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 3

The Duties and Power of the Trustee of Pension Fund in Managing Investment Funds

1. Introduction

In the previous chapter the roles and functions of the investment manager in providing investment products and services to his/her client were explored. This chapter now examines the duties and power of the trustee of a pension fund who has the authority of the fund to hire an investment manager to manage active investments by adhering to the trustee's investment policy. The exercising of the trustee's power to hire an investment manager for managing an active investment commits the trustee to build a relationship with the investment manager.

The researcher uses the superannuation funds in Australia as a model to illustrate the duties and power of a trustee. Australian superannuation fund management is chosen as an example of a typical structure of a well developed type of pension fund that can be used as a good reference point for highlighting the complexity of the duties and power of trustees in managing investment funds, and for guiding the exploration of an Indonesian trustee of pension fund's duties and power (chapter 7).
This chapter is organised around three topics: (i) the Australian superannuation funds, (ii) their administration, and (iii) their investment management. Australian superannuation funds have grown rapidly in terms of coverage of members, assets, and amount of funds invested in the stock market. The increase of superannuation funds available to be invested in the stock market has increased the demand for professional investment management. Superannuation funds are required by the SIS Act 1993 to appoint trustees, who may be individuals or a company's nominees. In managing the administration of superannuation funds, the trustee has duties, powers, and responsibilities. One power of the trustee in relation to investment management is to hire an investment manager to implement his/her investment plan.

2. The Australian Superannuation Fund.

According to the SIS Act 1993, a superannuation fund is defined as an indefinitely continuing fund that is maintained for the purpose of providing benefits to the members or the dependents of the members of the fund. This is one of the government retirement income policies requirement in Australia.

2.1. Superannuation Funds Background.

According to the Senate Select Committee on Superannuation of the Parliament of the Commonwealth of Australia (1992), the employer-superannuation funds in Australia has been developing since 1862 when the bank of New South Wales introduced a pension scheme for its employees. After the development of more
than a century, a survey of superannuation coverage conducted by the Australian Bureau of Statistics (ABS) reveals that in November 1991, 79% of full-time workers were covered by superannuation funds. This coverage was increased to 86% in November 1993 and 87% in November 1995. ABS data revealed that in November 1995 the pattern of superannuation coverage by industry showed marked differences in the spread of superannuation coverage. The highest level of coverage is in the manufacturing industry which has 1,026,500 employees covered by superannuation funds. The lowest level of coverage is in the mining industry which has 80,000 employees covered by superannuation funds. ABS data for November 1995 reveals that the highest level of coverage is that of clerks (1,237,800) and the lowest level of coverage is that of para-professionals (449,200). These data correspond to the number of employees in each sector.

The development of superannuation funds is also shown by the increasing value of their assets. The total assets of superannuation funds, consisting of both public and private sectors and approved deposits funds, grew from A$ 141,806 million, 30 June 1995 to A$ 238,408 million, 30 June 1998 (see Table 3.1). The assets of superannuation funds consist of assets in Australia and overseas. The assets in Australia include cash and deposits; loans and placements; short term securities, including bills of exchange and bank certificates of deposit; long term securities including Commonwealth Government bonds; and equities and unit trusts. The rapid growth in the assets of superannuation funds is in the equities and units in trust, these grew from A$ 55,645 million at the end of June 1995 to A$ 100,222 million at the end of June 1998.
2.2. Definition and Objective of an Australian Superannuation Fund

The definition of a superannuation fund is given in the Superannuation Industry (Supervision) Act 1993.

In section 10(1) of the SIS Act 1993, superannuation fund means:
(a) a fund that:
   (i) is an indefinitely continuing fund; and
   (ii) is a provident, benefit, superannuation or retirement fund; or
(b) a public sector superannuation scheme.

The establishment of superannuation funds may have social and private objectives. Davis and Hughes (1992) identify at least two social objectives of superannuation funds. Firstly, superannuation funds encourage individuals to take responsibility for their retirement income by contributing a small portion of his/her salaries to the funds. Secondly, superannuation funds accumulate the members' contribution during their working lives. These accumulation of funds will increase the national savings. Davis and Hughes (1992) also identify at least
two private objectives of the superannuation funds. Firstly, superannuation funds are expected to be able to provide a retirement income that is higher than that of the Aged Pension provided by the Australian Government. Secondly, superannuation funds will provide the members with an opportunity to maintain a 'quality' of life during the retirement period. For the individuals who did not have the opportunity to accumulate retirement savings for any number of reasons, including unemployment or a history of casual employment, the government pension will act as a safety net after the official retirement age.

2.3. Types of Superannuation Funds

Funds in the Australian superannuation system can be classified: by broad function, according to benefit design; the funding method used; by size; by the type of sponsor or contributor, and by regulatory and compliance status (Randal, Higgins, and Goddard, 1996). Each classification has within it several types. This thesis focuses only on the funds classified by the sponsor and the function.

In section 16(3) of the SIS Act 1993, an employer-sponsored fund is a regulated superannuation fund that has at least one employer sponsor.

In section 16(1) of the SIS Act 1993, an employer-sponsor of a regulated superannuation fund is an employer who:

(a) contributes to the fund; or
(b) would, apart from a temporary cessation of contributions, contribute to the fund;
for the benefits of:
(c) a member of the fund who is an employee of:
   (i) the employer; or
   (ii) an associate of the employer; or
(d) the dependants of such a member in the event of the death of the member.
2.3.1 Two Types of Single Employer-Sponsored Funds

An employer-based fund is one that is established by the employer for the benefit of the employees of the firm as part of the firm’s compensation system (Grath and Viney, 1998). An employer, in making the decision to establish a superannuation fund must take into account legal requirements, consider the types and levels of benefits to be provided to the members, and the level of the employer’s commitment to provide funding in the plan (Fairley, 1989). These considerations lead to a differentiation between superannuation funds as defined benefit and defined contribution funds.

2.3.1.1. Defined Benefit Funds.

A defined benefit fund is one in which the amount of benefit to the members is clearly determined in advance (Fairley, 1989; Cerche, 1993). The characteristics of defined benefit funds can be identified in terms of the benefit to the members, the commitment of the employer, and the disposition of the deficit or surplus of funds (Fairley, 1989). Firstly, in defined benefit superannuation funds, the benefits to the individual member are determined in advance by taking into consideration the member’s salary at retirement, length of employment or membership, and age (Fairley, 1989). The benefits will be paid on retirement, or in certain instances, such as total and permanent disablement immediately or in the case of untimely death the benefits are paid to the beneficiaries nominated by the employee.

Secondly, by establishing defined benefit funds, an employer is committed to ensure that there is sufficient in the funds at all times to pay out the benefits to
members who retire because of age, or total and permanent disablement, or the beneficiaries of those who die before retirement age is reached (Fairley, 1989).

Thirdly, the defined benefit funds must be reviewed by an actuary at least every three years (Fairley, 1989). The actuarial review includes an assessment of the assets of the fund, the current income, and the projected income. The aim of this review is to determine whether the contributions of the employer to the funds is sufficient to pay the benefits to the members (Fairley, 1989).

2.3.1.2. Defined Contribution Funds.

In a defined contribution fund the amount of benefit to the members is not defined in advance. The benefit paid to the members will depend on the contributions of both the employer and employees, and the investment returns on the funds after deducting fund expenses (Cerche, 1993). He identifies four characteristics of defined contribution funds, these are: (i) the employer and employees determine in advance the amount of their contribution to the funds; (ii) the member’s contribution is a fixed percentage of the member’s current salary; (iii) the member’s account is credited with the contributions and the proportion of investment income; and (iv) the employer’s contribution is usually based on actuarial factors that ensure the funds are able to pay the benefits to members as they arise. In a similar manner to defined benefit funds, the employer of defined contribution funds is also responsible for maintaining sufficient funds to cover the liabilities.
3. The Administration of Superannuation Funds

Superannuation funds are required by the SIS Act 1993 to appoint a trustee, who may be an individual or a company nominee, to manage the administration of the funds. This will consist of investment funds management, and record keeping of the superannuation funds. In managing the administration of the funds, the trustee of superannuation funds has duties, obligations, responsibilities and power.

3.1. Definition of Trustee.

The definition of trustee is given by the SIS Act 1993.

In section 10(1b) of the SIS Act 1993, trustee, in relation to a fund, scheme, or trust, means ... the person who manages the fund, scheme or trust.

The trustee of a superannuation fund may be a body corporate or an individual who: (i) is responsible for trust; (ii) ensures that the principles of trust law of state or federal legislation are adhered to; and (iii) the governing rules of the fund are followed exactly (Randall, Higgins, and Goddard, 1996). However, a company and an individual can not act as a trustee of a superannuation fund so long as they are disqualified as a body corporate or person.

In section 121(1) of the SIS Act 1993, a person must not intentionally be, or act as, a trustee of a superannuation entity if the person is, and knows that the person is, a disqualified person.

In section 121(2) of the SIS Act 1993, a person must not intentionally be, or act as, a responsible officer of a body corporate that is a trustee of a superannuation entity if the person is, and knows that the person is, a disqualified person.
In section 120(1) of the SIS Act 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.

A definition of dishonest conduct cannot be found within the SIS Act 1993, so the Common Law meaning is applied (Coleman and Bergin, 1994). They give as an example, a person will be disqualified as a trustee because of dishonest conduct if that person has been proved to have committed a serious offence, and convicted of the offence at any time during that person's life. The disqualification applies to a person who has been convicted of the offence in Australia or overseas.

The civil penalty orders can be made under SIS Act in the following circumstances:

- breaching of the sole purpose test
- lending or giving of financial assistance to the members
- breaching in house assets rules
- not making investments at arm's length
- failing to notify the ISC of a significant adverse event, and
- breaching the conditions relating to the return of surplus to employer sponsors.

(c.f. Coleman and Bergin, 1994, p.97)

Being insolvent under administration means that a person is:

- an undischarged bankrupt in Australia or under the laws of a foreign country
- a person with properties subject to control under Bankruptcy Act
- a person who within the preceding three years has executed a Deed of assignment or Deed of arrangement under the Bankruptcy Act, or
- a person whose creditors have within the preceding three years accepted a composition under the Bankruptcy Act.

(Coleman and Bergin, 1994, p.97)

Also under section 120(2) of SIS Act, a company will be disqualified from being a trustee if:

(a) subsection (2A) applies; or
(b) a receiver, or a receiver and manager, has been appointed in respect of property beneficially owned by the body; or
(c) an official manager, deputy official manager or administrator has been appointed in respect of the body; or
(d) a provisional liquidator has been appointed in respect of the body; or
(e) the body has begun to be wound up.

3.2. Three Types of Trustees.

Coleman and Bergin (1994) identify three types of trustees of superannuation funds. The first is the member trustee or director who represents the members of the superannuation funds and may be appointed by the members of the funds. The second is an employer trustee who represents the employer and has been appointed by the employer or an organisation representing the interest of that employer. The third is an independent trustee or director who is not a member of the fund, is not an employer of the funds, is not an employee of an employer-sponsor of the fund, and is not in any capacity a representative of an organization representing the interest of either members or employer-sponsors. For example, Kodak Australia Superannuation Fund has three types of trustees (Report to the Members, 1997). The Trustees consist of eight Trustee Directors, and one
independent Trustee as Chairman. The Trustee Directors consist of four Directors as the members’ representatives, and four Directors appointed by the employer, that is, Kodak Australia. The independent trustee is appointed by the Trustee Directors. Another example, Qantas Airways Superannuation Fund Limited has two types of trustees. There is a total of 10 trustees, 5 of whom represent the members and another 5 are appointed by the Qantas Airways Limited. Regardless of the type, all trustee have similar roles, duties, responsibilities, and power (Qantas-Report to Members, 1997).

3.3. Trustees’ Duties Under Trust Law and SIS Act:

The duties of the superannuation fund trustees arise from the SIS Act and trust law (Randall, Higgins, and Goddard, 1996). As a consequence, the trustee has many duties.

Under trust law, some duties are deemed to impose certain obligation on trustees. these are:

- duty to observe the governing rules of the fund
- duty to act impartially between beneficiaries
- duty not to make a profit
- duty not to purchase trust property
- duty to avoid conflicts of interest

Under the SIS Act, the governing rules of all superannuation funds are deemed to impose certain obligations on trustees, these are:

- to act honestly in all matters concerning the fund;
• to ensure that the trustee’s duties and powers are exercised in the best interests of the members
• to formulate and give effect to an investment strategy that takes into consideration the entire circumstances of the fund; and
• to exercise the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with the property of another for whom the person felt a morally bound to provide.

The SIS Act imposes the trustee to perform other duties which are more specific to superannuation funds, these include:

• to establish an internal complaints and inquires procedure (SIS Act s 101);
• to obtain certain information from investment managers (s 102);
• to keep minutes and records of meetings (s 103);
• to keep records of changes of trustees (s 104);
• to keep copies of report provided to members and beneficiaries and to make them available for inspection by the ISC when requested (s 105);
• to establish a procedure for the appointment of members representative and where applicable for appointing an independent trustee (ss 107-108);
• to advice the ISC of significant adverse events (s 106);
• not to make loans to members (s 65);
• not to acquire assets from members unless certain conditions are met (s 66); and
• not to borrow money except in certain circumstances (s 67).
(c.f. Randall, Higgins, and Goddard, 1996, p.31)

The Kodak Superannuation Fund, for example, determines the Trustee Directors duties as those which relate to the SIS Act, Trust Law, and Government legislation. The Trustee Directors must:

• understand and to follow the terms and condition of the Plan, as set out in its Trust Deed
• act in the interest of all members
• act impartially-without favouring one member over another, or being influenced by others.
• avoid conflict of interest— for example, a Trustee Director should not vote on something in which he or she would have a personal interest.
• maintain proper and correct Plan records and take “reasonable care” in what they do.
• keep members informed about benefits and Plan activities.
• invest the Plan’s assets in the best interests of members.
• keep Fund assets separate to other assets—like Company or personal assets.
• act in good faith.
• maintain confidentially about private information.
(Kodak-Report to the Members, 1997, p.3)

3.4. Trustee’s Responsibility.

A trustee of a fund has two main responsibilities in managing the overall operation of the fund, these are: (i) fund investment management (Coleman and Bergin, 1994), and (ii) the overall administration of the fund (The Insurance and Superannuation Commission, 1994). The first responsibility of the trustee is to determine: the investment objective of the fund, the investment strategy, and the implementation of the strategy (Coleman and Bergin, 1994). In relation to his/her responsibility for investment management, a trustee can obtain advice from external experts, such as an investment manager. In appointing an investment manager, the trustee must ensure that the appointment is in written agreement (Coleman and Bergin, 1994). For example, a trustee of the BHP superannuation fund uses an investment consultant to set the investment plan and strategy, and up to 17 investment managers to implement the investment strategy (BHP’s Report to Members, 1997).
The second responsibility of the trustee is to maintain accurate and orderly accounts and records of the superannuation fund (The Insurance and Superannuation Commission, 1994). For example, the trustee of Qantas Superannuation fund has the responsible for the day-to-day administration of the funds, such as keeping all records and accounts, collecting contributions, calculating and paying benefits, and answering member’s queries (Qantas’s Report to Members, 1997). However, the trustee delegates the duties to the staff of Qantas Superannuation fund by structuring the organisation into a number of divisions such as superannuation administration, superannuation adviser, superannuation accounting clerk, and superannuation system analysts. The SIS Act states the principles of record keeping and administrative responsibilities on trustees, these include:

- to maintain accurate and accessible accounting records that is to enable preparation of all accounts, statement, and report which are required by the SIS legislation;
- to ensure the accuracy of accounts and statements for a fund each year of income;
- to maintain for 10 years all minutes of trustee meetings, record of changes to trustees.....and copies of all reports to members and beneficiaries.
- to lodge an Annual Return with the ISC, the requirements relating to Annual Returns;
- to ensure that accounts and statements for a fund for each year income are audited by an approved auditor.

(c.f. The Insurance and Superannuation Commission, 1994, p.13-14)

3.5. The Power of Trustees.

The trustee is usually given a number of discretionary powers for the purpose of administering the funds, these include:
• power to determine the size of the benefit to be paid to the member;
• power to determine which dependants should receive a benefit payable on death, the proportions to be paid and the type of benefit (ie lump sum or pension); and
• discretion to choose particular forms of investment.
(Randall, Higgins, and Goddard, 1996, p.32 -33)

In law a trustee’s powers are divided into two types: mere powers, and trust powers (Randall, Higgins, and Goddard, 1996). Firstly, mere powers allow a trustee to take a particular action, such as discretion to insure trust assets. (Randall, Higgins, and Goddard, 1996). For example, in order to protect the Trustee Company, the trustee of Kodak Superannuation fund has an indemnity insurance policy with AMP general insurance (Kodak Fund’s Report to Members 1997). The aim of the insurance is to protect the Trustee Directors and the fund against negative financial effects of any honest mistakes that may happen in the running of the fund (Kodak Fund’s Report to Members 1997).

Secondly, trust powers give the trustee a choice to decide which action must be taken (Randall, Higgins, and Goddard, 1996). For example, the trustee of the BHP Superannuation fund has decided to manage investments in property and cash by in-house management, and to have investments in securities managed using external investment managers (BHP-Report to Members, 1997).

4. Superannuation Investment Management.

In managing the investment funds the trustee must formulate and implement an appropriate investment strategy. The investment strategy must consider
investment restrictions, risk tolerance, investment objectives, levels of diversification, and the liquidity requirement of the funds (Krithis, 1996). The investment strategy can be implemented by using in-house investment management and/or by hiring an investment manager. The relationship between the trustee of the superannuation funds and the investment manager is therefore part of the implementation investment strategy of the trustee of the superannuation funds.

4.1. Investment Restrictions.

The SIS Act contains a number of restrictions in relation to the investment of a superannuation fund, these are: borrowing, lending money to members, acquisition of assets from members, and investing in-house assets (Randal, Higgins, Goddard, 1996; Gray and Dorkins, 1996). Trustees, investment managers or others who breach these restrictions may be subject to civil or criminal penalties and the fund may also become non-complying (Gray and Dorkins, 1996). Firstly, the trustee is prohibited from lending any of the funds to the employer, or the members of the funds, or to the relatives of a member (Gray and Dorkins, 1996). Secondly, the trustee is restricted to invest in in-house assets by providing loans to the employer who contributes to a superannuation fund (Gray and Dorkins, 1996). Thirdly, trustee is prohibited to acquire certain assets from a member or a relative of a member of the fund. Exceptions to this restrictions are the assets in the form of securities such as stocks, units, bonds, and debentures that are listed on the stock market and acquired at market price value (Gray and Dorkins, 1996).
4.2. Investment Objectives.

The main investment objective of the superannuation fund is always to obtain reasonable returns with a minimal risk or with an acceptable level of risk (Short, 1987), and for the investment value to grow (Meek, 1993). If investment objectives are stated clearly, the investment strategy will be easy to formulate; and the overall probability of success in implementing the investment strategy is also increased (Templeton, 1996). Most trustees of defined contribution funds use inflation as a general benchmark for the returns objectives, because the investment funds must have real growth (Meek, 1993). For example, in the Qantas Superannuation Fund, the trustee has developed four return investment objectives, these are:

(1) to maximise long-term investment returns, subject to constraints aimed at containing fluctuations in returns over shorter periods within acceptable limits;
(2) to earn long-term returns (after tax and fees) that exceed CPI and AWE increases by at least 3% per year over rolling three and five-year periods;
(3) over shorter periods, to outperform the notional return on the benchmark portfolio in the Investment Policy Statement;
(4) over rolling three-year periods, the Plan’s average rate of return as sought by the Trustee is a return that is: in the upper third of results, and exceeds the asset weighted average of results as measured by the William M. Mercer Pooled Fund Investment Survey of diversified superannuation funds.

(cf. Qantas-Report to Members, 30 June 1997, p.7)

4.3. Tolerance for Risk

According to Trahair (1987), risk tolerance can be influenced by four decision variables: (i) the benefit design of the fund, (ii) the financial condition of the
fund, (iii) the attitude of employer toward risk, and (iv) the views of the trustees and members.

Firstly, the benefit design has a major effect on the tolerance for risk (Trahair, 1987). If the fund is a defined contribution, the full benefit of a bad or good investment performance will have an impact on the benefit of the members. In a defined benefit fund, a bad or good investment performance does not directly affect retirement benefits because the defined benefits are related to salaries (Meek, 1993). Therefore, the trustee and the investment manager must consider the benefits design of superannuation fund when determining the level of investment risk. For example, a trustee of defined contribution funds would prefer low risk and investment returns steadily year by year (Trahair, 1987).

Secondly, the financial conditions of the fund as measured by the liquidity and the level of contribution being paid by the members and employer will influence the investment risk tolerance (Trahair, 1987). A mature fund, for example, will be more concerned with reducing risks than achieving high investment returns because the superannuation funds require large funds to pay the retirement benefits.

Thirdly, the employer's attitude toward risk will affect the acceptable level of risks (Trahair, 1987). The employer may view the funds as a profit centre, and therefore prefers to adopt an aggressive investment strategy to achieve higher returns than those expected in order to reduce the employer's contribution. Other
employers may view the funds as part of a compensation system and as a consequence, the employer prefers to adopt a conservative investment strategy satisfied to achieve low to moderate returns.

Fourthly, the trustee of the superannuation fund needs to understand the members’ concern with their funds as a basis for deciding how the funds should be invested (Trahair, 1987). If the trustee and members are adverse to risk, then they will emphasis risk reduction rather than increasing investment returns. However, trustees must educate their members about the characteristics of short-term and long-term investment including the level of risk and returns (Meek, 1993).

4.4. Formulating the Investment Strategy.

One important duty of the trustee is to formulate the investment strategy. Most trustees of large superannuation funds seek advice from financial advisers but this will not reduce the responsibilities of the trustee for formulating the appropriate investments strategy.

4.4.1 The Criteria for Formulating Investment Strategy.

Cutler (1991) identified the criteria which must be considered in formulating an investment strategy to match the funds’ requirements, these are: (i) the size of funds, (ii) the maturity of the fund, (iii) age structure, (iv) types of members, and (v) the trustee’s investment knowledge. Firstly, the size of the fund will guide the trustee in choosing the options of investment such as investing in a pooled fund,
in an individually managed portfolio, in direct investment, or a combination of these approaches (Cutler, 1991). Secondly, the trustee of a mature fund may prefer to invest the funds in investment products from which cash can be obtained at relatively short notice and low liquidity costs (Cutler, 1991). This is because the mature fund will require a large amount of funds to pay a larger number of retirement benefits than a young fund. Thirdly, a criterion for selecting an investment strategy is age structure (Cutler, 1991). For example, a young age structure of members generally means the number and amount of benefit payments will be lower than for an older age structure. Consequently, an aggressive investment strategy can be adopted for the younger age structure, and a conservative investment strategy for the older age structure. The fourth criterion is the type of membership; if most members are familiar with investment markets, a more aggressive investment strategy may be appropriate (Cutler, 1991). The fifth criterion is the trustee’s investment knowledge, experience and attitude to investment that will lead to either an aggressive or conservative investment strategy (Cutler, 1991).

4.4.2. Investment Strategy.

Cuttler (1991) suggests that the trustee can use the criteria outlined above to determine the appropriate investment strategy to achieve the investment objectives. He identifies four broad investment strategies: (i) high equity oriented, (ii) medium equity oriented, (iii) capital stable, and (iv) capital guaranteed.
The first is a higher equity oriented strategy. This strategy focuses on heavy investment in stocks. The characteristics of this strategy are high volatility in returns and potential for capital losses but for the long-term investment (10 to 20 years) this strategy will produce high returns (Cutler, 1991). For example, the investment strategy of Kodak Superannuation fund is to maintain the funds invested in growth assets such as Australian and overseas equities in the range of 50% to 75% (Kodak-Report to Members, 1997).

The second is a medium equity oriented balanced strategy. This strategy focuses on investing the funds into full range of investment products available that come from many asset classes (Cutler, 1991). The characteristics of this strategy are stable portfolio value and moderate volatile of return, and in the long-term still give good returns. For example, Qantas Superannuation Fund's investment strategy is to maintain a mix of investment in: Australian and overseas shares, Australian and overseas fixed interest, and cash and short-term deposit. This ensures a balanced approach at all times which reduces risks (Kodak-Report to Members, 1997).

The third strategy is capital stable. This strategy focuses on heavy investment in fixed income interests (bonds) that will dominant the portfolio (Cutler, 1991). The characteristics of this strategy are low risks of capital loss and low returns (Cutler, 1991). For example, Coca-Cola's Amatil Superannuation Fund's investment strategy is to invest 60% of the funds in fixed interest and cash, with the balance of funds invested in shares and property (Coca-Cola-Report to
The aim is to ensure that negative returns do not occur over a full year.

The fourth strategy is capital guaranteed. This strategy focuses on a high portion investment in term deposit. The characteristics of this strategy are low returns on investment, high security of capital, and high liquidity. The capital guaranteed investment, such as term deposit, is the most appropriate for trustees who require absolute guarantees on capital values.

4.5. Implementing the Investment Strategy.

Carew and Hoffman (1997) suggest that trustees need to consider the degree of investment management control by the trustees in implementing their investment strategy. The trustees may want to be involved and control many aspects of the investment management, such as defining investment objectives, strategies, policies, and the implementation of an investment strategy. To do this, the trustee sets up in-house investment management. A survey conducted by the Insurance and Superannuation Commission in 1995 found that the major reasons for trustees to set up in-house investment management are: control of the investment strategy, and low investment costs (cf. Lambert, 1996). However, because of the complexity of the investment process, only trustees of large superannuation funds choose to keep the management of their investments in-house (Carew and Hoffman, 1997). Alternatively, trustees may only want to control the investment objectives and delegate the achievement of these objectives to investment
managers. This latter investment management alternative is the subject of this thesis.

4.5.1. Hiring Investment Managers.

Most medium and large superannuation funds hire one or more investment managers to implement the trustee's investment strategy. The implementation could be in the form of a discretely-managed portfolio or a pooled superannuation fund (Randall, Higgins, and Goddard, 1996). Trustees may appoint one or more investment managers under a formal written agreement.

In section 124(1) of the SIS 1993, the trustee of a superannuation entity must not make a non-written appointment of an investment manager of the entity.

Under section 102 (1) of the SIS Act there are several provisions which must be included in the investment management agreement. Firstly, the trustee must receive appropriate information from the investment manager about the investment returns and the investment process. Secondly, the trustee must receive appropriate information to assess the ability of the manager to manage the funds, and to evaluate the performance of investment.

In the Qantas Superannuation fund, for example, the trustees used 14 investment managers to manage the investment funds of $2,938 million (30 June 1997). The investment management agreement set out the contractual basis upon which investment managers will act on behalf of the trustee. These agreements include:
• the powers and duties of the investment managers;
• investment powers and prudential constraints;
• portfolio limitations;
• reporting requirements to the Directors;
• guarantees and insurance to protect the Plan’s assets; and
• fee structure.
(Qantas-Report to Members, 1997, p.12):

Cuttler (1991) proposes five basic rules for hiring the investment manager. These are: (i) performance is measured by trustee’s investment objective; (ii) stock market is uncertain; (iii) investment manager is not always right; (iv) the size of funds has impact on performance. Firstly, performance must be measured by the trustee’s investment objectives (Cutler, 1991). These objectives may relate to variability of returns, variability of portfolio value, the degree of return on investment and liquidity.

Secondly, the stock market is unpredictable or uncertain (Cutler, 1991). He acknowledges that the market and regulations are continually changing and the stock market reacts differently to each change. Thirdly, there is no investment manager who is correct all of the time (Cutler, 1991). He argues that every investment manager can make mistakes. This is part of the learning and managing investment process. Therefore, the best investment managers are those who can judge rightly more times than they judge wrongly.

Fourthly, the size of the fund has an impact on performance (Cutler, 1991). He identifies that (i) the impact is sometimes negative such as low ability to alter
asset allocation in a relatively short period, and (ii) the impact of the size of the fund could be positive, such as opportunities available to construct a large diversified portfolio. These four basic truths will help the trustees to understand better the procedure in selecting investment managers and the investment process used by them.

4.5.2 The Benefits From Hiring an Investment Manager.

The trustees gain at least three major benefits from hiring one or more investment managers (Radcliffe, 1994), these are: (i) active investment management (see chapter 2), risk diversification, and (iii) support for adequate discharge of the trustee’s function.

The superannuation fund regulations limits the maximum funds that can be managed by an investment manager. To deal with this limitation, trustees usually diversify their funds among investment managers. This is called split funding (Sharpe, Alexander, and Bailey, 1999). For example, the Trustee of Kodak Superannuation fund uses 5 investment managers. The trustee of the BHP Superannuation fund uses 17 investment managers: 10 Australian investment managers and 7 overseas investment managers.

The aim of using many investment managers is to reduce risks that stem from the possibility of mistakes taken by an investment manager. These mistakes could be caused by the investment style or lack of expertise that might have a negative effect on the value of the trustee’s portfolio. However, Sharpe, Alexander, and Bailey (1999) argue that if a trustee is to spread the investment broadly among
investment managers without regard to a particular investment managers’ expertise, the overall portfolio will be likely to produce results similar to those of the market portfolio. Therefore, the main reason to split funding is to introduce the hiring of investment managers with different skills and styles, and to reduce the negative effect of mistakes of investing the funds of the trustee.

4.5.3 The Cost of Hiring an Investment Manager.

Rodriguez and Kolb (1996) identify two types of costs in hiring an investment manager. The first is a measurable cost that consists of transactions costs, custodian fees, and management fees. The transaction costs include brokerage commission, and bid-ask spreads that have an impact on the portfolio returns. This is because the size of the brokerage commission depends on both the volume and the values of the transactions. The size of the bid-ask spread depends on active stocks, and volatility of stock prices. Custodian fees are paid by the trustee of the superannuation fund for the services provided to maintain and to physically control securities in the portfolio. An investment manager’s fees may be fixed or variable based on superannuation performance.

The second type of cost in hiring an investment manager is difficult to measure because it consists of costs such as time consumed in conference with the investment manager (Rodriguez and Kolb, 1996). In setting an investment policy for example, the trustee needs to spend time communicating with the investment manager, sharing information about the returns on investment, the risk of each class of investment and the difference between the past and future environment of
the stock market. The trustee also needs to spend time communicating with the investment manager in the form of regular meetings, regular monitoring, and periodic evaluation of investment performance. Trustees may also have psychological costs which take the form of regret in choosing the wrong investment manager, such as, one who has performed below the benchmark, provided poor investment services, breaches the investment agreement, or cheats in the relationship.

4.5.4 Theories of Investment Manager Selection.

Lee (1990) identifies two theories about the nature of the investment manager selection decision: (i) the Big Bang theory where investment manager performs the whole process of investment decision making to achieve the trustee’s investment objective, and (ii) the Cascade theory where investment manager only implements the trustee’s investment policy. The first is the Big Bang theory where the trustee of a superannuation fund decides the investment objectives and risk tolerance, delegates the rest of the investment decisions making process to the investment manager, and then, the trustee monitors and evaluates the performance of the investment manager. The trustee delegates the authority to the investment manager in order to determine asset allocation, the selection of stock, the taking advantage from market timing, and the management of trading costs. This means that a large number of investment decisions tend to be made by the investment manager simultaneously. The Big Bang theory indicates the importance of the investment manager selection for a successful investment fund, especially if the trustee only hires one investment manager (Lee, 1990). He argues that the big
The second theory of investment manager selection is the Cascade theory. This theory is adopted from the standard planning and control cycle to investment management (Lee, 1990) because a good investment management process must consist of the essential element of planning and control, these are: (i) the investment objectives should be specific to the preferences of the members and beneficiaries of the fund; (ii) the specific investment objectives translate into an asset allocation strategy by considering the behaviour of the stock market over the investment horizon; (iii) the asset allocations translate into the selection of individual investments within each sector and class of asset; and (iv) monitoring the performance of the investment manager for control purposes.

The Cascade theory is gaining in popularity, particularly among large Australian superannuation funds because it provides a disciplined and logical structure for investment decision-making for the trustees (Lee, 1990). The decision to use an investment manager is one part of the implementation of investment planning and control. The trustee decides to select an investment manager who is a specialist in a sector or asset class, and has shown consistency in his/her investment management style.

In using the Cascade theory, the trustee of a large superannuation fund is advised by an investment consultant. For example, the trustee of BHP superannuation
fund receives investment advice on an ongoing basis from Frank Russel Co Pty Ltd, investment consultants (Report on Member 1997). The trustee of Qantas Superannuation fund receives investment advice from William M Mercer Pty Ltd, investment advisers (Report on Members 1997).

4.5.5 The Criteria for Selecting an Investment Manager

There are many scholars who have proposed criteria for selecting an investment manager (Lee, 1990; Cutler, 1991, Randall, Higgins, and Goddard, 1996). For example, Lee (1990) identifies several criteria to select an investment manager, such as: investment performance, investment philosophy and style, investment decision making process, organization and staffing, and entry and exit conditions of the contract.

Cuttler (1991) identifies five general areas to be assessed in selecting an investment manager: management ability, technical ability, the amount of funds under his/her management, reporting ability, and commitment to the business of the trustee. The investment manager’s management ability includes leadership, quality and number of staff and organizational structure. His/her technical ability includes research staff and their capabilities, stock selection technique, sources of research information, strategies including asset allocation process, maximum and minimum limits in each asset class, extent of trading in the portfolio, performance including length of experience, previous records of the senior staff, the rate of return achieved both overall and for specific sectors, and the variability of returns.
Randall, Higgins, and Goddard (1996) have identified several aspects which need to be considered by a trustee in hiring an investment manager. A decision may be formed on the basis of: quantitative analysis or qualitative analysis. Firstly, quantitative analysis is concerned with historical rates of return, the degree of risk relative to the returns, the areas of strengths and weaknesses, and absolute returns (Randall, Higgins, and Goddard, 1996). Secondly, qualitative analysis is concerned with the financial strength and structure of the investment manager, the fund management teams, the qualifications of the team members, the leader's expertise and management style, the size of the team, the resources supporting the external and internal research, the manager's investment philosophy, the investment style, and attitudes toward risk (Randall, Higgins, and Goddard, 1996).

On the basis of various decision variables in selecting investment managers proposed by the three scholars above, it is concluded here that the key decision variables are: (i) general ability, (ii) investment style, (iii) the effort expended, and (iv) the organization structure of investment manager.

4.5.5.1. The Ability of Investment Manager.

The ability of the investment manager must reflect his/her investment skills, that is, “the ability to outperform an appropriate benchmark consistently over time” (Posey, 1996,p.33). These abilities can be measured by the track record of the investment performance in terms of returns. Therefore, most trustees of superannuation funds pay great attention to performance when selecting an
investment manager (Lee, 1990). This is because, the level and consistency of investment performance is important to both the employer and members of the superannuation fund (Stewart, 1998). For example, if the investment manager's performance has been poor over several years, the employer will increase its funding requirement for the defined-benefit fund. On the other hand, if the investment manager's performance has been good over several years, the employer can reduce its funding contribution to the defined-benefit fund. However, the trustee must realise that past performance is not necessarily an indication of future performance (Stewart, 1998).

In Australia, an early study of the performance of investment managers was conducted by Bird, Chin, and McCrae (1982). They studied 15 pooled funds managers over the period 1973 to 1981, and measured their performance by using risk adjusted performance as the benchmark. The result of their study indicates that only one investment manager performed above the benchmark. This result is in accord with studies in the USA (Malkiel, 1995; Gruber, 1996). However, a number of studies found that investment managers in aggressive growth funds have the ability to select stocks. For example, Daniel, Grinblatt, Titman, and Wermers (1997) investigated investment skills in the form of the selective ability of mutual investment managers who manage aggressive growth funds. The data consists of all equity mutual funds that existed over the period December 31, 1974 to December 31, 1994. They found that investment managers in aggressive growth funds exhibit some selectivity ability but they do not exhibit the timing ability. Beckers (1997) studied the link between the investment manager' skill to
investment performance. He uses the Monte Carlo simulation to simulate the behavior of 100 investment manager with identical investment strategies over a twenty year period. The findings of his study showed that investment managers with high investment skills stay in the business for five years or longer.

4.5.5.2. The Investment Style of Investment Manager

Investment style is an important criteria in selecting investment managers (Davis, 1997) and can be defined in both qualitative and quantitative terms (Posey, 1996). A qualitative definition includes the investment manager's market preferences (Carew and Hoffman, 1997). Some common styles are value, growth, market timing, contrarian, and theme. Quantitative definition includes references to the distinguishing applied aspects of prominent investment characteristics such as market capitalization, and dividend yields (Carew and Hoffman, 1997). For example, equity managers may be categorised in terms of their portfolios' average market capitalization, dividend yields, or earning growth prospects. Fixed income managers may be categorized by their portfolios' duration or quality ratings. Trustees need to recognise the investment manager's style, because the implementation of an asset allocation strategy needs the hiring of an investment manager who has a specific investment style (Grace, 1995). This is because, an investment manager's style is a key factor in how closely he/she will adhere to the fund's preferred level of risk (Carew and Hoffman, 1997).

The relationship between investment style and performance has been studied by several researchers such as Kuberek (1998), Grinblat and Titman (1993). For
example, Kuberek (1998) studies investment equity factors that are defined by a log of market capitalisation, book-to-price, earning-to-price, and dividend yield. These factors are commonly used to categorise the equity manager's style. The data used in his study were derived from monthly stock returns in Wilshire 5000 from January 1981 through June 1997. The findings are that the earning-to-price style of an investment manager has a positive relationship with a long-term investment performance. Grinblat and Titman (1993) have studied the investment style of mutual funds. The data in their study consists of 155 mutual funds December 31, 1974 to December 31, 1984. The performance of the portfolio holding is used as a performance benchmark. The finding of Grinblat and Titman's study indicate that an aggressive growth investment style has an abnormal performance compared with the benchmark over the period from 1976 to 1985.

4.5.5.3 The Effort of Investment Manager

Ang, Chen, and Lin (1998) argue that the type and level of effort of the investment manager has a positive impact on his/her portfolio performance. The type of effort includes stock selection and trading, cost reduction, and risk taking (Ang, Chen, and Lin, 1998). Firstly, an active investment manager of mutual funds may choose to obtain returns in the short-term by exploiting price movements, by increasing the frequencies of trading, by spending time and effort to gather and analyse information. Secondly, he/she can also increase returns by cutting administration costs, transaction costs, and information gathering costs. Thirdly, the returns can be increased by his/her willingness to take high risks.
4.5.5.4. The Organization and Clients' Services of Investment Manager

The investment decision making process is an important indicator of the quality of an investment manager in managing an active investment portfolio (Lee, 1990). Devlin (1998) and Carew and Hoffman (1997) suggested that the trustees assess the effectiveness of the investment manager's organization structure in relation to active investment management. These include assessing the degree of specialisation among investment analysts and administrative support personnel, to assess research facilities and to assess the investment services to the trustee. It is important to assess the investment services provided because the trustees have the responsibility of reporting to the members on investment management activities and performance (Carew and Hoffman, 1997). If the investment manager has a poor investment performance and/or investment services, it is suggested the trustee should terminate the investment management's agreement.

4.5.6. Evaluation

The trustee must undertake, with the investment manager, an evaluation of the investment management agreement (Carney, 1997), and assess whether key functions are being performed by the investment manager efficiently, effectively, and on time (Palmer, 1997). This is because, the trustee of the fund has a duty to seek information from the investment manager (Carney, 1997) and there may be a change of investment manager over time (Devlin, 1998). In this evaluation, the trustee can use the services of a financial consultant, an auditor, and a custodian (Carney, 1997). The financial consultant evaluates the performance of the investment managers who receive authority delegation or mandate from trustee.
and the investment service provided by investment manager such as regular reporting. The auditor examines the investment report provided by investment managers to find whether any contraventions or potential contraventions have occurred due to the behavior of the investment manager during the performing of their function in managing active investments on behalf of the trustee. The auditor is able to report whether the management of the investment manager is satisfactory. The custodian can ask for reports on the transactions performed by the investment manager in relation to active investment management.

Trone, Allbright, and Taylor (1996) suggest a number of questions in evaluating the performance of the investment manager, such as: (i) does the manager adhere to the strategy in the investment policy statement?, (ii) does the manager out perform a benchmark appropriate to the management objectives?, (iii) does the manager do as well as his or her peers?, and (iv) does the manager perform well in bull and bear markets?

The first question is to evaluate whether the manager is executing the investment strategy as stated in the investment policy guideline. For example, if the trustee hires a balanced-investment style manager, the trustee must evaluate the composition of the portfolio to determine whether the investment manager is following a balanced strategy consistently. The second question is to evaluate the performance of the investment manager by comparing it with the benchmark that is appropriate to the trustee’s fund objectives. The third question is to evaluate the performances of investment managers by comparing them with others
investment managers hired by the trustee. The comparison includes investment returns, the investment services, such as regular reports, up to date information, regular communication, and the commitment to the trustee’s business. The fourth question is to evaluate the consistency of investment manager’s skill.

5. The Relationship Between The Trustee of Superannuation Funds and The Investment Manager.

There is a relationship between the trustee of a superannuation fund and the investment manager which exists in investment management practice. The relationship begins from the need of the trustee to implement the fund’s investment strategy and to delegate to the investment manager the authority to manage active investment on behalf the trustee. As a consequence, an investment manager, who is charged to design the ‘right’ portfolio must be concerned with the trustee’s attitudes toward important investment management issues (Sharpe, Alexander, and Bailey, 1999), such as: the reasons for the trustees to invest in securities, the trustee’s investment objectives, the trustee’s motivations in using an investment manager to manage an active investment portfolio, the trustee’s investment guidelines for the investment manager, the trustee’s acceptance of the possibility of large losses, and the benchmarks of investment performance.

The importance given by trustees to their concerns will vary in accordance with their financial circumstances, nature of the fund, and restrictions on investments. The ability of the investment manager to understand the trustee’s needs for investment management is a key factor in building a strong relationship with
investors. However, the literature of investment contains very little material which discusses the importance of understanding the client's needs, the clients/investment manager relationship, and how to build a strong relationship. Many discussions only emphasise the need to estimate the client's level of risk tolerance. For this reason, this thesis explores two important aspects of the relationship between the trustee and the investment manager, using a trust theory as a guide. These two aspects of a relationship are the key factors of trustworthiness of an investment manager, and the key activities performed by the trustee and the investment manager for building a relationship.


This chapter explores the duties and power of the Australian trustee of a superannuation fund in managing investment funds. The type of superannuation funds discussed in the exploration is the employer-sponsored funds. The major duties of the trustee in managing investment funds include formulating investment strategy, implementing the investment strategy, selecting and hiring an investment manager, and evaluation. The power of the trustee in managing investment funds include making decisions to hire one or more investment managers. The results of this exploration support the contention that the trustee needs an investment manager to implement the investment strategy. Firstly, the trustee has the responsible for the growth of the investment funds for the benefit of the members. Secondly, the trustee of the pension fund allows investment of the funds in the stock and bonds directly or via an investment manager. Thirdly, the trustee of the pension funds has the power to hire more than one investment manager. Fourthly,
the trustee is responsible to the members for the performance of the investments under the management of the investment manager. A trustee as a consequence builds a relationship with the investment manager who will in turn protect the investment interests of the trustee. In the next chapter, a trust theory used as a guide to explore the relationship between the trustee of the pension funds and the investment manager will be explored.