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Attracting Talent to the Frontiers of Finance

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Introduction

The global geography of finance and investment is being reshaped by two important trends. On the one hand, a growing number of institutional investors are popping up in cities that have little or no history of financial services. In large part, this trend is due to the dramatic rise to prominence of sovereign funds, such as in Abu Dhabi, Auckland, Beijing, Edmonton, Juneau, Moscow, Oslo and elsewhere. Indeed, more sovereign funds have been set up in the last five years than in all the years' prior.⁴ On the other hand, in the wake of the financial crisis institutional investors have been dissatisfied with the traditional institutions of finance and investment. This is due, in large part, to the misaligned incentives, high fees, poor returns, and short-termism embedded in most third-party management agreements. As a result, institutional investors are, today, much more willing to think creatively about deploying their capital, such as through in-house teams.

The combination of these two trends has ushered in a new era of "Frontier Finance" – where institutional investors, many of which are public pensions or sovereign funds in regions without a history of financial services, are making direct investments that bypass traditional financial intermediaries. It seems the world's financial center of gravity is shifting away from the traditional financial hubs, such as London, New York and Tokyo, to cities at the frontiers of financial markets.

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⁴ Most commentators agree that SWFs are special purpose vehicles that invest sovereign assets in private financial markets. Commodity funds, reserve investment corporations, and pension reserve funds are all types of SWFs that exist to facilitate or sustain the policies of sovereign entities (nation-states, governments, and their instrumentalities). While SWFs have various macro-economic functions or purposes, they typically invest their assets in global financial markets in accordance with the interests and objectives of the sovereign sponsor (see Monk 2009, 2011)

But while this new geography of finance and investment offers some unique opportunities for these investors to leverage their organizational endowments (e.g., scale, time horizon, certainty of capital, etc.) – in particular through creative capital deployments (e.g., in-house management, seeding new managers, etc.) – it also creates a variety of new challenges. For example, how do public pension and sovereign funds set up world-class investment organizations out on the frontiers of finance? More specifically, how do these funds attract the talented investment staff they require to implement a sophisticated investment strategy that combines both in-house and external mandates?

In this brief white paper, we highlight how certain public pension and sovereign funds are attracting the necessary human resources.⁵ We focus, in particular, on the recruitment of the organization's leaders, both current and future, within the investment departments. We recognize that this represents a small segment of the fund's population, but hiring talented investors is crucial to the success of any services oriented business, especially finance (Teece, 2000).

In making our arguments, we draw on the findings of twelve in-depth case studies of public pension and sovereign funds conducted over the past 18 months around the world. While specific cases and findings are eschewed in favor of drawing useful generalization for the broader community of public investors, we do illustrate some of our principles and policies through a specific case study of the Alberta Investment Management Corporation.

The Challenge of (Human) Resourcing

A new report by CEM benchmarking shows that institutional investors like public pension funds can achieve the same or better returns through in-house asset management for a fraction of the cost of outsourcing assets to external managers (see White 2012): *“These funds spend an average of 46.2 basis points on external management, compared to 8.1 basis points on internal investment capabilities...the funds with internal management platforms are better performers after cost, and this is largely driven by lower costs of internal management.”* In short, there are sound reasons for pension and sovereign funds (as well as their institutional cousins) to consider a policy of in-sourcing (Clark and Monk, 2012). And yet, the CEM report goes on to show that the successful funds at managing assets in-house have highly sophisticated and generous human resources offerings for employees. Indeed, these funds focus a great deal on attracting highly qualified individuals.

The question, then, is whether these public funds in frontier cities can attract the investment staff they will need to execute on these strategies. To do so, they will have to overcome the following constraints:

- **Public Agency:** Publicly sponsored funds tasked with investing in private markets have to find creative ways to fill ‘public sector’ jobs with individuals that can compete in and with the private sector.⁶

⁵ Note that we are focusing exclusively on the attraction of talent in this paper and leave the issue of retention and development to a subsequent paper. In our view, both topics are crucial and warrant individual treatments.

⁶ The mistake most often made by sovereign funds is to underpay – and sometimes dramatically – their people. The governing bodies that resource these funds will at times (erroneously) base the salaries of sovereign fund staff off of government salaries instead of basing them off of market wages in finance.

- Frontier Finance: While hiring talent can be a challenge in any location, it is made more difficult by the fact that many public funds are located far from the world's financial hubs and, as such, labor pools.
- Alignment: A pressing challenge facing long-term investors is how to align the interests of new staff with the interests of the organization. Public pensions and sovereign funds have inter-generational time-horizons, while the funds' managers do not (Dixon and Monk 2012b). This 'principal-agent problem' makes hiring and motivating talent to act in the best interests of the fund difficult.
- Direct Investment: Funds that are moving assets in house need to hire 'investors' rather than 'allocators', but the former are harder to identify than the latter. Many institutional investors already have a deep pool of 'allocators' that may have to be retrained or even let go.⁷
- Emerging Markets: If the fund is looking for exposure in emerging markets, it will need staff with local knowledge of these markets. Research shows that local knowledge and asymmetric information can lead to as much as two percent per year in additional returns (Coval and Moskowitz, 2001), which means this local knowledge is paramount (Gertler, 2001).
- Alternative Assets: If a pension or sovereign fund is looking to compete in alternative assets, talent can become more scarce and expensive than it already is in financial services generally.

In short, as funds on the frontiers of finance consider 'in-sourcing', their success will ultimately be a function of their ability to overcome the constraints above and attract the necessary talent to succeed. But institutions are difficult to change, and it may take years for the public sector to converge towards private sector norms of human resources management (Boyne, et al., 1999). And this means that Boards and management of the organizations will have to get creative.

Today's Strategy: Green, Grey and Grounded

Given the many constraints cited above, public pension and sovereign funds have faced some clear challenges in attracting investment talent. Notwithstanding, our case studies have been, in general, quite successful recruiting within certain segments of the financial services industry. Indeed, among the 12 cases we performed over the past 18 months, there was a consensus that frontier investors have considerable success hiring the green, the grey and the grounded:

- The Green: Public pension and sovereign funds are generally quite competitive in attracting early career individuals (i.e., the green). At this early stage (e.g., 0-5 years experience), the disparity between the public sector salaries and the private sector salaries are lowest. Moreover, the opportunities for career development at a public fund are (in many cases) far superior to those in the private sector. As a CIO recently told us, the sales pitch to his recruits begins by saying, "If you give me three years of your time, I'll give you 20 years of experience." And this tends to be a successful HR strategy, as there are many individuals that will give up some current income to accelerate their career prospects and opportunities.

⁷ The direct investor will also have to hire the risk, operations and legal staff to manage the in-house processes. By some calculations, for every 'direct investor' the fund hires it has to hire two back and middle office personnel to keep up with the workload.

- The Grey: Public pension and sovereign funds are also competitive in hiring experienced individuals (i.e., the grey). Generally, these are individuals that have had successful careers in the private sector (e.g., 15 to 25 years experience). They've made their money and are now interested in giving back or, depending on the circumstances at the fund, escaping the rat race. They also get to sidestep the fundraising cycle that so many private managers dread. They get a (relatively) stress free environment to 'practice their trade' through to the end of their careers. And they get to serve as mentors to younger employees (i.e., the green).
- The Grounded: Public pension and sovereign funds are also competitive at hiring people that are tied to the region (i.e., the grounded) due to family, identity or affinity. Indeed, many employees at public funds are there because they want to stay close to relatives, give back to their country, or just because they want to be close to some great skiing or fishing (see Edmonton or Alaska).

In sum, these are the types of individuals that seem most attracted to working at public funds. By implication, then, these funds are relatively less competitive at hiring the mid-career professionals that command high salaries in the private sector.⁸ Indeed, public funds will remain a second order option for the 'Wall Street' labor pool so long as these funds do not pay the market median for finance (see Ambachtsheer, 2011 and Bertram and Zvan, 2009).⁹ And very few funds have the governance arrangements that would see this compensation level realized (Clark and Urwin, 2009). As such, a dash of creativity and innovation is required to compete successfully. And, in our view, the three Gs of 'green, grey and grounded' represent a successful strategy for recruiting finance talent into public pension and sovereign funds today.

However, we do see the potential for a different approach in the future; one that makes no concessions to Wall Street investors or the private sector in terms of talent. Put simply, we think public funds should recognize how they differ from the mainstream and tailor their human resources strategies accordingly.

In fact, they may get closer to actually achieving their objectives by targeting a different type of employee altogether.

Tomorrow's Strategy: 'Moneyball'

The conventional finance wisdom has it that the highest paid investors are the best at their jobs. So, in theory, if an investment organization wants to have the best returns, it has to be willing to pay the highest salaries. Following this logic, then, a public pension or sovereign fund can never really hope to compete successfully in the financial marketplace due to resource constraints, which is why these funds should outsource their investment mandates to the highly paid professionals in the private

⁸ That's not to say that there aren't some very talented mid-career folks. There are those that fall into the "grounded" category. And there are others that come for the same reasons as the "Grey" but are simply willing to leave the private sector earlier.

⁹ As White (2012) reveals, the top five salaries for investment staff at Canadian pension funds was \$1.5 million, while the same people at US pension funds made only \$372 thousand. The fact that Canada has a world-class reputation for in-house management (and the US funds do not) should not come as a surprise. The important thing to remember, however, is that the Canadian funds total costs (both internal and external) are lower than the American funds and the returns are better.

sector. Is this right? We think not. In fact, we do not equate the compensation of Wall Street investors with their ability to generate long-term returns at a public pension or sovereign fund.

Consider the telling case study of the Oakland A's baseball team as highlighted in Michael Lewis' now famous book 'Moneyball'. At the time, the prevailing theory in baseball was that the teams with the highest paid players would inevitably have the most wins. However, something strange began happening when the team with the lowest payroll, the A's, began consistently beating the teams with the highest payrolls. In fact, the A's fielded a winning team with a payroll that was a quarter of the highest paid teams. And this raised the question as to how a resource-starved team could consistently beat teams with 'better players'.

The A's success was driven by the team's willingness to revisit the fundamentals of baseball in order to understand what actually makes a winning baseball team. With this information in hand, the team then set out to hire players that could maximize the team's capacity in those domains that had the highest correlations with winning. Put simply, the team gave up on the 'conventional wisdom' of baseball and re-conceptualized the characteristics of a winning team. And by revisiting the very foundations of the game of baseball, the team found a set of cost-effective ingredients that could replicate the costly ingredients used by other teams.

The A's story has obvious parallels to the world of public pensions and sovereign funds and the 'game' of finance. These resource-constrained investors need to attract investors that can compete in and with the private sector but at a fraction of the cost. And, in order to accomplish this, they will need to re-examine the very nature of finance and investment. Moreover, they will need to re-examine the constraints and comparative advantages that they bring to the table. These are the ingredients they have at their disposal. And with these ingredients to hand, the funds can better identify the types of individuals that can add the most value for the organization over the long-term.

In the most generic terms, a public pension and sovereign fund's objective is to generate financial returns over a long-term time horizon (Dixon and Monk, 2012a).¹⁰ These funds are thus (in theory) unconstrained, long-term investors. As such, they should behave in a different manner from short-term, private sector managers (Clark and Monk, 2011). These long-term investors should thus see the "game" they're playing as one where "the winners" generate sustainable economic growth and value through investments in a (reasonably) diversified portfolio of assets. In our view, this requires thinking about real assets and companies rather than focusing on abstract financial products and concepts (Clark and Monk 2012b).

All this is to say that the game a long-term investor plays is different from the game short-term investors play, which means that a different type of employee may be 'the ideal type' for the former than for the latter. For example, public funds may want to hire people that can think in concrete terms about creating businesses and generating value. Consider, as a tangible example, the skill set required for assessing a farmland investment in the manner outlined by long-term pension investor TIAA-CREF (2012):

"In every acquisition, our agricultural investment team considers farm-specific investment criteria. These factors take into account regional and micro-climate factors, including weather variability and soil types; the strength of local infrastructure and tenant markets; water availability and sustainability; crop returns; environmental and social impacts; the potential for future operational growth; and capital gains. Our investment decision-making is also based on crop type..."

¹⁰ We leave stabilization funds to the side here, as these are not long-term investors and have to concern themselves with the short-term liquidity needs of the sponsoring government.

There are no financial abstractions in this investment decision-making process. The investor is seeking insight into how this asset will develop and grow (literally) for decades. We think this is a useful way for long-term investors to approach investments of all kinds.

So let's reconsider the human resources question again: What type of person would be better suited to making a successful farmland investment? Put another way, what game is the investor playing above and is it the same game that the highest paid hedge fund managers are playing in New York and London? The answer is almost certainly no. Let's also pose the question as to whether an investment professional with deep experience structuring and assessing various financial products and their risks would be the appropriate choice for managing a portfolio of farmland investments over time? Or, rather, would an agricultural professional with deep experience building farming businesses be the better option? If we were planning to hold the asset for thirty years, we'd choose the latter.

In short, long-term investors are focused on creating lasting value (rather than just taxing market inefficiencies, which seems to be the focus of short-term investors these days). Long-term investors build businesses, buildings, bridges and, yes, they even plant beans. They invest on a direct basis to avoid the distortionary (short-term) influence of intermediation. They look for ways to remove unnecessary abstractions in order to better evaluate the long-term growth prospects for a given asset.

In our view, then, public funds shouldn't be trying to hire employees away from Wall Street; they should be looking for people with a slightly different make-up that can drive sustainable growth for decades to come.¹¹

Case Study: The Alberta Investment Management Corporation

The Alberta Investment Management Corporation (AIMCo) manages roughly \$70 billion on behalf of 26 public sector clients, including Alberta's pensions, endowments, and government funds. It was launched in 2008 as a 'Crown Corporation' to professionalize the management of Provincial assets, which were previously managed by Alberta Finance and Enterprise. While the Government remains the sole shareholder, it operates independently and has the over-arching objective to build an effective asset manager with the capability to manage assets internally.

Since 2008, AIMCo has grown from roughly 130 professionals to more than 300. The fund has roughly 80 percent of its assets managed in-house, which means that it depends on being able to hire highly sophisticated individuals. And yet, AIMCo is located in Edmonton, which can make recruitment a bit of a challenge. Even though the summers are beautiful and the geography is incredible (see Banff), the winters are long. In addition, the city is not a global financial center, which means there isn't a ready pool of investment talent to fill jobs. Moreover, the fund has to compete against a thriving oil and gas industry for 'the green' employees (as well as operational

¹¹ With this in mind, we'd rather hire an army of project managers with little knowledge of finance than hire an army of investment professionals with little project management experience — especially since all public pension and sovereign funds will have a senior investment professional (e.g., the CIO) that will have to bless any investment decisions anyway. Why project managers? Because they are team players (most of what they do is coordinate and delegate). They are disciplined and rigorous about getting things done. They can navigate bureaucracies, while internalizing and integrating innovative practices. And, finally, they have a high tolerance for ambiguity. This is the practical reality of life inside a sovereign fund, and these are the individuals that we think would make up a winning team for less money.

talent). This all means that AIMCo is a very useful case for studying some of the human resource constraints discussed above.

Governance: AIMCo was the last of the big Canadian pension plans to be spun off from the Ministry of Finance into a Crown Corporation. The fund followed the lead set by other successful Canadian funds, such as CPPIB and OTTP, by operating at arms' length to the government with a highly sophisticated Board. The credibility (in terms of independence and business acumen) of the Board has been a key part of attracting senior leaders to the organization. If a person is going to move their family to Edmonton, he or she will want confidence that the organization and its strategy have longevity. In addition, the Board has put in place compensation practices that are compatible with the industry.

Recruiting: AIMCo focuses its recruiting efforts on the individuals for whom the fund has an inherent competitive advantage in hiring. Like other funds, AIMCo has come to recognize that there are certain types of people that the fund is effective at recruiting, while there are other types of employees that are more challenging to recruit. Specifically, three types of people tend to fit within AIMCo's competitive frame:

- AIMCo is generally quite competitive at attracting early-career individuals that are 'rising stars' in the organizations they are in. At the early stages of an individual's career, the disparity between AIMCo's salaries and the private sector salaries are low (or even in favor of AIMCo). Moreover, the opportunities for career development at AIMCo are far superior to those in the private sector, as young employees that demonstrate skill and are reliable tend to receive responsibilities far exceeding peers in the private sector. In addition, these rising stars are given a 'bigger sandbox' to play in. To tap into this local talent, AIMCo sponsors a variety of local initiatives, such as a course at the University of Alberta and the Alberta Finance Institute in Calgary.
- AIMCo is also competitive at recruiting experienced employees at the later stages of their career. Many of these individuals are looking for an entrepreneurial challenge in a younger organization (i.e., less bureaucracy and more fun). These are individuals that tend to have had successful careers on Wall Street or in Toronto and are interested in spending a few years 'giving back'. These individuals also tend to be the mentors for the rising stars, which is a crucial role for developing the organization's capabilities.
- AIMCo is also competitive at hiring people that have ties to the region due to family, identity, affinity or geography. Indeed, many employees at AIMCo are there because they want to stay close to relatives, 'give back' to their Province or simply live near some of the world's best skiing (see the Rockies). AIMCo has grown very adept at tapping into these local networks and sourcing talent therein.

By implication, then, AIMCo is less successful at hiring mid-career professionals who can earn high salaries in the private sector. However, that's not to say there aren't some of these mid-career people at AIMCo, but those at AIMCO in mid-career roles are often attracted by more than just money; it's often the platform (i.e., working for a \$70 billion fund), the career acceleration (i.e., contacts, deals and experience); the mission (i.e., helping to provide pensions for the elderly), or the ability to avoid fundraising every four years (as private sector managers have to do) that drive the appeal of the job. And AIMCo does a good job of articulating these factors when recruiting mid-career people.

Implications and Conclusion

Because institutional investment is a talent intensive industry, public pension funds and sovereign wealth funds have to attract high caliber investment professionals and leaders to be successful. The funds' reliance on human capital tends to be compounded by the pervasive trend to invest in emerging markets and illiquid assets through in-house teams.

However, public funds – like many institutional investors – face a variety of human resource constraints that generally stem from weak governance arrangements and the simple reality of geography; the low pay and small pools of labor generally mean that successful human resources policies for these funds tend to require creativity and innovation. Today's public funds are thus adopting human resources strategies that target segments of the labor market where they are competitive.

In general, funds are targeting: 1) Early career employees that want experience (the green); 2) Late career employees that want a change of pace from Toronto, London or Wall Street (the grey); and 3) People tied to the region due to family, identity, affinity or even geography (the grounded). However, while this approach offers public funds the ability to get the talent they need, the three Gs only offer a short-term solution.

Tomorrow's public funds will want to re-consider the very nature of finance and investment and the objectives of their organizations. In our view, long-term investors should be focused on generating lasting value; creating businesses, buildings, bridges and even planting beans. And the people they hire to achieve these goals should be expert at these tasks. In other words, public funds will have to re-conceptualize the types of people that best align with the fund's objectives; this is 'moneyball' finance.

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