity is generally measured by the total value of the stock trading and the ratio of the total value of stock trading to the size of the stock market (Levine and Zervos, 1996). Market liquidity depends on several factors, these are: (i) many active market participants, (ii) the availability and quickly distributed relevant information to all market participants, and (iii) the confidence of market participants in the fairness of the stock market (Ellis, 1998). For example, investment firms can increase the trading volume and value in the stock market which will affect the stock market liquidity.

Market returns volatility is an important indicator of stock market development. This indicator is usually used to distinguish the characteristics of an emerging
stock market from a developed one. The averaged volatility of market returns of an emerging stock market is higher than that of the developed stock markets such as the USA, the UK, and Japan (Richards, 1996). High volatility of market returns occur in a developing country because it has a low credit rating, low ratio of market capitalization to gross domestic product, and volatility of exchange rates (Bekaert and Harvey, 1997). For example, investment firms may increase the frequency of stock trading and this will affect the market returns volatility (Gooptu, 1993).

In summary, investment intermediaries in the stock market can provide services and perform functions that benefit others, creating relationships among themselves, and contribute to the performance of the stock market. The next section will discuss a specific type of investment intermediary, the investment firm which manages funds.

3. Investment Firms in the Stock Market

An investment firm is an investment intermediary that “obtains funds from a large number of investors by selling shares. These funds are placed in a pool under professional management, and the securities (financial assets) are purchased for the benefit of all shareholders” (Rose and Kolari, 1996, p.666). This definition implies that pooled funds are a collective investment by a large number of small funds investors who may need to diversify their assets portfolio which can only be done through the pooling of their funds.
The investment firm may offer investment services not only in the form of pooled funds but also individually managed portfolios. This is because, medium to large sized funds need a particular design of portfolio to meet their investment objectives, risk profiles and other requirements. In the individually managed portfolio, the investment firm receives a mandate from the trustee to manage an active investment portfolio on behalf of the trustee. It can be concluded that investment firms are needed in the stock market to provide investment services in the form of pooled funds of small pension funds, and individually managed portfolios of medium to large sized pension funds. The investment services provided by the investment firm also make a significant contribution to the stock market liquidity by increasing the trading volume and value of stocks because a portion of the proceeds from a number of small pension funds will be invested in securities to construct a securities portfolio. This securities portfolio is managed actively.

3.1. The Managed Funds.

A managed fund is "an investment scheme in which a number of entities ('investors') hand over their money to professional managers who invest the funds in a particular type or mix of assets and then manage the fund to produce a return for the investors" (Covick and Lewis, 1997, p.233). The characteristics of managed funds reflect the needs of investors who have pooled their funds which the investment manager then invests and manages on behalf of the investors. This frees investors from the need to control the day-to-day management of the fund (Covick and Lewis, 1997). In Australia, for example, managed funds grew from
A$ 296,619 million in June 1995 to A$ 455,445 million in June 1998 (Table 2.1). This growth may have been influenced by the increasing rate of funds flowing into institutions, the decreasing rate of redemptions, and investment incomes that are retained for the benefit of the contributors (Hunt and Terry, 1997).

The types of institutions in the managed fund market include: life insurance firms, superannuation funds, public unit trusts, friendly societies, common funds, and cash management trusts. There are three major institutions in the managed fund market: superannuation funds, life insurance companies, and public unit trusts. The superannuation fund is the largest segment in the managed fund market; these funds grew from A$ 125,709 million at the end of June 1995 to A$ 201,762 million at the end of June 1998 (Table 2.1).

The managed funds have been invested in a number of assets such as cash and deposit, loans and placements, short-term securities, long-term securities, loans, equities and unit trusts, property, and overseas assets. The size of equities and units in trusts are the most significant assets of managed funds. They grew from A$ 82,796 million in June 1995 to A$ 131,714 million in June 1998 (Table 2.1).

The funds within the Australian managed funds market can be divided into several categories: retail, wholesale, and discretely managed funds (Hunt and Terry, 1997). Retail funds account for money that is commonly raised from individuals. Wholesale funds are mainly pooled funds that are raised from investors such as superannuation funds, corporations, or individuals. The funds are pooled for the
purpose of investments managed by professional investment managers. Discretely managed funds are portfolios managed by professional investment managers on behalf of clients: individuals or corporate (e.g., superannuation funds or life insurance companies). ASSIRT published data about the retail and wholesale funds under management of the nine largest investment managers, as follow (Table 2.2)

<table>
<thead>
<tr>
<th>Table 2.1: Managed Funds</th>
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<tr>
<td>(in A$ million)</td>
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</table>

Sources: ABS-Managed Funds-5655.0-December Quarter 1998.

In summary, managed funds come from a number of investors who believe the investment firms will use a professional investment manager to manage their investment. The next section will discuss the roles, functions and responsibilities of an investment manager.
Table 2.2: The Nine Largest Investment Managers - June 1995 (in A$ million)


4. The Investment Manager.

The investment manager plays an important role in managed funds by developing an investment product and offering active investment management in the form of collective investment and/or individually managed investments. Therefore, the better the investment manager performs his/her roles and functions the longer the relationship with the trustee can be expected to last. Most trustees of large pension funds, however, prefer to hire more than one investment manager to manage active investments on their behalf.

4.1. The Definition of an Investment Manager.

The Commonwealth Superannuation Industry Supervision (SIS) 1993 legislation defines who can be an investment manager, and the circumstances in which an investment manager can be disqualified and removed.
In section 10(1) of the SIS 1993, investment manager means a person appointed by the trustee of a fund or trust to invest money of the fund or trust;

In section 125 of the SIS 1993, a person must not intentionally be, or act as, an investment manager of a superannuation entity (other than an excluded fund) if the person is not a body corporate.

In section 126(1) of the SIS 1993, a person must not be, or act as, an investment manager of a superannuation entity (other than an excluded fund) if the person is, and knows that the person is, a disqualified person.

In section 126(2) of the SIS 1993, a person must not intentionally be, or act as, a responsible officer of a body corporate that is an investment manager of a superannuation entity (other than an excluded fund) if the person is, and knows that the person is, disqualified person.

In section 120(1) of the SIS 1993, an individual is a disqualified person if:
(a) at any time (including a time before the commencement of this section);
   (i) the individual was convicted of an offence against or arising out of a law of the Commonwealth; a State; a Territory; or, a foreign country, being an offence in respect of dishonest conduct; or
   (ii) a civil penalty order was made in relation to the person; or
(b) the person is an insolvent under administration.

In this thesis, an investment manager is a qualified person, who acts on behalf of a body corporate, appointed by the trustee to manage active investments on behalf of the trustee; the trustee pays management fees for his/her services (section 10(1) and 125 of SIS Act 1993).

4.2. The Sources of funds managed by Investment Managers

In Australia, the source of managed funds by investment managers grew from A$ 252,361 millions in June 1995 to A$ 421,387 millions in June 1998. Investment managers manage funds that come from both Australian and overseas sources.
The funds from Australian sources grew from A$ 245,483 million in June 1995 to A$ 403,471 million in June 1998 (Table 2.3). These funds come from: life insurance companies; superannuation funds; public unit trusts; friendly societies; common funds; cash management trusts; and others but the major Australian source of funds comes from life insurance companies, superannuation funds, and public unit trusts (Table 2.3).


Table 2.3: The Sources of Funds Managed by Investment Managers.

<table>
<thead>
<tr>
<th>Source</th>
<th>($ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life insurance companies</td>
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<tr>
<td>Superannuation funds</td>
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<tr>
<td>Public unit trusts</td>
<td></td>
</tr>
<tr>
<td>Other sources</td>
<td></td>
</tr>
</tbody>
</table>

Source: ABS-Managed Funds-5655.0-December Quarter 1998.

4.3. The Role of an Investment Manager

The role of the investment manager in managing funds on behalf of the trustees will increase in the future. Already the major source of funds managed by
investment managers coming from the trustees of the superannuation funds has grown from A$ 75,134 million in June 1995 to A$ 143,212 million at the end of June 1998 (Table 2.3). A number of large superannuation funds, such as Qantas, BHP, and Kodak use more than one investment manager. The trustee of Qantas superannuation funds, for example, uses 17 investment managers. Thus, investment managers play an important role in managing the funds of superannuation funds. Taylor (1991) identifies two major roles of the investment manager: to offer investment products, and to manage active investment management efficiently as measured by costs and effectively as measured by returns.

4.3.1. Investment Product Development.

The investment manager offers an array of investment products and services to meet the various needs of major clients such as trustees of superannuation funds. Ellis (1992) identifies the evolution of the existing paradigm into a new paradigm of investment product development. In the existing paradigm, one market is served by one investment product (Ellis, 1992), but over time, most trustees of medium and large pension funds split their funds into the care of many investment managers and this encourages the formation of specialist investment managers who show their investment style to be either as a value manager or a growth manager (Ellis, 1992). Therefore, a new paradigm has come into being, the multimarket which is served by multiproducts (Ellis, 1992).
A multimarket is formed by large, medium, and small pension funds which have fundamentally different characteristics in investment objectives and risk preferences. This multimarket needs to be served by the investment manager with multiproducts because they realise that it is hard to beat the market consistently with a single product (Ennis, 1997).

An illustration of the advantage of multiproducts under the conditions of market efficiency is given by Ennis (1997). He demonstrates the relationship between the probability of success and the number of products offered by a firm. The probability of success is measured by the performance of the investment product over the benchmark for ten years, and assumed to be independent among products and from year to year. In order to reflect the condition of market efficiency and the effect of costs, the probability of success of an investment product, in any given year is set at 0.45, and during 10 years is set at 0.38. The results indicate that from 5 investment products, the probability of having at least 1 success is more than 90%. From 10 investment products, the probability of having at least 3 successful products is 80%. Ennis (1997) concludes that the probability of having at least 1 successful investment product during 10 years rises sharply when multiple products are offered.

In Australia, Macquarie Investment Management Limited, for example, offers several investment products for superannuation such as: capital stable, balanced, growth, and fixed interest funds. The balanced fund is a very popular investment product for Australian superannuation funds because most trustees of
superannuation fund are satisfied that returns are meeting their objectives (Holzberger, 1996). A survey conducted by In Tech (1997) showed, that the performance of a balanced fund was higher than the sector funds, for the four years to June 1996. The median earnings of balanced funds, for example, was 10.4 per cent in June 1996, that is, higher than 10.10 per cent of the sector funds (c.f. Mace, 1997). However, this evidence only indicates that balanced funds can produce returns over long periods. This evidence did not show balanced funds to be better than special funds.

Some of large pension funds has shifted their approach from using a single investment manager to multiple balanced manager or sector specialization (Gosling, 1995). He gives his reasons that specialist managers can be used to (i) overcome the problem of portfolio size, (ii) substitute for an in-house team, and (iii) access to the best investment managers within each sector which typically balanced investment managers are not able to provide.

The difference between balanced funds and specialist funds managers is shown in their approach to asset allocation and stock selection (Macek, 1995). The specialist fund managers use asset allocation and stock selection to produce returns within assets sectors. While the balance fund managers produce returns by using asset allocation and stock selection within a range of asset sectors (Holzberger, 1996).
4.3.2. Active Investment Management.

The second role of the investment manager is to manage active investment efficiently as measured by information ratio and effectively as measured by returns, on behalf of the trustee (Taylor, 1991). Active investment management means that the investment manager continuously monitors the factors that will affect the investment returns, and rebalances the portfolio in line with those predicted in order to increase the value of the portfolio (Carew and Hoffman, 1997).

The fundamental law of active investment management is provided by Grinold (1989). This law relates to three variables: (i) the skill of an investment manager in forecasting returns as measured by the strength of link between the forecast and the realised returns, (ii) the breadth of the investment manager's trading strategy as measured by the portfolio turnover rate each year, and (iii) the value added of the investment strategy as measured by annual return. The law is that the annual returns is a simple function of the investment manager's strategy, skill, and breadth.

The investment skill represents the ability of the investment manager in managing investment processes that are expected to produce positive returns in both good and bad times (Posey, 1996). However, the empirical evidence regarding the impact of the investment skill on the portfolio returns is inconclusive. For example, Malkiel (1995); Halpern, Calkins, and Ruggels (1996) indicate that the performance of the majority of investment managers in managing active
investments have failed to obtain returns which increase the value of the portfolio but Daniel, Grinblat, Titman, and Wermers (1997) found that the selective ability of investment managers is still shown in the returns of aggressive funds.

Secondly, the law of active investment management also implies that the portfolio turnover rate as measured by trading activity will increase the portfolio returns but the empirical evidence is inconclusive regarding the impact of the portfolio turnover on the portfolio returns. For example, Ippolito (1989) found no correlation between funds returns and portfolio turnover while Grinblat and Titman (1989) found that some of the returns to the funds in their sample were generated by active portfolio management.

The active investment management can be applied to pooled funds and individually managed portfolios. In the later application, the trustee for example, gives the investment manager a mandate to manage active investments on his/her behalf (Carew and Hoffman, 1997). The trustee also give an investment guideline for the investment manager to use in managing the funds. The guideline may include investment strategy, benchmark returns, investment constraints, investment restrictions, and investment reporting requirements. According to Carew and Hoffman (1997), the guideline is useful for the trustee as a means of controlling the investment manager’s actions, and facilitates the measurement of the performance of the investment manager against the benchmark of other managers.
4.4. The Function of Investment Managers in Active Investment Management

Bodie, Kane, and Marcus (1993) identify two major functions of investment managers these are: making investment decisions, and asset allocation. Damodaran (1998) identifies three major functions of the investment managers: asset allocation, asset selection, and portfolio execution. Ennis (1997) identifies the investment services as an additional important function of the investment manager. Thus, the major functions of the investment manager in managing the client's portfolio are portfolio management and investment services. This is because, the 'right' portfolio management is important to the overall portfolio returns (Damodaran, 1998), and a good investment services is important in retaining the trustee's investments during a poor performance period (Ennis, 1997).

4.4.1. Portfolio Management.

The investment manager can offer the trustees of the funds, for example, two types of managed portfolio: (i) an unit trust and/or (ii) an individually managed portfolio. Most trustees of large superannuation funds hire many investment managers to manage an individually managed portfolio but most trustees of small superannuation funds buy units trust.

4.4.1.1 Unit Trust

A unit trust is "an investment vehicle that pools money from numerous investors to invest in a portfolio of shares, bonds, deposits and other risky instruments" (Kee, 1999, p. 49). A unit trust is the classic form of collective investment that an
investment manager uses to manage a portfolio on behalf of many investors (Hunt
and Terry, 1997). In Australia, unit trusts began to operate in the 1930s but only
began to play an important role as investment vehicles for Australian investors
from the mid 1980s. Most unit trusts are of the open-end variety.

The operation of each unit trust is governed by its trust deed. The trust deed below
was defined before the Managed Investment Act 1998.

The trust deed is the constitution of a unit trust. A trustee is appointed
under the terms of the trust deed. The trustee’s main responsibility is to
represent unitholders and look after their interests. The trustee receives
and holds all money, reviews the investment proposals of the manager,
holds the investment in the name of the manager, distributes income, has
the fund’s account audited each year, and sends accounts and statement to
unitholders. It is essential that the trustee be established, be independent,
and be a reliable company approved by the ASC (Beelaerts and Forde,
1994, pp.4-5)

This trust deed implies that there are three parties involved in the unit trust
business: the trustee, the investment manager, and the unit-holder or investor.
According to Kee (1999), the responsibility of the trustee is to ensure that the
investment manager adheres to the regulations set out in the trust deed. The
trustee’s responsibility is aimed to protect the interest of unit holders and to
minimise the risk of fraud by the investment manager. According to Kee (1999),
the responsibility of the investment manager is to manage and administer the unit
trusts on behalf of the unit holders to produce reasonable returns for them. The
functions of the investment manager include: managing active investments;
preparing the annual report of the funds; and investing on behalf of unit holders.
According to Kee (1999), the unit holder is an investor who buys a unit trust as an investment product and expects a return in the form of dividend income and/or capital gains. The unit holder can buy units at the new or the secondary issue price.

Under the Australian Managed Investment Act 1998, the dual responsibility between the trustee and the investment manager is replaced by a single 'responsibility entity'. The responsibility entity is to operate the registered scheme and perform the functions using as a guidance the scheme's constitution and the Management Investment Act 1998 (section 601FB). The responsible entity must have a licence from the ASIC (Australian Securities & Investments Commission) to operate this scheme (section 601FA). In addition, if the external director of responsible entity is a minor, there must be a 'compliance committee' (section 601JA). This committee can be either the board of the responsible entity or the established committee separately (Pragnell, 1998). The functions of the Compliance Committee are to monitor the operation of the scheme, to assess the adequacy of the Compliance Plan, to report to the responsible entity any breaches or non-compliance, and to report to the ASC if the responsible entity did not take remedial action (Pragnell, 1998).

The Managed Investment Act 1998 has specified the duties of the responsible entity (section 601FC), the duties of the officers of the responsible entity (section 601FD), the duties of employees of the responsible entity (section 601FE), and the
The major duties of the members' Compliance Committee (section 601JD). The major duties of the responsible entity (section 601FC) are summarised as follows:

a. act honestly; and
b. exercise the degree of care and diligence...; and
c. act in the best interests of the members...; and
d. treat the members who hold interests of the same class equally and members who hold interests of different classes fairly; and
e. not make use of information acquired through being the responsible entity in order to:
   (i) gain an improper advantage for itself or another person; or
   (ii) cause detriment to the members of the scheme.

(Management Investment Act 1988, The Responsibility Entity Part 5C2)

4.4.1.1.1 The Benefits of Unit Trusts.

A unit trust offers several benefits for the unit holder, such as: diversification of risk, services of professional investment managers, liquidity, low capital requirement, and convenience (Gruber, 1996; Kee, 1999). Firstly, the pooled funds of unit trusts are invested in a large number of financial assets, depending on the type of unit trust, to construct a diversified portfolio. Unit holders who invest in unit trusts, obtain the benefits from the diversification of risks in the form of eliminating idiosyncratic risks of individual assets (Kee, 1999). This is because, the investors' ownership in a unit trust is a fraction of the current value of a diversified portfolio held by unit trusts. Secondly, the investment manager is expected to perform investment function such as detailed analysis of individual stocks, monitoring the sensitivity of stock price from changing information, increasing the market value of the portfolio, and actively researching information (Kee, 1999). Unit holders obtain the benefits of the reduction in their activities to manage the portfolio because they need only to monitor the daily price of unit...
trusts. Thirdly, most unit trusts are open-end funds that allow the unit holders to sell back the units purchased to the investment manager of the unit trust, at the current price and any time. These offer liquidity benefits for the unit holders. Fourthly, the initial funds required by investors to invest in unit trusts is very low. The investors can then add to their investment regularly as part of their saving plan (Kee, 1999). Fifthly, the unit holders are free from administrative investment tasks. The investment manager of the unit trust has the responsible to register stocks for obtaining bonus and rights issues, to collect or to deliver stock certificates as a result of buying and selling stocks, and to collect dividend cheques from listed firms (Kee, 1999).

4.4.1.2 Individually Managed Portfolio.

In managing a client's portfolio, the investment manager is encouraged to perform an investment process that is "a chain of considerations and actions for an individual, from thinking about investing to placing buy/sell orders for investment assets such as stocks and bonds" (Bodie, Kane, and Marcus, 1993, p.886). They suggest that there are three steps to the investment process: determining the client's objectives, identifying all the constraints, and translating objectives and constraints into investment strategy and its implementation. These processes are appropriate for investment managers who are appointed by the trustee of the funds on the basis of the 'Big Bang' theory (Lee, 1990). For an investment manager who is appointed by the trustee of the funds on the basis of the 'Cascade' theory (Lee, 1990), the investment process includes managing the portfolio by adhering the investment agreement and evaluating the portfolio's performance. Thus, the
investment manager must understand the trustee’s investment policy and decision making process.

4.4.1.2.1. Understanding the Trustee

To understand the client (e.g., the trustee of the superannuation funds), Ellis (1998) suggests that the investment manager and the trustee of the funds need to communicate with each other in order to discuss the trustee’s investment policy. The investment manager may assist the trustee in setting an investment policy. This is because, the investment policy is useful for the investment manager as a guide for developing a strategic investment plan, and the trustee of the fund as a basis for evaluating the performance of the investment manager (Sharpe, Alexander, and Bailey, 1999).

BHP’s superannuation fund’s investment policy, for example, set out by its trustee is as follows:

- a long term approach is taken in managing the investments consistent with the long-term nature of benefits due to members.
- it is recognised that short-term changes will occur in the Fund’s earnings due to movements in the investment markets.
- there is a five year planning time frame during which the long-term strategy can be changed within the range approved by the Trustee.
- risk is minimised by spreading the assets over a number of investments and investment managers.

(Report to Members, 1997, p.3)
The trustee of the funds needs to communicate with the investment manager about: (i) the trustee’s decision making process and decision making technique (Worzala and Bajtelsmit, 1999), (ii) the trustee’s attitudes toward risk and returns (Sharpe, Alexander, and Bailey, 1998), and (iii) the trustee’s understanding about the realistic expectations for each type of security in the portfolio, and the long-term average rate of returns (Ellis, 1998). This highlights that communication between the trustee of the funds and the investment manager is an important factor in managing the trustee’s portfolio.

Firstly, Worzala and Bajtelsmit (1999) studied the decision making process and techniques of the trustees of pension funds by sending questionnaires to the largest corporate, government, and union pension funds in the USA. They found that in this sample, a large majority (63.5%) of trustees of funds used general experience as a decision making technique in the process of asset allocation. Depending on the size of the funds, the smaller funds relied much more heavily on general experience and intuition (45%) than the larger funds which are more inclined to use modern portfolio theory (80%). This evidence is useful for the investment manager as a guide to communicate with trustees.

Secondly, risk and returns are essential elements in the investment process that must be considered together (Cassell, 1999). Most trustees agree that to obtain high returns, they must be willing to take greater risks. However, the willingness and the attitude of each trustee to accept risks is different (Ellis, 1998). This is because risk is traditionally viewed as a negative factor in investing (Damodaran,
An earlier study of risk suggested that risk could be measured by using returns variance or standard deviation (Balzer, 1995). Recent studies of investment risk suggest that risk must be measured in relation to particular behaviours (e.g. Olsen, 1997). He identifies three definitions of investment risk that the investor should consider before he/she starts investing, these are (i) the possibility of losing some of the principle capital, (ii) a possible large drop in securities price, and (iii) returns on investment below the expected or inflation rate.

4.4.2. Investment Services.

Enis (1997) argues that investment products offered to trustees will lose their differentiation. This is because most investment managers differentiate their investment product by their style of investment management, such as, growth or value. Investment style is not a proprietary item that can be replicated by others based on published information concerning the investment manager’s investment process (Posey, 1996), therefore, many investment managers use free investment services as a mean to maintain their existing clients and to attract potential clients. The investment services can be in the forms of providing a transfer of knowledge to the clients, providing high quality investment reporting, providing up-to-date market information, and giving the opportunity to share information. Thus, investment managers need to build a relationship with their clients (Ellis, 1992) by demonstrating their concern and the value of their active investment decision (Posey, 1996).
In managing a portfolio on behalf of a trustee, investment managers must focus on their core competencies to improve not only the portfolio’s performance but also the quality of the investment services provided to the trustee of the funds (Forbes, 1998). He argued that a successful investment manager in the future will depend on his/her attention to products, investment service, and reputation. This means that investment managers will manage the ‘front office’ and may decide to outsource the ‘back office’ of an active investment management firm. The front office of active investment management includes activities associated with offering investment products, and providing good investment services that are needed by trustee of funds. The back office includes activities in relation to custody activities, portfolio administration, fund accounting, unit registry, and call centre.

4.5. Responsibility of an Investment Manager.

The investment manager has fiduciary responsibilities (Wicklander, 1998; Droms, 1992) because he/she acts on behalf of the trustee in managing active investments. Droms (1992) identified two generic categories of fiduciary responsibilities of an investment manager, these are: standard of loyalty and standard of reasonable care (prudence). There are four specific areas to assess the responsibilities of an investment manager, these are: the commission paid for the brokers, performance reporting, investment performance, and proxy voting (Wicklander, 1998).

4.5.1. Standard of Loyalty

James L Walters (1980, p.575) explain the duty of loyalty clearly and succinctly:
... the manager must give disinterested advice and... actions on a client’s behalf must be carried out for the sole benefit of the client. Where more than one client is involved, the manager has a duty to treat each one of them fairly. A manager’s advice cannot be disinterested if the manager’s range of discretion includes alternatives which, in some way, financially advantage the manager. A conflict will exist whether or not the client is actually harmed.... The concept of loyalty is presented as an ideal, unlike the flexible prudent man rule which looks to see how others similarly situated are carrying out their responsibilities. The rationale that “everyone else was doing it “ is a poor defense in questions involving loyalty (cf. Droms, 1992, p.60).

The key phrase in the Walters’s explanation in the standard loyalty are: (i) giving disinterested advice, (ii) acting on behalf of the clients, and (iii) providing benefits to the clients (Droms, 1992). He suggested that an investment manager must adhere to the standard of loyalty when he/she implements a portfolio theory in managing active investment for the clients.

4.5.2. Standard of Reasonable Care (Prudence)

The investment manager is expected to manage an active investment on behalf of the clients as a prudent expert who has a duty to exercise “the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims” (ERISA Section404(a)(1)(B) cf. Droms, 1992, p.61). Therefore, the investment manager, as a prudent expert, must implement the modern portfolio theory in managing active investments of the clients to be reasonable and prudent within the context of the theory. For example, investment risks must be measured both in term of variability of return
and relative to the market that is associated with market factors beyond the control of the investment manager.

4.5.3. The Area of Responsibility.

Wicklander (1998) identifies at least three areas of investment manager responsibility, these are: commission of broker, performance reporting, and investment performance. Firstly, the trustee of the pension funds has an obligation to pay the commissions of the brokers who execute the orders from the investment manager to buy or sell stocks and bonds on a trustee's behalf. The amount of commission paid to the brokers can be high or low depending on the frequency and volume of orders.

Secondly, the investment manager must be responsible for providing information in relation to transaction data and trading policy that includes: (i) the transaction data summary which must include: the commissions paid to every broker; the commission paid for best execution order or soft dollars; listing of firms selected for best execution and the criteria for its evaluation; and listing of soft dollar firms; (ii) trading policy information to the trustee must include: soft dollar research and services used for investment decision on behalf of the trustee; and the allocation of costs of services among their clients.

Thirdly, the trustee of large pension funds who hire more than one investment manager will need to compare their investment performance. Wicklander (1998) argued that the investment manager must be responsible for providing
explanations in relation to the method of calculating returns; clarity on the composition of portfolio for each client and risk of the portfolio of each client. The investment manager must consistently use the method of calculating returns, the fees for information, and risks in the portfolio. This consistency is important for the trustee to easily evaluate the investment performance of the investment manager.

5. Summary

In this chapter, the roles, function, and responsibilities of investment managers were explored. The results of this exploration support the contention that an investment manager's role is very important in the relationship with the trustee because pension funds are major institutional investors in the stock market. Firstly, an investment manager manages active investments on behalf of the trustee. The total amount under investment management increased during 1995 to 1998 and will probably continue to do so in the future. Secondly, investment manager offers several investment products to meet the various needs of the trustee. Thirdly, the investment manager builds a relationship with the trustee by implementing the trustee’s investment policy.

In the next chapter, the pension funds' administration and its investment management will be explored in order to understand the relationship between the trustee and the investment manager again using an Australian illustration for clarity.