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 7

The Development of Indonesian Pension Funds

1. Introduction

The previous chapter explored the development of the Indonesian investment management industry. This analysis indicated that dramatic increases in both the number of Indonesian investment managers and the investment products on offer to Indonesian trustees, encouraged those trustees to hire investment managers and further encouraged the trustees of large pension funds to hire more than one investment manager. This chapter now analyses the development of the Indonesian pension funds industry. The aim of the analysis is to understand the major duties and power of Indonesian trustees of pension funds, their investment management role, and the process of hiring an investment manager.

The case data of the development of Indonesian pension funds consist of both primary and secondary data. The secondary data were derived from annual reports of pension funds for the year 1996 (the latest edition available). The primary data were collected by conducting interviews with Indonesian trustees of the pension funds whose answers are transcribed and given in the Summary of Interview Data (Appendix 7) and analysed by using the pattern coding technique (Miles and Huberman, 1994). The aim of the analysis is to explore the characteristics of
Indonesian pension funds and the process of Indonesian trustee in building a relationship with the investment manager.

The structure of this chapter is organised around five topics: (i) the profile of the selected Indonesian trustee interviewees, (ii) the regulations and types of Indonesian pension funds, (iii) the organization of pension funds, (iv) the investment fund and its management, and (v) and the relationship between the trustee and the investment manager. The Indonesian trustees of pension funds who participated in this study as interviewees were selected on the basis of their experience in hiring investment managers. In order to obtain the maximum benefit from the investment manager, the trustee defines the process of selecting and hiring an investment manager, and the activities to build and develop a relationship with him/her. This is because the pension fund's regulations (a) provides the authority for the trustee to hire an investment manager, (b) defines the duties of trustees in managing the investment funds, and (c) allows the trustee to invest the funds in the stock market, the investment manager's area of expertise.

2. Profile of Trustee Interviewees.

The criteria used to select trustees of pension funds to participate in this study as interviewees were that: (i) all trustees must have had experienced at least two years in securities investment; (ii) the amount of funds invested in securities could be in the range of small to very large; (iii) the trustee used an investment
manager to manage active investments; (iv) the pension funds came from several business sectors; and (v) the pension funds were listed in the Annual Report of Pension Funds 1996.

Using these criteria, 16 trustees of 16 different pension funds were selected for this study from 6 industry sectors: banking, oil and gas, life insurance, telecommunication, postal, and publishing. A letter was sent to the trustees of these 16 pension funds, the target interviewees, seeking their cooperation in agreeing to be interviewed. Of this number 12 trustees of 11 pension funds agreed, of those who declined, the most common reason given was 'I am very busy'. However, one trustee who agreed to be interviewed is not reported in this study because he does not formally hire investment managers. The results of the interviews are used as a basis for the analysis. The specific profiles of the 11 trustee interviewees of 10 pension funds are presented in chapter 8 but their general profiles are given below.

Firstly, the 10 pension funds in this study consisted of 6 industry sectors. These were 4 from the banking sector, 2 from the oil and gas sector, 1 from the insurance sector, 1 from the postal sector, 1 from the telecommunication sector and 1 from the publishing sector. The details of the pension funds are listed below:

The banking sector:
the A pension funds
the B pension funds
the C pension funds
the H pension funds
The oil and gas sector
   the J pension funds
   the G pension funds
The life insurance sector:
   the K pension funds
The telecommunication sector:
   the I pension funds.
The postal sector
   the F pension funds.
The publishing sector
   the E pension funds.

Secondly, the amount of funds invested in stocks and bonds by the 10 pension funds were Rp 1,209 billion, that is, 47.5% of the total funds invested by the 159 pension funds in securities (stocks, bonds and units of mutual funds) at the end of year 1996 (Table 7.1).

Table 7.1: Profile Investment in Securities of the 10 Pension Funds
Year 1996 (in millions Rp)

Please see print copy for image

Source: Annual Report of Pension Fund - Year 1996
Thirdly, the trustees of the 10 different pension funds have all invested their funds in stocks and bonds. The investment in stocks by some pension funds has grown rapidly, even more than 100%. In the twelve months period of 1995-1996, for example, 'A' pension fund investment in stocks grew from Rp 115.01 billion in 1995 to Rp 202.95 billion in 1996 (Annual Report of Pension Fund - Year 1996). The investment in stocks of 'T' pension funds grew from Rp 87.59 billion in 1995 to Rp 145.60 billion in 1996. 1996 (Annual Report of Pension Fund - Year 1996).

Fourthly, the trustees of 11 of the 10 different pension funds invested in stocks and bonds through the hiring of investment managers. 3 pension funds hired 4 investment managers; 1 pension fund hired 3 investment managers; 5 pension funds hired 2 investment managers; and 1 pension fund hired 1 investment manager. The detail of pension funds are listed below:

<table>
<thead>
<tr>
<th>Pension Funds</th>
<th>Number of Investment Managers Hired</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>4</td>
</tr>
<tr>
<td>H</td>
<td>3</td>
</tr>
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<td>B</td>
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<td>E</td>
<td>2</td>
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<td>J</td>
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</tr>
</tbody>
</table>

Fifthly, the total number of trustee interviewees was 11 from 10 pension funds (see Appendix 7.7: List of Interviewees). All have named positions which are summarised as follows: (a) 4 - President Director or Chairman, (b) 2 - Investment
Director, (c) 1 - General Manager, (d) 2 - Treasurer, and (e) 2 - Investment Manager.

To summarise section two, the profile of Indonesian pension funds in this study are: (i) the trustees of pension funds who come from 6 different sectors; (ii) the sample of pension funds is equal to 6.3% of 159 pension funds which have investment in the stock market; (iii) the amount of funds invested in stocks and bonds is equal to 47.5% of the total funds invested in the stocks and bonds by 159 pension funds; (iv) the pension funds have a wide range from small to large in terms of the amount invested in the stock market; and (v) the trustee interviewees hire investment managers in the range of 1 to 4.

3. The Regulations and Types of Indonesian Pension Funds.

The number of pension funds in Indonesia has grown from 100 funds at the end of 1994 to 262 funds at the end of 1996. Fund under management have increased from Rp 10,185 billion at the end of December 1995 to Rp. 12,463 billion at the end of December 1996. Pension funds typically invest their funds in term deposits, bonds and stocks, promissory notes, private placement and property. The trustee of a medium to large pension fund hires at least one investment manager to manage the active investment portfolio on his/her behalf. It can be argued here that allowing the pension funds to invest their funds in the stock market is the initial impetus for the relationship between the trustee and the investment manager.
3.1 The Regulations for Developing Pension Funds in Indonesia.

Law No. 11, 1992 was established for the regulation of the pension funds. Its aim is to encourage Indonesian firms to establish corporate pension funds in order to provide a retirement income for their employees. By establishing pension funds, the firms can expect increased loyalty from their employees, to retain good employees and to attract new employees. The accumulation of funds gained through the pension funds increases national savings which is useful for financing Indonesian economic growth. To assist firms in achieving these aims, the Indonesian government provides tax incentives such as tax rate reduction for the contributions provided by both the employers and employees and tax-free returns on investments in the stock market.

Many regulations of the pension funds have been issued by the President of the Republic of Indonesia, the Minister of Finance of Republic of Indonesia, the Minister of Manpower of Republic of Indonesia, and the Director General of the Financial Institution of Ministry of Finance of the Republic of Indonesia. These regulations are concerned with: guidance to establish pension funds, the services to be provided by the pension funds, the types of pension funds, the requirements to establish the Board of Supervisor of Pension Funds and the Board of Director of Pension funds, the types of financial reports to be produced, their performance measurement, the controlling, and the investment of pension funds.
3.2 The Types of Pension Funds.

A pension fund is defined as a legal entity entitled to manage and run pension fund programs. The types of pension fund depend on the founders, the benefits and the members. Firstly, pension funds can be divided into two types: state or privately owned. In 1996, the number of state-owned pension funds was 52 and privately-owned 210. Secondly, using the benefits received by retirees, pension funds can be divided into two types: defined benefit funds and defined contribution funds. In 1996, most pension funds were defined benefits funds. This comprised 86% of the total pension funds (Annual Report Pension Funds, 1996). Thirdly, using the composition of the members of pension funds, the pension funds can be divided into two types: (i) financial institution pension funds that is pension funds which manage and conduct a pension fund program on behalf of their clients, and (ii) employer pension funds which manage and conduct a pension fund program for the benefit only of its employees. In 1996, the number of financial institution pension funds totalled 22 and employer pension funds 240.

3.3. Establishing the Pension Funds.

In line with the growth of the Indonesian economy, most employers want to establish pension funds and to manage pension programs for their employees. As a result, the number of pension funds grew from 100 at the end of 1994 to 262 at the end of 1996 (see Table 7.2). The employer pension funds grew from 90 at the end of 1994 to 240 at the end of 1996. The financial institution pension funds grew from 10 at the end of 1994 to 22 at the end of 1996.
Table 7.2
The Number of Pension Funds.

In order to explore the reasons for the employer establishing a pension fund, the following question was asked of the trustee interviewees: 'would you explain your reasons for establishing a pension fund?'. Their individual answers are summarised in Appendix 7.1 (Reasons for Establishing a Pension Fund). For the purpose of data analysis, their answers are treated together so that similar answers are in the same category. By using the pattern technique (Miles and Huberman, 1994), the reasons given by the trustee can be condensed into two major categories. These are:

1. **providing retirement income to the employees on retirement** (100% of interviewees)

2. **increasing the employees' loyalty to the firm** (70% of interviewees)

Providing retirement income to the employees on retirement is a major reason for establishing a pension fund and supports the purpose of superannuation funds (Covick and Lewis, 1997) that it is a means of making financial provision for employees during their working life for use as superannuation payment in their retirement.
Indonesian employees realise that they cannot work forever. They reach retirement age or may have an accident during their working life and be forced to retire early. Therefore, employees expect to have an income during their retirement period from their pension fund plan. The Indonesian employers also realise that the pension fund plan can be used to retain employees who are good performers and to recruit new employees with a good performance record. Thus, by establishing a pension fund, both the employer and the employees will gain many benefits. *For example, Mr. ‘L’, Indonesian trustee of ‘C’ pension fund, gives as his reason for establishing a pension funds, employees can expect to have a retirement income, and the employer can expect enhanced loyalty from the employees* (Appendix 7.1).

4. The Organization of Indonesian Pension Funds.

An examination of the organization of pension funds is focused on 3 aspects: (i) the organization structure, (ii) the reason for establishing the pension fund, and (iii) the investment funds management. The organization structure includes the duties of the supervisory board and the duties and powers of the trustee. The investment funds management includes the function of investment funds, the factors considered by the trustee in constructing a portfolio investment and the reasons for the trustees of the pension funds for investing in the stock market. It will be shown here that the responsibilities, duties and powers of the trustee to manage, the growth of the investment funds by investing in the stock market, are all part of the initial impetus for hiring an investment manager.
4.1. The Organization Structure.

According to the decree of the Finance Minister Number 229/KMK.017/1993, the organization of a pension fund must consist of a supervisory board and an executive board. Firstly, members of the supervisory board must be of good standing and morals, and never convicted anywhere or at any time of dishonest conduct. The members of the supervisory board consist of two types, those who represent the members of pension funds, and those who represent the employer. For example, an interviewee from ‘A’ pension funds, one of the largest pension funds in Indonesia, revealed that the members of the supervisory board consisted of 6 members, 3 who represented the members of the pension funds, and 3 who represented the employer. Secondly, members of the board of directors must be of good moral standing, never convicted anywhere or at any time of dishonest conduct, and have experience and knowledge of pension funds management. For example, the trustee of ‘A’ pension funds is a retiree who has been appointed by the supervisory board of the pension funds.

4.1.1. The Duties of The Supervisory Board.

The duties of the supervisory board include: selecting and appointing the trustee, evaluating and approving the investment policy proposed by the executive board, evaluating and approving the annual plan of the pension funds; and to monitor and evaluate the implementation of the investment policy and the annual plan by the trustee. The major duties of the supervisory board are to appoint or to replace the trustee, and to approve the investment policy and to evaluate its implementation. The investment policy must follow the Law of Pension Funds
1992 requirements and the decrees of the Minister of Finance of the Republic of Indonesia. For example, the Minister of Finance has issued decree number 231/KMK.017/1993 concerning the investment of pension funds. This decree has, in turn, been revised by the issuing a new decree 78/KMK.017/1995. This decree has again been revised by the issuing of a further decree 93/KMK.017/1997. These decrees provide guidance for the pension funds in managing their investments. The investment policy must state explicitly the composition of the portfolio investments, the minimum and maximum amount of funds invested in each type of investment, the minimum and maximum amount of funds invested in each investment manager, the accepted level of risk in the investment portfolios, the level of liquidity for each type of investment, the method for calculating the returns on investment, a system for monitoring and controlling the investment management and a system of reporting.

4.1.2 The Duties and Powers of the Trustee.

The major duties of the trustee are: (i) to manage the funds, (ii) to invest them in order to obtain reasonable returns, and (iii) to safeguard them. Firstly, in managing funds, the trustee must prepare an investment and an annual plan. The investment plan must reflect the investment policy approved by the supervisory board of the pension funds. Secondly, the trustee may invest the funds in term deposits, securities, promissory notes, private placement or property. However, the trustee is prohibited from investing the funds in derivative instruments or overseas. Third, the trustee has the authority to use an external investment manager to manage the funds to be invested in the securities investment portfolio.
To do this, the trustee must determine the criteria for selecting and using the services of an investment manager. Depending on the amount of funds available to be invested, the trustee can engage more than one investment manager. Finally, the trustee must submit the investment reports to the supervisory board, to the members of pension funds, and the employers.

5. The Investment of Pension Funds

Investment funds have the important functions of obtaining returns and maintaining liquidity. The returns on investment grew from 9.80% at the end of 1995 to 11.13% at the end of 1996. The investment activities of the pension fund must adhere to the Law of Pension Funds, 1992 and the decree of the Minister of Finance of the Republic of Indonesia number 93/KMK.017/1997. These regulations allow the pension funds to invest their funds in the money market, securities or property. The trustee must consider several key factors in making investment decisions in these markets. The key factors include: (a) risks and returns on investment, (b) liquidity, (c) safety and (d) diversification.

5.1 The Function of the Investment Funds.

The investment funds allocated by pension funds increased by 22.37%, a growth from Rp 10,185 billion at the end of 1995 to Rp 12,463 billion at the end of 1996 (see Table 7.3). The main reason for the increase was the increase in net assets of the pension funds by 23.5% for the year 1996. In line with the increased amount of the investment funds, the returns from investments also increased by 39.12%, a
growth fromRp 0.998 billion at the end of 1995 to Rp 1,387 billion at the end of
1996 (Table 7.3).

Table 7.3
Investment Funds
(Rp billion)

Please see print copy for image

Source: Annual Report of Pension Funds for the year 1996

In order to explore the functions of investment funds, the following question was
asked of the trustee interviewees: 'would you explain the function of investment
funds?'. Their individual answers are summarised in Appendix 7.2.(Function of
Investment Funds). For the purpose of data analysis, their answers are treated
together so that similar answers are in the same category. By using the pattern
technique (Miles and Huberman, 1994), the answers given by the trustees can be
condensed into one category namely that the major function of investment funds
is:

- **to obtain returns on investments** (100% of interviewees).

The returns on investment are useful for increasing the benefits for the retirees,
and for reducing the amount of the employer's contribution. Firstly, in the
defined benefits plan, the benefit of the retirees is defined in advance. As a
consequence, the employer will be liable to pay the contributions if the funds
are insufficient to cover the total benefit owed to the retirees. On the other hand,
if the funds are sufficient to pay the total benefit to the retirees, the employer does
not need to pay any contributions, or the contributions of the employer will be reduced. Secondly, in the defined contribution plan, the performance of the investment, good or poor, will have an impact on the benefits to the retirees. In a good investment performance, the returns exceed the target returns, will increase the funds which can in turn be used to increase the benefits to the retirees, or reduce the contribution of the employer and the employees. A poor investment performance means that the return is lower than the target return. As a consequence, the benefits to the retirees will not increase.

5.2 The Investment Portfolio of Pension Funds.

The investment funds are invested in several financial instruments (Table 7.4) but the majority are invested in term deposits. The next choices are to invest the funds in securities, property, private placement, or promissory notes. Investment in term deposits increased by 26.64%, a growth from Rp 5,323 billion in 1995 to Rp 6,741 billion in 1996. Investment in securities increased by 24.13%, a growth from Rp 2,051 billion in 1995 to Rp 2,546 billion in 1996. Investment in private placement increased by 16.53%, a growth from Rp 1,161 billion in 1995 to Rp 1,353 billion in 1996. Investment in property increased by 7.66%, a growth from Rp 1,606 billion in 1995 to Rp 1,729 billion in 1996. Investment in promissory notes increased by 136%, a growth from Rp 39 billion in 1995 to Rp 92 billion in 1996. Funds invested in mutual funds decreased by 16%, a decrease from Rp 75 billion in 1995 to Rp 63 billion in 1996. The Indonesian pension funds' portfolios support the statement of McCarthy (1999) that the primary investment of pension funds are term deposit, stocks, bonds, and property.
In order to explore the factors considered by the trustees in constructing portfolio investments, the following question was asked of them in their interviews: ‘would you explain the factors you considered in constructing your pension fund’s portfolio investment?’. Their individual answers are summarised in Appendix 7.3 (Factors Considered in Constructing Portfolio Investment). For the purpose of data analysis, their answers are grouped together so that similar answers are in the same category. By using the pattern technique (Miles and Huberman, 1994), the answers given by the trustee can be condensed into three categories. These are:

- **risks of investment** (100% of interviewees)
- **safety of funds** (80% of interviewees)
- **returns on investment** (45% of interviewees)

This thesis found that returns on investment is a factor considered by the trustee in constructing the portfolio. This finding confirms the evidence of Amir and Benartzi (1998) and Blake, Lehmann, and Timmermann (1999) who investigated...
the relationship between the expected rate of return on investment with the composition of the pension portfolio, although the relationship is not strong.

Individual Indonesian trustees have different perceptions as to which factor is the most important in constructing a portfolio. This is because, the number of retirees, the number of members of the pension funds, the experience of the trustee and the financial conditions of the pension funds will determine which are the most important factors to be considered in constructing a particular investment portfolio. For example, Mr. M, Indonesian trustee of 'G' a small pension fund is more concerned with the level of risk than the returns on investment (Appendix 7.3).

| Table 7.5 |
The Investment Pattern in Securities, 1995-1996 |
| (Rp billion) |

| Source: Annual Report of Pension Funds for the year 1996 |

5.3 The Investment Securities Portfolio of Pension Funds.

The investment funds invested in securities in the form of stocks, bonds and mutual funds grew from Rp 2,051 billion at the end of 1995 to Rp 2,546 billion at the end of 1996 (Table 7.5). The investment in stocks grew from Rp 1,006 billion at the end of 1995 to Rp 1,247 billion at the end of 1996. The investment in
bonds grew from Rp 970 billion at the end of 1995 to Rp 1,236 billion at the end of 1996. The investment in mutual funds decreased from Rp 75 billion at the end of 1995 to Rp 63 billion at the end of 1996.

In order to explore the reasons the trustees invest in the stock market, the following question was asked of them in their interviews: ‘would you explain your reasons for investing in the stock market?’ Their individual answers are summarised in Appendix 7.4 (Reasons for Investing in the Stock Market). For the purposes of data analysis, their answers are treated together so that similar answers are in the same category. By using the pattern technique (Miles and Huberman, 1994), the answers given by the trustees can be condensed into two categories as the major reasons for investing in the stock market; these are:

(1) **returns on investment** (90% of interviewees)

(2) **investment diversification** (60% of interviewees)

The returns on investment as a reason to invest funds in the stock market is that the trustee wants to match the duration of the investment to the maturity of the liabilities of the pension fund. For example, if the members of the pension fund are young, the pension funds will have long-term liabilities to its members. As a consequence, the funds need to be invested in long-term investments that are expected to have high returns. The second reason is that the trustee may prefer to diversify the investments in order to reduce the risk on the total investment portfolio, and to improve the total returns of the investment portfolio in the future.
For example, pension funds, which have excess liquidity, need to diversify their investments.

6. Investment Management.

The aim of investment management is to make sure invested funds keep growing by obtaining returns on investment for a given period. The Indonesian trustee can manage the investment funds in two ways: in-house investment management and/or using an external investment manager. This thesis focuses on using an investment manager, that is, the form of discretionary funds management managed by an investment manager or buying mutual funds offered by an investment manager. The major motivations for using an investment manager are to have an active investment management, to obtain a transfer of knowledge from the investment manager, to obtain returns on investments and to obtain investment information. It is shown here that the motivations of the trustee for hiring an investment manager increases the need of the trustee to build a good relationship with him/her.

6.1 Using Investment Managers.

A trustee uses an investment manager to manage active investments in a securities portfolio. The funds invested in securities may be in the form of mutual funds or discretionary funds. The motivations of the trustee to buy units of mutual funds or to establish discretionary funds are: to have an active investment portfolio, to obtain a transfer knowledge from the investment
manager, to obtain monetary benefits such as returns on investment, and to obtain investment information.

6.1.1. Mutual Funds Management.

Trustees invest their funds in mutual funds issued by investment management firms. Most investment management firms offer many types of funds such as a fixed income, equity, and mixed. These allow the trustee to select those most suited to his/her needs. Most trustees of large pension funds invest their funds in mutual funds as a sponsor.

In order to explore the reasons for the trustees of large pension funds to sponsor mutual funds, the following question was asked of the trustee interviewees: 'would you explain your reasons for sponsoring mutual funds?'. Their individual answers are summarised in Appendix 7.6 (Reasons for Sponsoring Mutual Funds). For the purposes of data analysis, their answers are grouped together so that similar answers are in the same category. By using the pattern technique (Miles and Huberman, 1994), the answers given by the trustees can be condensed into three categories as the major reasons for sponsoring mutual funds. These are:

1. **To receive free stock market information** (60% of interviewees).
2. **To have free transaction costs** (40% of interviewees).
3. **To receive transfer of knowledge** (40% of interviewees).
Most trustees of large pension funds set up a team to learn about active investment management. The investment team needs to monitor: price fluctuations, trading volume and frequency; to identify the information that make stock prices increase or decrease, and to search for up to date stock market information. The investment team can ask for assistance from the investment manager for up-to-date stock market information and transfer of investment knowledge. In some instances, the investment team follows the investment manager in buying or selling stocks.

The transaction costs for buying and selling mutual funds is high. Therefore, the trustee is interested in free transaction costs for buying and selling mutual funds. Transaction costs is a major reason for the Indonesian trustees to sponsor mutual funds. This supports the argument of Spencer (1998) that traditionally, sponsors ignored management fees; and also support the study of Livingston and O'Neal (1998) that investors must consider expenses as a criterion when buying mutual funds because expenses have a negative effect on returns.

### 6.1.2 Discretionary Funds Management.

Most trustees of big pension funds hire an investment manager to manage an active securities portfolio on their behalf. The trustee provides the investment manager with investment guidelines to be used in managing the active securities portfolio. The trustee has the responsibility of paying the fees of the investment services provided by investment management firms, to provide investment
guidelines, to evaluate the performance of the investment manager, and to make decisions to continue or discontinue the relationship with the investment manager.

The investment manager has responsibilities and duties to the trustee. The responsibilities of the investment manager include: to safeguard the funds from fraud or careless decisions, and to keep the promises given in the investment agreement. The duties of the investment manager include: to invest the funds in a securities portfolio, to implement consistently the trustee’s investment guideline, to manage the securities portfolio as an active investment, to submit a monthly report of the portfolio performance, to provide explanations of the stock portfolio, to give investment services, to conduct regular meetings with the trustees, and to keep in contact with the bank custodian.

The major benefits for trustees from hiring the investment manager are: to have an individually managed portfolio that reflects the trustee’s objective and constraints, and to receive good investment services.

In 1997, most trustees of large pension funds hired more than one investment manager to manage an active investment portfolio, on behalf of the trustee. For example, Mr. ‘A’. Indonesian trustee of ‘A’ pension funds hires four investment managers from four different investment management firms to manage his active investments. The main reasons for a trustee to hire more than one investment manager are to compare the performance and investment services among the
investment managers; to reduce risks of the failure of one investment manager; and to check the accuracy of information (Appendix 8.2).

7. The Relationship Between the Indonesian Trustee of Pension Funds and the investment manager.

The relationship between the Indonesian trustee of a pension funds and the investment manager begins with the need for a trustee to invest in an active investment and/or in mutual funds. The relationship between the trustee and the investment manager may be in the form of a collective investment contract or a discretionary investment contract. For the purpose of obtaining maximum benefits from the investment manager, the trustee selects and hires an investment manager through various activities designed to build and to develop their relationship. The detailed analysis of the relationship between the trustee and the investment manager are analysed in chapters 8 and 9.

7.1. The Process of Selecting and Hiring an Indonesian Investment Manager.

The results of interviews with the trustees and investment managers indicate that selecting and hiring of an investment manager consists of six processes in which the trustee and investment manager are directly involved in this process. Firstly, the trustee defines the reasons for the investment in the stock market, the benefit and cost of hiring an investment manager, and the criteria of a good investment manager.
Secondly, the trustee sends a letter of invitation to investment managers to present their investment capabilities in managing active investment on behalf of the prospective client. In this letter, the trustee nominates the amount of funds to be invested in securities portfolio, the general investment guideline and limitations, the duration of the investment, the number of investment manager needed, and any information required. For example, Mr. 'D', investment manager of 'IIIB' investment management firm has been invited by a financial consultant of trustee to present and submit an active investment proposal to the trustee (Appendix 7.5).

Thirdly, investment managers, who are interested in the trustee's invitation, conduct presentations to the trustee. For example, Mr. 'E', investment manager of 'MIS' investment management firm, made a presentation to the trustee on (i) his firm's profile including investment experience, the firm's reputation, and (ii) his experience in managing active investments including the investment philosophy, the investment style, the performance of investment manager and investment services (Appendix 7.5). In individual presentations, the investment manager outlines the performance record, the investment philosophy, the investment management team, the decision making process of buying and selling stocks, the research facilities, the portfolio administration, the relationship with the custodian, the investment services provided to the clients, the funds under management, and the relationship with the clients. Investment managers also invite the trustee to visit their offices for a personal tour. For example, Ms. 'C', trustee of 'E' pension fund, has been invited by an investment manager to visit his office to see the research team, and facilities (Appendix 7.5).
Fourthly the trustee evaluates the information presented by the investment manager. The evaluation includes a check on the truth of the information given, by asking other clients, the custodian, or stock brokers. This information is compared with the criteria for hiring an investment manager. For example, Mr. 'D', trustee of 'H' pension fund, asks for information from custodian in order to check the performance of an investment manager in buying and selling stocks (Appendix 7.5). In making an evaluation, the trustee may use an independent consultant. For example, Mr. 'M', trustee of 'G' pension fund, uses a consultant to evaluate the profile of investment manager to select an investment manager (Appendix 7.5).

Fifthly, the trustee sends a letter to the investment manager accepting or refusing the offer. The trustee asks the chosen investment manager to prepare an investment management agreement. For example, Mr. 'Y', trustee of 'F' pension fund, emphasises that investment management agreement must consider trustee's investment guideline and safeguards the funds from fraud (Appendix 7.5).

Sixth, the trustee evaluates the contents of the investment management agreement. If he/she agrees with the contents, both parties will sign the investment management agreement, and by doing so both the trustee and the investment manager begin to build a relationship. For example, Ms. 'C', trustee of 'E' pension fund, emphasises that the investment agreement must be written in the Indonesian language; and the investment manager must be responsible for making transactions in the stock market (Appendix 7.5).
These processes of selecting and hiring an investment manager assist us to explore the key factors of trustworthiness addressed in the first major questions of this study. Exploring relevant aspects of these issues may be summarised in the following question:

7.1. What are the criteria used by Indonesian trustees to select and hire investment managers?

The answers to this question are analysed and presented in chapter 8.

7.2. The Activities to Build and Develop a Relationship with Investment Manager.

The trustee performs several activities in the process of building relationship with the investment manager. Firstly, the trustee monitors and evaluates the benefits of a relationship with an investment manager. This is because, the trustee will need to convince the members of the funds that his/her decision to hire an investment manager will provide benefits for them by increasing their retirement income. The benefits may be in the form of obtaining returns on investments and reducing transactions costs. For example, Mr. 'L', trustee of 'C' pension fund, claims that monitoring and controlling the investment manager’s activities and performance is important for assessing benefits from the relationship with him/her (Appendix 7.5).

Secondly, the trustee also monitors and evaluates the potential cost of a relationship that could be an initial loss of funds, careless buying and selling transactions, or fraud. This is because, the costs of the relationship with the
investment manager will affect the benefits to members of the fund. *For example.* Mr. 'D', trustee of 'H' pension fund, evaluate the custodian cost as the result of selling and buying decisions taken by investment manager (Appendix 7.5).

Thirdly, the trustee builds communication links with the investment manager that may be direct or indirect. In direct communication, the trustee meets with the investment manager, converses via the telephone, and/or visits the investment manager. In indirect communication, the trustee of the pension funds receives current stock market information, and investment reports. *For example, Ms. 'J', trustee of 'I' pension fund, converses regularly with the investment manager asking for explanations or obtaining stock market information.*

These activities performed by the trustees for building relationship with the investment managers provide a means of exploring the second major issue of this study. This issue seeks to explore the development of the trust relationship between trustees and investment managers in Indonesia (see question two, chapter one). We can summarise this exploration in two sub questions:

7.2. What are the key activities performed by the trustee and the investment manager to build their early relationship?

7.3. What are the key activities performed by the trustee and the investment manager to develop their long-term relationship?

The answers to these two questions are analysed and presented in chapter 9.
8. Summary.

In this chapter, the development of Indonesian pension funds was explored and analysed. The focus of analysis was on the regulations and types of Indonesian pension funds, the organization of pension funds, and investment management. Primary data was collected by conducting interviews with the trustees of the pension funds. The results of the data analysis support the contention that there is a relationship between the Indonesian trustee of pension funds and the investment manager. There is some evidence for this. Firstly, the regulators have issued regulations allowing the pension funds to invest their funds in the stock market. Secondly, the trustee has a duty to construct a portfolio investment in order to obtain returns on investments that will increase the benefit to members. Thirdly, the trustee of the pension fund has the power to hire an investment manager to manage active investments on behalf of the trustee. Fourthly, the trustees of large pension funds hire more than one investment manager. Fifth there are several processes of selecting and hiring an investment manager, and there are subsequent activities performed by trustee for building and developing a relationship with an investment manager.

In the next chapter, the key factors of trustworthiness of an investment manager will be explored and analysed as the criteria used by the trustee to hire an investment manager.