Investment house strategy and controllership: The management of portfolios delegated to discretionary agents

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INVESTMENT HOUSE STRATEGY AND CONTROLLERSHIP: THE MANAGEMENT OF PORTFOLIOS DELEGATED TO DISCRETIONARY AGENTS

Submitted by Kamal M. Saeed

for the degree of Ph.D

of the University of Bath

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Submitted by **KAMAL M. SAEED,** for the degree of PH.D.
Of The University of Bath (England).

(Signed)

Dedication

This thesis is dedicated to my parents, to my wife and children.

ACKNOWLEDGMENTS

I wish to acknowledge the genuine support of my supervisors Professor C.R. Tomkins, Dr. G.H. Ray and Dr. R.A.A. Karim. They have advised me in overcoming the complications of the research problem. Their academic research experience has been a pillar of support in my attempt to document my experience as a practitioner. They have dealt patiently with the tremendous volume of data that I piled up and have helped me as a practitioner to produce this academic thesis in its current form.

My parents, my wife, and my children deserve special acknowledgment for their sacrifices, patience and supportive stance throughout my learning process in my quest for a Ph.D. My brother and sisters have instilled in me, by their sincere wishes, the will to make their dream a reality.

My journey in search of knowledge for more than 25 years rewarded me with an invaluable wealth of acquaintances with people/organizations whom I will remember and will respect. This journey also has given me the pride of gaining the respect of great organizations. I cannot mention all. My late brother Tamam of the Shell Company Ltd. was the first to tell me about the glory of the accounting profession in dealing with people and life. I have learnt a lot from the American partners of Arthur Young International over the long years of professional service with this great firm. My relationships with more than 150 leading organizations as audit clients for

more than a decade had been a continuously flowing source of diversified knowledge which has contributed to prepare me for this research. Over the last five years, my interactive involvement with more than 50 multinational professional investment institutions (portfolio managers) and leading banks also taught me much. I am indebted to my friends the portfolio managers in Europe, North America, Japan, Manama (Bahrain) and the rest of the Gulf States. My working relationship with them has been the driving force behind the richness of this research data. We have all agreed that through open-minded interaction the best quality of data can be secured. In fact, this is a strong bedrock for investment strategy formulation.

I look forward and pray for my God to introduce my study to these respectful organizations and high value individuals of my professional community. For their sake and for the sake of my respected colleagues (the Controllers, the Professional Auditors and the Academics), I am determined to complete and publish this research monograph.

Indeed, my professional community from which I am still learning includes audit managers, controllers, top management level executives, accountants and support staff. It is difficult to mention all. However, I always feel the value of my interaction with them in significant aspects related to this research. The challenge which I still face is to maintain and develop my relationships and interaction with these different sets of people to enhance knowledge.

My sincere advice to these respected practitioners is: *"Offer the data from our practising operations and seek to understand it in close interaction with academics and the academic literature. Such a partnership is needed to advance our knowledge of management."*

Kamal M. Saeed

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CHAPTER - 1

INTRODUCTION AND SUMMARY OF THE THESIS

In this chapter, I shall briefly outline **what** my thesis is about, **why** my research problem needed to be researched, and **how** I went about researching it. I also will present a summary of my research findings and implications for theory and practice together with the contents of the chapters of the thesis.

What The Thesis is About

This research addresses the complexities of strategy formulation, controllership functions and control systems in a Middle Eastern investment house - Mosnic - which has decentralized the management of its investment portfolios to a number of discretionary agents.

The thesis examined the process of strategy formulation and setting of investment goals in fast-moving and unpredictable financial markets. This involved the issue of selecting a portfolio of discretionary agents. This also emerged to be one of the most significant and difficult aspects of running the corporate control system in Mosnic.

The problem inherent in selecting the agents was due to two main reasons, namely 1- the difficulty in obtaining comparable data on the quality of performance of all the portfolio managers and 2- the subjectivity involved in

evaluating the means and methods (i.e. strategy, structure, and processes) of the intended portfolio managers.

The research also investigated the problem of managing different strategic decision levels which emerged from the involvement of the discretionary portfolio managers in the strategy formulation process. In such a process, portfolio managers advocated their rational economic and security analysis to justify their own sub-strategies and models. However, while such an analysis was important, it remained the responsibility of the controllership function to interpret the objectives of the stakeholders to the portfolio of agents so that they could accommodate it in their analysis. Thus, considerable similarities were shown with regard to investment houses to Quinn's (1988) conclusion related to large diversified manufacturing companies of the nature of strategy, although there are some points of differences which will be discussed in Chapter 8. Hence, this thesis also attempts to enhance our understanding of how security analysis for resource allocation takes place in real life.

The thesis also examined the design and implementation of post-investment controls to deal with the monitoring and evaluation of the performance of different discretionary portfolio managers. One of the major complexities which emanated from such a process was how to accommodate the strategies, structures, and processes of the different agents within Mosnic's Corporate post-investment control system. Another dilemma which developed was how to hold

the discretionary agents accountable for their performance while taking into consideration the involvement of Mosnic in the investment decision making process.

The thesis also discussed the role of the Corporate Controller and how it was influenced by the upheavals in the international, political and economic scene. It also highlighted the mixture of both the advisory and functional nature of that role. This threw light on the complexity of Mosnic's control system and its Controller's role.

Another theme which was considered in this research is how the controllership function in investment houses was affected by the requirement of the Owners of the organization who adhere to their religious beliefs in their business dealings and transactions. This tended to trigger the need for different controls role to cope with the accountability of non-Muslim agents who work for Muslim principals.

Why Was the Research Needed?

Funds expatriated from the Middle East (and other parts of the world) to the global financial markets for discretionary investment amount to hundreds of billions of U.S. dollars. The Middle Eastern discretionary portfolios invested in the global markets are held by individual owners, offshore incorporations, public institutions, local financial institutions and different investment funds.

However, there is insufficient understanding of the detailed processes by which these discretionary funds are managed. Indeed, the strategy formulation process of such expatriated financial assets and their returns cannot be adequately explained from the available academic strategy and finance literature. Also, the corporate control problems resulting from the process of decentralizing the management of funds to external portfolio managers has not been examined in the finance, accounting, strategic control, agency, or professional literature. One of the major themes emerging from this research is the lack of appreciation in the finance literature of the inter-disciplinary nature of the investment decision-making process although academics (e.g. Tomkins 1991) have recently started to draw attention to this important issue.

Perhaps one of the main reasons which contribute to the lack of research in the problems tackled in this thesis is that it requires access to sensitive information which investment houses would not usually be willing to grant.

How Was The Research Conducted?

In early 1987 I was made aware of the opportunity to read part time for a research degree at the University of Bath. This was when it was proposed to me and a former colleague of mine at Arthur Young International (AYI) the notion of doing research about our own organizations. I

was thrilled with the idea, but also thought of the demand which the research would put on my time as a Corporate Controller of Mosnic where at that time I had completed one year.

Prior to joining Mosnic, I was a senior audit manager with AYI having worked with them for nearly ten years. My journey of experience with AYI provided me with a wealth of technical knowledge of accounting and auditing practices, particularly as I had to deal with different types of large and small organizations.

However, whereas the nature of my work with AYI was mainly geared towards the technical aspects of control systems, in Mosnic I found that I had to deal more with the behavioural and organizational aspects of control systems. Nevertheless, my experience in AYI seemed to have influenced the way I approached my job in Mosnic. I was more concerned with establishing control procedures as explained in Chapter 3.

However, I gradually started to realize that the role of controller in investment houses was broader than I had envisaged initially because it dealt with risk management where the owners' objectives were continuously shifting in response to volatile financial markets. This meant that I had to learn how to cope with the interaction between the owners of Mosnic and their portfolio managers. On the other hand, I hardly had any knowledge of concepts like strategy formulation and strategic control nor was I able

to explain the complexities of the strategy and control processes in Mosnic.

It was with this state of mind that I started my research degree at Bath University. At the beginning, I wrestled to understand the academic language of my research supervisors. My concept of academic research at that time was very vague. I thought that, given my knowledge of investment houses and my experience at AYI together with the data I had at my finger tips, I could easily meet the requirements of a doctorate. Such beliefs proved to be very naive as I started to struggle to fulfill the demands of my supervisors who initially advised me to pile up my data in the form of rich descriptive cases. This came to be known between me and my supervisors as the "pile it high syndrome". This process continued for sometime until I was able to shape the data in the form required. While I was going through this painful process, I was asked by my supervisors to start acquainting myself with the research methodology literature. In fact, the supervisors also helped by giving me and my research colleague who was also working for a Ph.D., some seminars on this literature. It was only then that I began to appreciate that the nature of my research is what Glaser and Strauss (1979) call grounded theory and that I was using the case study research method.

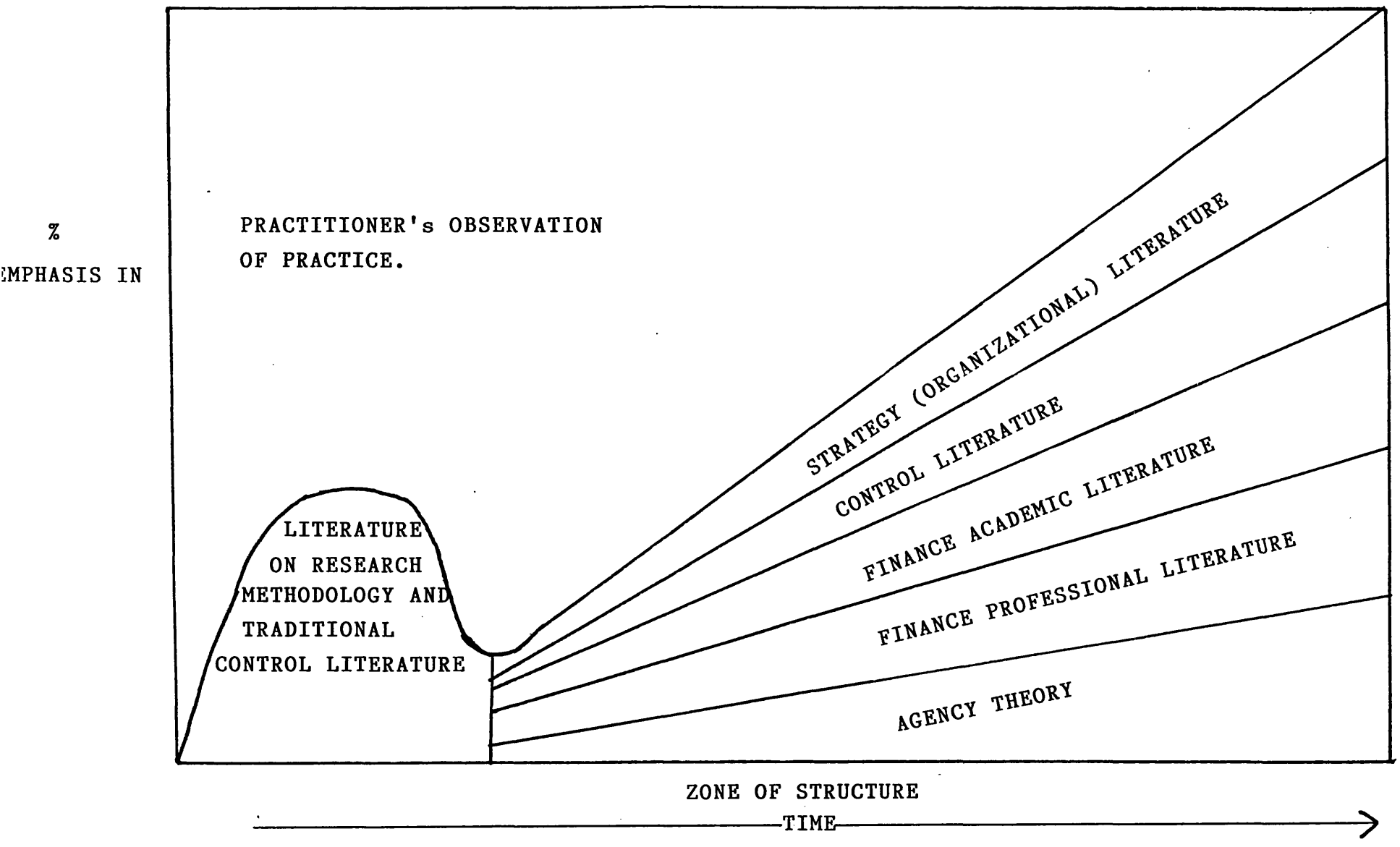
Fig. 1.1 attempts to depict the above process. It reflects my position at the start of the research and the stage of the research in which I was exposed to the rele-

vant academic literature while documenting my practice. Initially I was confined to my observation of practice and then gradually started to learn about the research methodology literature. As time passed by, I expanded the observation of my practice, but also was led by my supervisors to appreciate the need to consult the relevant literature as my research problem became clearer. The former process involved building a conceptual framework (see Fig. 4.1) from the analysis of the initial case study. This was later developed into a detailed conceptual framework (see Fig. 7.6) from the analysis of five case studies (Chapters 5, 6 and 7) on the interaction between Mosnic and some of its portfolio managers.

However, by the time I finished my field work and developed my theory, I was widening my survey of the literature in order to relate the relevant areas to my research problem. This painful process, which required from me considerable time and effort, continued until the end of the research as explained in more depth in Chapter 8.

The above process meant that it would be more appropriate to place the literature review towards the end of the thesis after I had presented to the reader my field research and the conceptual frameworks I had developed. However, this approach also meant that I needed to discuss certain concepts, e.g. (the use of return on investment (ROI) in evaluating the performance of portfolio mangers; the relevance of the Modern Portfolio Theory and the risk

FIG. 1.1. THE PROCESS OF MY PRACTITIONER RESEARCH



adjusted rate of return in managing the risk to which investment houses are exposed) which emerged while I was developing my theory, in isolation from what is advocated in the literature. In Chapters 8 and 9 the relevant literature is reviewed and such concepts are examined accordingly. Thus, the reader is requested throughout the thesis until chapters 8 and 9 to be patient when he/she comes across a discussion of such concepts. They will be discussed later on and related to their use in current academic literature.

The reader will realize from my above description of the way I conducted my research that I have used the case study method as my sole research vehicle. This was necessary because in order to get detailed understanding of the research problem's processes, I needed to present a thick description of what actually occurred in Mosnic and its relationships with discretionary agents. This was essential because the academic and professional literature has not described the process by which investment houses actually develop their strategies and control the portfolio managers to whom they decentralize the management of their discretionary funds. Indeed, given such a gap in the literature, the only way I could have developed my research was by writing the lengthy case studies which I present in Chapters 3, 5 and 6.

In this respect two points need to be spelled out. First, the case study of Mosnic was written in a chronological order to give the reader a flavour of the sequence

of developments which took place in this organization and a description of the process of the changes which were introduced to cope with these developments. Second, additional case studies were presented to enhance our understanding of the broad working hypotheses which were generated from the case of Mosnic. Indeed, the notion of developing additional case studies to provide further information on issues raised in an initial case study should be of interest to those attempting to highlight the advantages of case studies for accounting research (e.g. Scapens 1990) as well as to those who are calling for more field research in accounting (e.g. Tomkins and Groves 1983; Kaplan 1984; Bruns and Kaplan 1987).

It is worthy noting that throughout the whole research process I had lengthy interactions with my supervisors who also visited the Middle East a number of times as part of the research process. These visits were shared by myself and my research colleague who was completing a different thesis. The very lengthy discussions with my supervisors were tape recorded. This helped me to capture the "nuggets" of the debates which sometimes ended up in my drafts and chapters being either completely or partially torn apart.

Contents of the Thesis

Chapter 2, which presents the methodology pursued in this research, elaborates on the advantages and limitations of practitioner research. The Chapter also

reviews the use-fulness of case studies as a research vehicle in addressing problems (similar to the one of this thesis) which require in-depth information. The qualitative nature of the research methodology adopted in the thesis was dictated by the need for detailed documentation on the intricacies of the control processes in investment houses like Mosnic.

The case of Mosnic is presented in Chapter 3. The reader is informed about the developments which took place in Mosnic's control system and controllership function in dealing with discretionary portfolio managers. The Chapter also reveals the goals and strategy of Mosnic as well as the requirement of its owners to have their resources invested in accordance with their religious precepts. The uncertainties of the international financial markets in which Mosnic's funds are invested and the developments in the telecommunication technology which helped the company to cope with the changes in these markets are also illustrated in the Chapter.

The case of Mosnic is analyzed in Chapter 4. Several working hypotheses were generated to reflect the major factors (environment, goals, strategy) which affected the control systems and the controllership function in the company. A conceptual framework was developed to summarize these relationships as well as to enable the reader to have an initial overview of the research problem. The limitations of the conceptual framework are also highlighted.

However, the initial case study does not cast light on the processes of selecting and de-selecting Mosnic's portfolio managers nor does it show how they affect the company's control system and controllership function. The three case studies presented in Chapter 5 demonstrate the problems which Mosnic encountered in developing its pre-investment control processes to deal with three of its portfolio managers and how these controls were affected by the latter's attributes.

The two case studies presented in Chapter 6 describe how the post-investment control processes in Mosnic were affected by several attributes of two portfolio managers. These case studies were intended to enable the reader to appreciate how the development of the control systems to monitor and evaluate portfolio managers are a result of the interaction between the owners of Mosnic and their agents.

The five case studies also project the importance of the role of the Corporate Controller both in coordinating the processes involved in the pre-and post-investment controls and as a gatekeeper in the owners-agents interaction process.

The relationships emerging from the analysis of the five case studies are produced in Chapter 7. It is suggested that the strategy, structure and process of the portfolio managers themselves influence the design of control systems and controllership function of their parent

investment houses like Mosnic. The initial conceptual framework, which was developed in Chapter 4, was then adjusted to take on board these relationships to produce the theory contributed by this thesis.

In Chapter 8, an attempt was made to highlight the similarities and differences between the theory developed in this thesis and what is advocated in the literature on strategy formulation, strategic and operational control. In Chapter 9, the thesis addresses the implications for the literature on finance theory and agency theory. One of the significant themes which emerged from the latter exercise was that the finance theorists could significantly advance their resource allocation theories if they would draw from the management control literature to appreciate and consider the complexities involved in the investment decision making process.

The professional literature, which is available on the subject of this thesis, is also reviewed in Chapter 9. This is followed by an examination of the implications of the findings emerging from the case of Mosnic for practice. Implications for practice, suggestions for future research and concluding remarks are presented in chapter 10.

Implications and Findings

The findings emerging from this research indicate that there is a legitimate place for practitioner research in accounting and finance. However, although this type of

research is important,in comparison with more conventional styles (e.g. quantitative research conducted by academics and graduate students), it should not be viewed as a replacement for them.

The research also provides very interesting insights on the strategy formulation and control processes in investment houses specialized in marketable securities. These insights are consistent with more recent thinking on the incremental nature of corporate strategy formulation and control. The thesis also projects a different, more informal role for the Corporate Controller in these processes.

A complete theory covering the management of investment houses specialized in marketable securities needs to cover a number of different areas. At the moment, we have techniques reasonably well-developed by the Modern Portfolio Theory and also some recent work has been carried out on the Agency Theory. However, this study reveals the strategic and controllership aspects required for the development of a complete theory on this type of organization.

CHAPTER - 2
THE APPROACH TO THIS THESIS

Objectives and Outline

The research methodology of this thesis builds on the use of the case study method and the concept of practitioner research. However, as there is still insufficient work of this nature in accounting and finance, and particularly in finance, it will be useful to reconsider the advantages and limitations of (1) the case study as a research method; and (2) practitioner research.

The Case Study Method: Advantages and Limitations

The Need for the Case Study Method.

A range of different authors (Hopwood 1983; Tomkins and Groves 1983; Kaplan 1984, 1986; Bruns and Kaplan 1987) have argued for the need for more case study research in accounting and finance. However, this is now well established and well known. Just Scapens (1990) and Yin (1984) will be used to illustrate the argument for the use of the case study method.

Scapens (1990) examines different uses which can be made of case studies in management accounting. He argues that accounting researchers in the U.K. have grown more interested in management accounting as practiced. He adds:

> *"This interest was initially prompted by a perceived gap between the theory and practice of management accounting and especially the generally held belief that the conventional wisdom of management accounting is not widely used in practice." (P.259)*

Yin (1984) explains why investigators continue to use case study methods by stating that:

> *"One explanation is that some people just do not know any better and are not trained to use alternative methods." (P.10)*

He further argues that:

> *"..... case studies continue to be used extensively in social science research.... The method is also a frequent mode of thesis and dissertation research in all of these disciplines and fields." (P.10)*

In addition, he adds that:

> *"In general, case studies are the preferred strategy when "How" or "Why" questions are being posed, when the investigator has little control over events, and when the focus is on a contemporary phenomenon within some real-life context." (P.13)*

Yin believes that direct observation is an advantage of case study strategy. He claims that:

> *"the case study relies on many of the same techniques as a history, but it adds two sources of evidence not usually included in historians' repertoire: direct observation and systematic interviewing." (P.19)*

Based on the previous theoretical arguments, the case study method was used in this research to describe in detail how events happened in the organization to be studied. However, it is necessary to be aware of the

limitations of the case study methods in order to attempt to overcome them in the research. This will be dealt with in the following section.

Limitations of the Case Study Method.

The use of the case study method in research has its limitations. Some of these limitations are pointed out by management research methodology theorists. A principal criticism of case study methods is that they are unrepresentative. For example, Smith (1990) argues that theoretical conclusions derived from case studies are not considered to be valid unless the cases can be demonstrated to be 'typical' of the phenomena under investigation.

However, such an argument does not seem to be so applicable to practitioner research because the practitioner tends to maintain a holistic knowledge of the organizations with which he deals and so he has already a sense of whether the case has general application. On the other hand, an outside researcher who mainly depends on the case study method may not be able to broaden his data particularly if the process being described is changing over time. Hence, the situation described by the practitioner is more likely to have general representation.

On the other hand, considerable theoretical arguments have been put forward to show the irrelevance of the representativeness problem of the case study approach.

Smith (1990) suggests that:

> *".....the problem of representativeness may become temporarily irrelevant either by choosing to view case studies as appropriate to exploratory work only, or by making them representative through the application of quantitative procedures. However, both solutions still accept the espistemological requirement for representativeness. One may, alternatively, view it as absolutely irrelevant." (P.13)*

He further argues that:

> *"Representativeness is irrelevant for many research purposes, particularly when the distinction is made between logical and statistical inference. The validity of explanations or theory derived from case studies depends on the logic of the analysis and acknowledgment of ceteris paribus conditions, not on how typical the cases may be." (P.4)*

Yin (1984) has also enumerated the following prejudices against the case study strategy:

> *(1) " .....single and multi-case studies have been viewed as a less desirable form of inquiry than either experiments or surveys." (P.21); (2)" .... they provide very little basis for scientific generalization. How can you generalize from a single case? is a frequently heard questions." (P. 21); (3) "they take too long and result in massive, unreadable documents." (P. 21)*

A major complaint about the case study method in this particular research is that it is an endeavour to confine to a few pages (by limited description), an interactive, changing and shifting process. It cannot reflect the daily events and processes which take place inside the organization. The reflection of all that takes place in the phenomena to be studied may require thousands of pages to describe. The practitioner deals with an on-going social context which cannot be described in the limited space available.

However, this problem is less likely to affect the validity of the work of the practitioner because the latter has the insight to select the most recursive but significant incidents to make detailed rich description of the phenomenon being studied. In other words, the insight of the practitioner helps him to recount what is and is not significant of his daily incidents to be included in the case study.

Scapens (1990) adds to the weaknesses and problems of case studies by arguing that:

> *"First, there is difficulty of drawing boundaries around the subject matter of the case. The holistic perspective emphasizes the importance of relating parts of social systems to the larger system of which they are part. But how far should a researcher expand the case in studying interrelations with larger systems? A similar problem occurs in the historical dimensions, as social systems and practices evolve through time... How far back in time should the case study researcher probe?" (P.276)*

Adding to the problems of the case study method, Scapens also points to the ethics of the researcher's relationship with the subject. His argument on ethics states that:

> *"Many accounting case studies require access to organizations and to confidential information." (P. 277)*

The above limitations of the case study method were taken into consideration in this practitioner research. With regard to the problem of how far back in time should the researcher probe, I have attempted to include the

historical information which I considered was relevant for the era since I started with Mosnic until the present time. As for the ethical problem which stems from the release of confidential information, I have tried to include all the relevant information without jeopardizing the interest of the organizations involved in the research.

In the next section, I discuss the advantages and limitations of the practitioner research and how it attempts to make the best use of the case study method in this context.

Relevance of Practitioner Research

Accounting academics (e.g. the authors cited at the beginning of the chapter) have recently started to appreciate the need for more field research. Tomkins and Groves argue that

> *"academics might profitably move more into detailed field-work (i.e. recording what is happening in the setting within which decisions are made and action occurs) and focus rather more on studying how practitioners perceive their worlds, what issues concern them, why these issues concern them and how they perceive them affecting accounting practices and the influence accounting has." (1983: 364 emphasis in original)*

They further claim that

> *"in this way it is far more likely that academic research can be linked up with practitioners and their views of the world; in this way it is more likely that reliable theories about accounting in action and theories about the effects of alternative accounting procedures can be developed." (P.364), emphasis in original).*

On the other hand, Bruns and Kaplan (1987) justify their call for more field research in accounting on the grounds that:

> *"since management accounting phenomena exist only in complex organizations, with their rich interaction of people, products, processes, markets, technologies, and cultures, it becomes extremely difficult to study the subject except in actual organizational settings; management accounting systems must be studied in the settings where they have been developed and where they function. (pp. 1-2, emphasis in original)*

The concept of practitioner research advocated and implemented by this thesis attempts to give an additional dimension to the call of the above academics for field research.

The practitioner, as a researcher of his own organization, might be qualified to have more insights than the academic getting close to the practitioner. This is due to his continuous presence in the scene of the research as part of the organization. Such a privileged position, enables the practitioner to sharpen his insights from the field throughout the whole research process. This is supported by Glaser and Strauss (1979) who argue that:

> *"The root source of all significant theorizing is the sensitive insights of the observer himself. As every one knows these can come...while at work..." (P.251)*

Also, due to his presence at work, the practitioner enjoys an early and mature knowledge of the data he uses to ground his theory. The insights which the practitioner is bound to gain from his involvement in the day to day problems of his organization, qualifies him to bring to light the complexities of the problem he addresses. Indeed, Otley believes that:

> *"it is unrealistic to expect purely statistical methods of analysis to unravel a complex pattern of interaction. The researcher must have a closer involvement and develop hypotheses as to likely relationships as he explores the organization he is exploring." (1980:424)*

From a different perspective, Emory (1980) argues that a practical problem-solving emphasis is a critical feature of applied research. To Emory, one should expect such studies to be closely related to action or policy needs. He further argues that pure research is also problem solving but in a different sense. He adds that pure research is aimed at solving perplexing questions i.e. problems of a theoretical nature that have little direct impact on action or policy decisions. Hence, to Emory, both applied and pure research are problem directed, but applied research is much more decision directed. Nevertheless, this study attempted to produce theory from the Controller's insights and compare it with existing theory. Thus, it aimed to provide theoretical explanations to real world problem in addition to highlighting policy making proposition.

In addition to the previous theoretical arguments in favour of practitioner research, the following advantages should also be appreciated. The author of this thesis is involved in the decisions and control problems of the organization to be studied. Such a privileged position was utilized in this research to produce knowledge through interpreting the pragmatic decision and control problems of real life.

Furthermore, the author of this thesis has continuous access to information and data required for the research. An outside researcher would not have been able to have access to information in the manner that was available to the practitioner conducting this study. Indeed, beside his involvement as a Corporate Controller, the author has also been the custodian and the manager of information for Mosnic. Thus, to give strong support to the theory advocated in this thesis, the researcher depended on first hand information.

The involvement of the researcher in solving the control problems of Mosnic helped in enriching the data that was used in the qualitative analysis. On the other hand, unlike the practitioner, a researcher who does not have the privileged position of participating in solving the real life problems of his organization is likely to develop interest in his research only after familiarizing himself with the problem.

A further advantage of this research approach is that the researcher attempted to provide an explanation to complex decision and control problems of real life situation through the development of a conceptual framework based on the rich information that was available to him.

This research developed working hypotheses to broaden our understanding of the theoretical associations between the variables incorporating the research contingency

model. The advancement of our understanding of the working hypotheses were to be achieved through further detailed case studies on specific agents operating as portfolio managers for Mosnic.

One of the advantages of the qualitative approach of this research is that it did not depend on either statistical inference or cases from outside to substantiate the validity of its analysis. The researcher in this situation was part of the phenomenon under investigation from the start to the end. Thus, the approach to this thesis is in agreement with Karim et. al (1989) who argue that:

> *"While, obviously, broad statistical analyses can add considerably to human knowledge, such work in accounting seems to have resulted in loss of relevance in terms of both accounting research to practitioners and the set of measures which management accounting systems produce in today's environment." (P.3 & 4)*

One can add to the above arguments that, through quantitative data analysis, the relationships between the contingent variables of this research would be difficult to observe. The researcher had the opportunity to sharpen his observations through interaction with the senior executives involved in decision making, i.e. either stakeholders or discretionary portfolio managers. Outside researchers may not be successful in observing the processual interaction between constructs of the contingent variables which determine the features of control system in this context. An outsider could conduct this research but would be remote from the inside source

of information used in decision processes. This actually involves the risk of not ensuring the quality of data the outsider would use in his analysis.

Based on the above, one can suggest that conducting accounting research through practitioners can enrich the field study research and may make it less costly. Less costly because an ordinary research student would find it difficult to bear the costs to obtain evidence from portfolio managers scattered in the most expensive cities in the West e.g. the banking and financial centres in Geneva, London, New York, etc.

Field research methods alone cannot give insights of the theory produced. Validity of the theory produced by field research can gain more support from the involvement of the practitioner in the field study. The limited presence of the academic researcher in the field of research, or the distant presence of the field researcher from the phenomenon under study after collecting limited data are problems for accounting research. The methodology in this research overcomes that problem. Indeed, Tomkins and Groves (1983) have expressed the complaint of practitioners about accounting research as follows:

> *"Very little accounting research has been published of this naturalistic type. This, in itself, may be a fundamental reason why practitioners often claim that accounting research is of little relevance to accounting practice."(P.364)*

Based on the approach of this thesis, one can add that there is likely to be more relevance in the management accounting researches conducted by practitioners than those conducted even by academics who usually stay for only a short time at the site of the research.

The approach of this research also addresses the problem of internal validity suffered by field research methods. The work of Bruns and Kaplan (1987) has highlighted the internal validity problem as follows:

> *"field research methods, in contrast, tend to be high on external validity and low on internal validity." (P.3)*

However, practitioner research is likely to reduce the problem of internal validity suffered by the field research methods. This is because given that he is close to his data, the experience of the practitioner helps him to understand it better and, therefore, be able to select freely the important explanatory variables and not to overlook or fail to observe significant alternative explanations.

In their concern about applying grounded theory, Glaser and Strauss (1979) have discussed how theory has been developed in order to facilitate its application in daily situation by sociologists and Laymen. They argue that:

> *"The practical application of grounded sociological theory, whether substantive or formal, requires developing a theory with (at least) four highly inter-related properties. The first requisite property is that the theory must*

> *closely fit the substantive area in which it will be used. Second, it must be readily understandable by laymen concerned with this area.*
>
> *Third, it must be sufficiently general to be applicable to a multitude of diverse daily situations within the substantive area, not just to a specific type of situation. Fourth, it must allow the user partial control over the structure and process of daily situations as they change through time." (P.237)*

The argument of the author of this thesis is that the involvement of executives in accounting research can help to satisfy the requisites specified by Glaser and Strauss to a considerable extent. This point leads us to draw from the argument of Emory (1980) who argues that executives who once functioned effectively by relying on their own experience and informal analysis, need to be better equipped to manage in the future. He adds that, even though the major interests of the executives lie elsewhere, they must be able to do research for themselves and others. Students in management areas can, therefore, benefit from knowledge contributed by the practitioners because the latter are best positioned to produce theories of high external validity. Thus readers can extrapolate the finding to similar organizations.

The previous arguments regarding the applicability of the practitioner's research, its credibility, and significance lead us to draw a number of conclusions. As said previously, the practitioner has easy access to decision making and control data because he participates in both processes. Thus, the practitioner's privileged position

helps him to overcome many of the limitations suffered by scholars who conduct field researches to generate grounded knowledge. However, the latters' access to information could be restricted by the members of the organization. On the other hand, the practitioner is more qualified to give more depth to the research than an outsider. The latter may suffer lack of experience with the industry under research.

The practitioner uses first hand evidence to ground his theory while the outside researcher may depend on intermediation to obtain the necessary data from the organization. In other words, uninvolved researchers may need to interview executives in the organizations to elicit the necessary data. However, unlike the case of the practitioner, even with such a mechanism it would be difficult to describe complex processes for ensuring the quality of data. In fact, the practitioner has the opportunity of testing the quality of data before using it for analysis purpose. In addition, the risk of conducting research through outsiders is that members of the organization to be studied may respond formally, conservatively and cautiously to such information gathering process. Indeed, executives are usually reluctant to disclose sensitive information to an outsider.

The possession of first hand information and the continuous surveillance of the phenomenon to be studied enables the practitioner to develop a relevant theory

which, if well argued, would be difficult to reject by more data or replaced by another theory.

Having enumerated the merits of practitioner research, it is now appropriate to caution the reader with the limitations of this type of research. This is done in the next section.

Limitations of Practitioner Research

The risk of this type of research is that the practitioner has the tendency to look into everything in his real world. He is accustomed to describing the minute details of the decision making processes of his real world. Hence, he has the tendency to give more information than necessary. His job in business is the surveillance of a very limited situation in depth. This may expose the practitioner researcher to lack of clarity of concepts. This is because over-description of the phenomenon to be studied might trigger numerous but unrelated issues.

The audiences of this research are from different backgrounds. For example, we have the investors, the controllers in investment departments in big companies, the global portfolio managers and academics. Thus, the approach of this research may have problems in satisfying the requirements of the different audiences. The practitioners are expected to be seeking solutions for their problems in a clearly prescribed way. This research cannot describe every action that a portfolio manager

would need to do in order to develop a good investment model. On the other hand, a controller in an investment house would expect to read a description of an accounting control system that he can adapt to his own investment house. Indeed, the author of this research is not aiming to conduct management consultancy. However, it is planned in this study to address fundamental issues which can help different audiences to perceive their different concerns from a new perspective.

The practitioner, while researching a problem academically, cannot reflect all the bits and parts of the iterative decision making and control processes he lives everyday. Moreover, he may be confronted with the problem of changing processes in the organization being researched as the researched goes on. On the one hand, he has deeper insight than the academic field researcher because he sees all the movements and shifts taking place in the organization which the academic researcher may well miss especially if he was only allowed limited visits to the organizations. On the other hand, this also provide a problem to the practitioner because he has to try to unravel key concepts from a much more complex set of data which is changing through time.

The practitioner may be critical of the simplicity of the research conceptual framework which obviously does not encompass completely the processes lived by the practitioner. He is accustomed to interacting in a processual manner with his surroundings to formulate

decisions and to exercise control.

Practitioners may even have the tendency to ignore the research framework. They might have a tendency to drift away from academic research and seek a solution for a certain decision in a specific situation. Therefore, they might seek specific action courses to help them to make a decision. In that sense, there is a risk of the practitioner becoming a decision consultant rather than undertaking the role of an academic researcher.

The practitioner is usually surrounded by a huge amount of information. Hence, in conducting academic research, the practitioner would need to select the relevant information that would fit his research problem. However, this may require skillful abilities which the practitioner may not posses and would need to develop in order to identify the "wood from the trees".

The practitioner's decision-making style may not coincide in all respects with academic research methodology. The first involves courses of action while the latter enhances literature and develops arguments. The lack of coincidence of approach is ascribed to the difference in the task of the executive and the goal of the academic researcher. This means that the practitioner may require more time to adapt to the academic research mission.

Practitioners have the tendency of reporting in their own style. Their reporting cannot be called 'research'.

Change of the reporting style is a problem for practitioners and it may consume a considerable part of the research time.

Conclusion

This chapter justified the research methodology pursued in this research. The advantages and limitations of the case study method were highlighted together with the concept of practitioner research. In the next chapter, the initial case study of Mosnic is presented.

CHAPTER - 3
THE INITIAL CASE STUDY
(The case of Mosnic)

Objectives and Outline

The objectives of this Chapter are to describe how Mosnic, an Investment House located in the Islamic World, operates and to highlight its major characteristics. This will not include how Mosnic operates with specific portfolio managers as this will be covered later in the thesis. Nevertheless, the chapter gives a lot of details about Mosnic as an investment house.

This case study is divided into three parts. Part (A) presents basic description (characteristics) of Mosnic. Part (B) emphasizes the investment decision levels in Mosnic. In part (A) Sections 1 and 2 describe the formation of Mosnic, the nature of its business, the organizational goals, the stakeholders' conception of investment risk and the evolution of Mosnic in terms of managerial and organizational aspects. These sections point out that Mosnic's goals are defined by its stakeholders who interact with the fast-moving and often unpredictable global financial markets. The section on goals also discusses the impact of the Islamic religious beliefs of the stakeholders on their goals. The section also explains how the investors in this context perceive and manage investment risk.

Part (A) also examines the need for the structure maintained by Mosnic. Section 3 addresses the issue of why

Mosnic needs to operate through agents. This section concludes that as a result of decentralizing investment decision to agents, certain strategy and control problems emerge. Hence, to address these problems, Mosnic needed to look for a Corporate Financial Controller.

Sections 4 and 5 in part (A) elaborately tell the story of how the Corporate Controller was recruited, without clearly perceiving the job required from him, and how he developed his own job description in cooperation with the company President. In particular, section 5 shows how the Corporate Controller found a lack of clarity about how Mosnic operated. To remove this, the Corporate Controller surveyed two levels at which investment decisions are taken in Mosnic namely the principals level and the agents level. Hence, this chapter describes two decision and control levels.

In part (B), section 6 explains the types of the corporate decisions taken at the level of the principal stakeholders without the direct involvement of the agents. Section 7 discusses, in general terms, the strategic decision making problems at the corporate level. Section 8 gives an idea about how agents undertake their fiduciary management role within the overall investment process while section 9 provides an integrated view of the whole investment decision processes.

In this chapter, it is argued that one of the most significant decision processes in Mosnic was the selection of agents to manage the security investments. Maintaining

the portfolio of the agents and evaluating the performance of the discretionary portfolios were also found equally important aspects of the corporate control system.

Part (C) is concerned with the Controller's preliminary thoughts and his initial perception of the decision and control problems. This part concludes the chapter by identifying the general control problems inherent in the selection of agents. Part (c) also discusses the corporate investment portfolio appraisal problems resulting from decentralization to external agents. The conclusions of the Chapter are presented in Section 10.

(A) BASIC DESCRIPTION OF MOSNIC

1. FORMATION AND NATURE OF BUSINESS

Mosnic is an off-shore investment house owned by a group of investors. The company was formed in 1970 to invest the surplus funds of its owners in the international financial markets through portfolio managers. In other words, Mosnic's investments are decentralized to a number of external portfolio managers mainly operating in Western and Pacific financial markets. Portfolio managers are given a considerable degree of discretion over how they invest the company's funds put into their care.

In terms of resource allocation, Mosnic invests mainly in financial assets, particularly marketable securities which represent 90% of the total holdings. The

financial assets held by Mosnic are divided up over a number of discretionary portfolio managers. Thus, maintaining the portfolio of agents and evaluating their performance represented the major feature of Mosnic control system.

There was no specific number of agents set to be maintained by Mosnic. This depended on how the stakeholders viewed diversification and risk spread. The articles of incorporation of Mosnic specify the areas of business in which it can operate as follows.

" *The purchase, sale of marketable securities in the global stock, capital and money markets, dealing in the precious metals, the purchase, sale, exchange, lease and negotiating of properties whether movable or immovable, over and above other commercial or financial operation as well as participation in other corporations, or the acquisition by purchase of the whole corporate capital of enterprises.*"

The asset managers (the agents) were given discretionary powers to invest on behalf of Mosnic in the global financial markets but at Mosnic's own risk. The fiduciary portfolio managers obviously undertook a major role in investment decision making which involved never-ending interaction processes between Mosnic and its agents. This projected the importance of post-investment monitoring of agents and the evaluation of their performance.

The fiduciary investment policy adopted by Mosnic led to complex financial relations with the agents. Beside the control problems stemming from the interaction processes, agents selection and de-selection was a complicated

decision perpetually interacting with the investment strategy. Agent performance measurement was also a problem. The interaction processes made it difficult to define the effective agent in a clear cut manner. It seemed that Mosnic was struggling to be rational, dynamic, and to maintain a portfolio of agents who could achieve acceptable performance. However, it was difficult to manage these contradictory aspects without a Controller. These were contradictory because the principals did not want simplistic dependency on rate of return on investment (ROI) for evaluating portfolio managers' performance. In fact, the records of the company hardly showed a fiduciary relationship being terminated due to unsatisfactory performance of agents. The reasons had to be explored.

Before the employment of the Corporate Controller the absence of a Corporate Financial Control Department with clear responsibilities meant that attending to information about intended agents was an unorganized process. Thus, trust dominated the major decisions in Mosnic at that time. This situation created a range of control system problems.

HISTORICAL DEVELOPMENT OF MOSNIC'S MANAGEMENT AND ORGANIZATION

From the company's inception through to 1990, Mosnic evolved from an organization small in size (number of personnel) and simple in structure (limited number of agents) to a relatively large organization managing a sizeable portfolio of agents. The company also experienced growth in its financial assets. This projected

the need for further diversification of risk. The growth of investments was associated with an increase in the number of the fiduciary asset managers working with Mosnic. As the need arose for more agents to manage the growing financial assets, Mosnic tended to improve the system of both choosing and controlling the appropriate agents. Accordingly, and as said previously, decision and control at the corporate and the agents level became a function of the principal-agent interaction. The managerial and the organizational developments in Mosnic are described in the following paragraphs in a chronological order.

THE 1970 - 1982 ERA

During this period, the amount of expatriated assets was not material. The investment decisions were confined to small transactions with some leading commercial banks of brand names. Moreover, the time of stakeholders was mostly devoted to their local businesses (the cash cows). The brand name agents were simply selected based on their general reputation. The directors hardly thought of rigorous pre-decision analysis to choose an agent. The whole operation was on trust.

Mosnic was relatively small in terms of the number of the in-house personnel. Due to the limited size of operations, decentralization was not a major managerial issue. Thus, agent performance evaluation and control were given little importance. The principals were of the

opinion that *"money management is an easy enjoyable game."* After the simple process of selecting brand name agents, unlimited trust was vested on them. These agents were considered by the principals to be of high expertise and dependable to the extent that the principals would deal with them directly without realizing the need to intermediate any in-house Corporate Controller.

Hence, there was no formal system to select, monitor and evaluate the performance of the agents in the post-investment phase. There was no corporate strategy nor was there a business plan to be monitored in the post-investment stage. Corporate investment goal setting was handled in a dynamic manner corresponding to the market circumstance. Hence, the strategy process was unprogrammed. Agents almost had a free hand in the financial strategy process. They would even structure the portfolio, select securities based on their own risk perception and would liquidate the portfolios as they considered appropriate. There had not been a situation where an agent was deselected following his failure to produce a certain return on investment.

THE 1982 - 1986 ERA

Recruitment of an Investment Advisor.

Reviewing the portfolio performance of 1982, the founder realized that the brand name agents (e.g Vidicorp, Orange bank Manhattan etc.) were strong in commercial banking, but poor in attending to private investment

management. The private investment banks proved to have more readiness to interact with the investors to perceive their requirements on a timely basis.

Moreover, with the increase of funds to be managed, Mosnic's interest became more exposed to the volatile financial markets. These factors made the stakeholders anxious about the risk they were taking in their agents. Hence, considering the risks of investing through the brand name commercial banks, and bearing in mind the markets' uncertainties, the principals realized the need for recruiting somebody to help them in both their investment decision of selecting private investment management banks and in evaluating the portfolio performance. In particular, the stakeholders were interested to recruit a person to assist them in the following: (1) allocation of the corporate fund surpluses; (2) formalizing a system for regulating the selection of the appropriate asset managers and for monitoring the performance of each agent; and (3) for evaluating the performance of the corporate portfolio.

Thus, the Board of Directors (The Board) decided to recruit a local commercial banker to work on a part-time basis in consultation with the directors. This Advisor started to play a significant role in selecting the agents. He dominated the appraisal of the intended agents. However, he did not explain to the Board how he conducted the appraisal process nor did he formalize the analysis of the critical factors for choosing an agent. Nevertheless,

his opinion was a determining factor to classify an agent as appropriate or inappropriate. The role of the Advisor in the performance evaluation of agents was, however, quite minor. The Advisor also determined the overall mix of agents to be maintained by Mosnic. He did not explain the logic behind maintaining a certain portfolio of agents.

The Advisor did not explain to the Board the risks involved in selecting a particular agent. On the other hand, he was not asked to explain how he measured the risk associated with the way he allocated assets through negotiation with agents. The Advisor believed that risk management, within a certain portfolio, was the discretionary responsibility of the agent with little feedback from his (the Advisor) side. He did not strive to exercise tight control over the agents. He simply put high trust on particular agents, their methods and decision styles.

The Advisor was also entrusted with reviewing the proposed asset management agreements before they were signed by the principals. Despite the lack of rigor in his control procedures, the monitoring and evaluation of the performance of the portfolio managers remained the formal responsibility of the investment Advisor. But, as explained above, the depth of these procedures were not clear. He used to compare agents on the basis of their performance. In cases of unsatisfactory performance i.e. lower ROI, he would recommend, orally, actions to be

taken. He did not explain any detailed processes to compare agents based on ROI produced. The process of negotiating strategy amendment with the agents, and then communicating them to the principals, was verbally undertaken by the Advisor who used to call himself `the Manager of Managers' but without clear accountability for corporate performance.

The Advisor succeeded in recommending to Mosnic some private investment banks to replace the unsatisfactorily performing brand name commercial banks. Nevertheless, he failed to formalize a control system that should ensure the implementation of the corporate investment.

THE 1986 - 1990 ERA

Following a report on performance at the end of 1985, the stakeholders decided to intervene more heavily in the asset allocation matters. At the beginning of 1986, the asset mix decision was approved by the Board. Allocation of the assets into shares and fixed income securities and short-terms was achieved through a process of iteration between the principals and the agents. It was not clear how the Advisor was conveying to the agents the stakeholders' perception of markets' uncertainties. It seemed that the process of interaction between the principals and the agents was not adequately fluid. Indeed, the Advisor was living in a different city far away from the principals (1000 km away). The principals started getting more concerned about examining the rational

economic and financial analysis forwarded by the agents to the Advisor. They showed interest in closely interacting with the agents for giving additional information about their perception of the nature of the financial markets' risk. In fact, they started feeling that the agents were responding to the Advisor's perception of uncertainty and not to the stakeholders'. Indeed, they started seeing the need for an in-house corporate financial controller to translate their perception of risk to the agents.

By the start of 1987, the Board considered reducing the role of the investment Advisor. The chairman of the Board expressed his concern as follows:

> *"The Advisor could not tailor an investment model that could solve all our problems. I think he depends on interacting with the agent to form his opinions. Now I believe our in-house management can do his job in a better way through interaction with our agents. Our system is dynamic. We do not require ready-tailored investment models. They do not work. We need more presence from our side in the investment control processes. A board member has to reside permanently in Mosnic offices to look after our interest. We have to start controlling our information through an in-house financial control department. The person to be in-charge of the control department has to work very close to the agents. The Board wants to expand the role of the in-house management in corporate decision making and control of agents."*

At the end of 1987, the Advisor's appointment was terminated. The Board then decided to establish a corporate finance control department to improve the selection of agents and to actively monitor them. An Investment Policy Committee (IPC) was then formed to formulate investment policies for the Board. The Board members agreed on the following points as major reasons for terminating the Advisor's appointment:

1. The best manager of agents could be an involved Controller. The latter can be of a value in formulating investment strategy through interaction with agents and in controlling them.

2. The Advisor did not have more expertise than the Western agents have. Hence, there was no point in making him as manager of agents.

3. The Western agents had shown readiness to give advice to their principals within the agreed fees. Thus, the cost of keeping the advisor could be saved.

4. The principals wanted to be closer to their agents: (1) to participate in risk management, and (2) to control any potential conflict of interest between the Advisor and the principals. i.e they planned to eliminate the risk inherent in intermediating the Advisor as a middle-man in accessing their agents.

5. The Advisor could not develop a complete management control system.

6. Trust on the Advisor was not an objective way to evaluate agents for selection. The principals needed to know more about the agents' means and methods.

THE CURRENT ORGANIZATIONAL SETTING

Mosnic maintained the organizational setting shown in figure 3.1 (the current organizational chart) after the cancellation of the Advisor's position. The Investment Policy Committee emerged as a coalition dominating the corporate decision of selecting agents. The Investment Policy Committee consisted of the Controller and two principals. One principal was nominated as the executive member of the Board and called the Resident Director (the Director).

The current chart of the organization shows the hierarchial relationships between the in-house divisions of Mosnic. Note that there is no responsibility centre that undertakes the investment management functions. The discretionary portfolio managers do not have line

relationships with the divisions of Mosnic. There is no line relationship between Mosnic internal divisions and the external agents. The current chart of the organization depicts that most of the investment management functions are decentralized to external agents.

The job descriptions of the Controller are presented in section 4. However, it is necessary to emphasize that the Corporate Controller operated as a dominant figure in the IPC. The Controller was the link between Mosnic and its agents. The Director wanted him to attend to every information necessary for managing the strategic uncertainties.

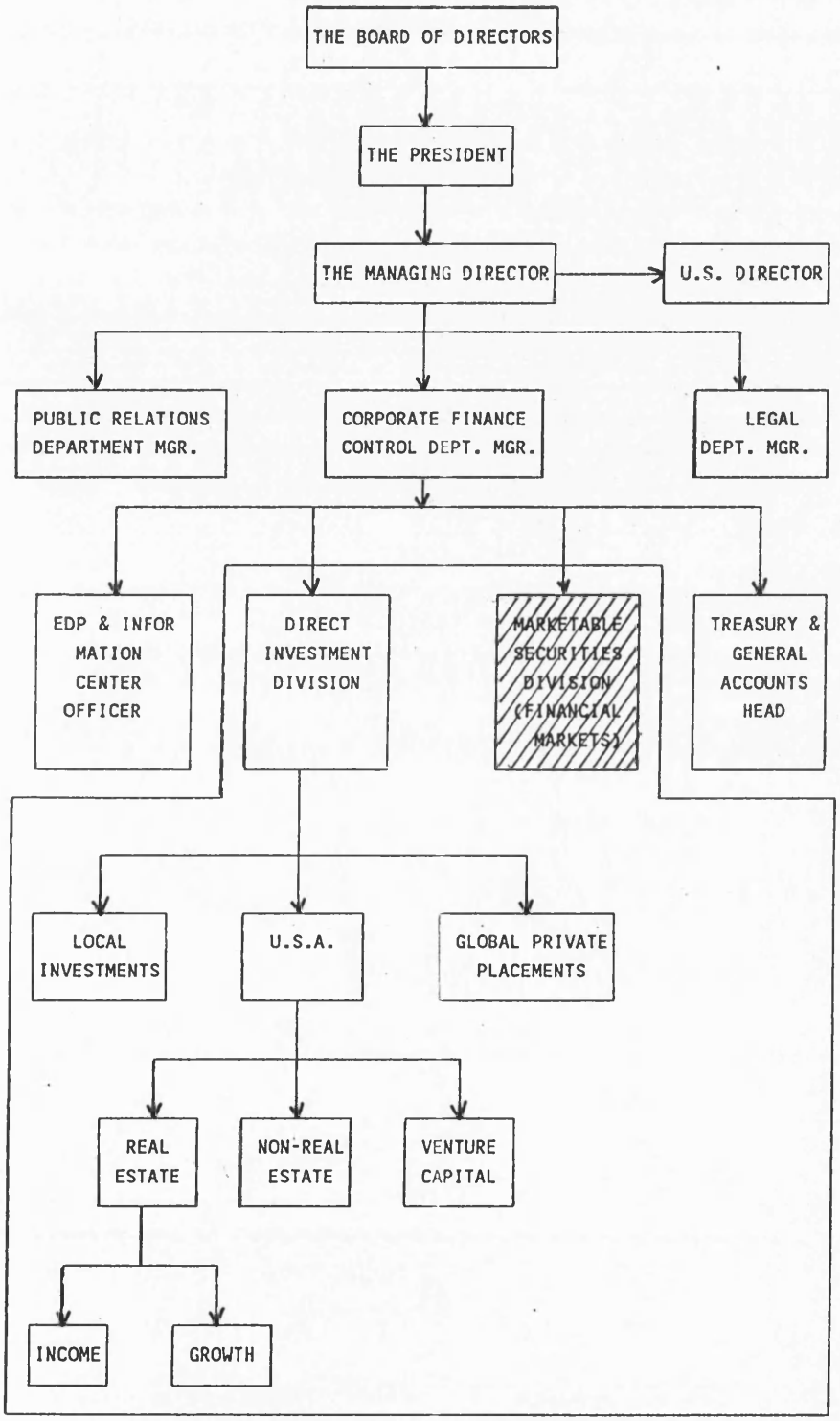
2. THE ORGANIZATIONAL GOALS AND THE STAKEHOLDERS' CONCEPTION OF RISK

The Goals.

The prime goal of Mosnic has been to maximize the wealth of its stakeholders. To do this, Mosnic was established with a view to investing all around the world, particularly in the financial markets. A global investment strategy was adopted because of the limited local investment opportunities and local economic risks and also to achieve better diversification of the funds by expatriation and holding a portfolio of currencies and agents.

However, the maximization of wealth through globalization proved to be a debatable goal considering the turbulences in the financial markets. Mosnic had no option but to adopt dynamic investment strategies. It could not set measurable (standard) goals. The financial markets

FIG. 3.1
THE CURRENT ORGANIZATIONAL CHART OF MOSNIC



Area of this research

were fast-moving in an unpredictable manner rendering pre-determination of financial goals unrealistic. Hence, the corporate goal setting was an unprogrammed process and rendering performance evaluation to be problematic. ROI predetermination and ex-post performance measurement was difficult considering the uncertainty of the markets' behaviour.

The dynamic management style followed by Mosnic seems to have the stakeholders amending their goals from time to time. The pattern of amending the goal was dependent on the way they perceived the risks of the financial markets. They were often not sure whether to go for long-term profit maximization or short-term benchmark objectives. Indeed, there was no standard investment model that Mosnic distributed to every agent for implementation.

Mosnic was also formed as an offshore institution to gain tax advantages. In addition, it was also designed as an investment vehicle to reduce transaction costs and fixed overhead expenses. The stakeholders believed that one way of managing the risks associated with operating through agents was by reducing the number of agents. But they were not definite about an exact number of agents to be maintained as standard.

RELIGIOUS BELIEF AND INVESTMENT GOAL

Profit maximization as a goal is allowed by Islam but care-fully regulated. A Muslim has to manage the source of his income.

Certain economic and religious factors affected the annual income realized by Mosnic. First, Islamic investors have a religious commitment to pay a tax (2.5% of the annualized market value of the marketable securities) to the needy citizens. This is called Zakah. Second, Islamic investors must deduct from the return on investment any interest earned which has been added to the value of the portfolios. This is because the receipt and payment of interest is defined as usury which is prohibited by Islam. Hence, the stakeholders have always been keen to make sure that any interest earned should properly be accounted for throughout the investment strategy implementation processes. The principals had difficulties in technically conveying their reservations about interest income to the Western portfolio managers.

THE STAKEHOLDERS' CONCEPTION OF THE RISKS ATTACHED TO STRATEGY AND GOALS

While risk is critical to every investment decision, there is no conceptual clarity or sophisticated management of risk in Mosnic.

The Director claims that: *"We try to manage risk through setting investment policies and through frequent liaison with the agent and the Controller. Despite all measures we take to reduce risk, we cannot totally eliminate it.*

(1) The expatriated funds still face foreign and local environment risk, (2) Choosing the fiduciary asset managers involves risk taken on the selected agent. The agent's market is not that efficient. (3) Diversification over the asset managers, involves risk taken on the number of the agents. We do not know how many agents to maintain. (4) Diversification of the corporate assets, does not eliminate risk taken on the securities chosen. We cannot check corporate risk implications of each new security added to the portfolio. (5) Diversification of the assets within each portfolio aims at managing portfolio risk. But the portfolio risk is still there. (6) Monitoring and

assessing the performance of the agents is subject to risk taken in relying on the agents' information system."

As for the diversification of the company's portfolio to control risk, the President of the company commented:-

" We broadly talk about risk, while we do not have a clear measure for it. We worry about `exposure to loss' and uncertainties surrounding `future returns.' The only exceptions are the treasury bills and their equivalents (which offer low risk of loss and high certainty of return). Despite that, the treasury bills carry the risks of lost opportunity or diminishing purchasing power. So, risk determination is very imprecise."

The Director believed that subjectivity is always involved in risk assessment. He thought that changing conditions in the financial markets meant the future seldom directly paralleled the past. Therefore, he believed that even the most sophisticated calculation of risk would lead to suspect conclusions. There was no one decision situation where management calculated risk using a mathematical formula. Risks attached to all decisions were managed through principal-agent negotiation and exchange of opinions. Also, the perception of risk differed from one stakeholder to the other. The difference was ascribed to variation in the investing personality of each principal. One of the Directors commented that:

"The perception of risk by agents often differs from that of the principals'. That led to different responses from different agents to the markets' event. Moreover, risk perception even differs from agent to agent depending on each ones self-image. It was not even clear to us how risk was managed by each agent".

Time was an important factor in each party's perception of risk. When unrealized losses were incurred on portfolios, the Director had a tendency to allow less

time for the portfolios to pick-up whereas the Chairman and the other Director tolerated unrealized losses for a longer time. Also, in terms of measuring the performance of the portfolios, some stakeholders preferred the benchmark* system. Others liked the bottom line** approach. The resident Director wanted to know about agents performance as frequent as possible. His response to the market fluctuations was higher than the other director. The latter wanted to allow longer time for the agent before judging on his performance. However, all the board members encouraged the interaction with agents to attend for the information necessary to manage strategic uncertainties. Even for the same stakeholder, risk attitudes could vary from one market circumstance to the other.

One of the Directors saw lower risk in allocating most of the assets to the fixed income securities, namely in bonds. He expressed his worry about bonds as follows.

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* Benchmark system of portfolio performance appraisal represents comparison with market indices. The performance of equity portion of portfolios (common stocks, convertible securities and warrants or options) may be measured against anyone of a number of stock market indices e.g. Standard and Poors 500, New York Stock Exchange index, Dow Jones composite index, etc. Fixed income or bond portfolios can be appropriately compared to bond indices e.g. Salomon Brothers, Moody's index, Merril Lynch index, etc.

** The bottom line approach to measurement is concerned with a longer-term appraisal of portfolio performance based on, say, the increase in wealth. This approach is known to the portfolio managers as a system whereby investors will have little concern for the manner in which the results were produced but concern very much for the absolute result in aggregate. This is inadequate for Mosnic.

" The financial risk in a bond is the rise in interest rates over and above usury problems. Some agents advise that if you sell bonds before maturity you overcome the interest income problem."

He suggests that one might hold fixed income securities. However, the risk did not just relate to interest rate investments but also whether or not he was guilty of usury if he realized capital gains from fixed interest stock even though he received no interest payment. In other words, there was a religious risk involved. The President has also commented on this theme. He believes that:

"(1) The agents' culture is different. Their belief is different. The agents' personnel neither believe in the cause nor have the right perception of the concept of interest in Islam. (2) Separation of interest from the investment instruments traded in the Western financial markets is beyond the reach of both the principals and the agents. (3) Agents may accept the idea of filtering out interest earned from the portfolio but they argue that it is expensive to change the whole data processing system of the bank to report separately interests earned."

Turning to equity risk, the Director explained the nature of market risk by saying that:

" If the big risk in stocks is in a rising and falling market, it can largely be offset by long-term holding. We must not worry about the stocks short-term depreciation of value, nor should we care for the short-term capital gains.

By all means we need to diversify. By diversification I mean choosing a number of agents for the discretionary management of the portfolios and requesting them to spread our money over a number of companies, industries, areas and currencies. This is then followed by efficient and close monitoring of the agents performance. Most important of all we must keep in touch with the agents to manage risk."

Risk management within each portfolio was considered the discretionary responsibility of the agent. Agents took a view on their principals' risk attitudes and then managed the portfolios without disclosing detailed data showing how they calculated the risks actually being taken by the principals. Hence, in effect, the agents managed risk on behalf of Mosnic and yet the stakeholders never formalized a method of measuring the risk taken in choosing an agent. The major risks faced by Mosnic stakeholders were therefore in the first place choosing the agents and also controlling the agents by being aware of what risks they were taking on behalf of the stakeholders. It is, therefore, important to consider the need to operate through agents.

3. THE NEED TO OPERATE THROUGH AGENTS

The Chairman (the President) advocated the use of the external portfolio managers as follows. "*We need to invest through a portfolio of agents for a lot of reasons. I will give some of these reasons.*

1. *The use of outside services facilitates diversification over the styles or philosophies applied to portfolio management.*
2. *There is less risk of conceptual stagnation. Principal-agent interaction creates new ideas and refines the investment decision process.*
3. *Outside managers have survival needs that motivate them continually toward excellence.*
4. *The use of multiple external managers eliminates dependence on a few key people.*
5. *Investment professionals have only limited career opportunities in a corporate environment."*

The stakeholders also believed that their funds were not large enough to justify the cost of establishing a huge in-house portfolio management team. Moreover, they believed that investing abroad was the appropriate strategy for their situation in the Middle East. They argued that the high cost of internal management, imported technology, etc outweighed the other factors in favour of internalization.

Commenting on expatriation of portfolio management, the Director stated that the lack of local skills and the scarcity of investment opportunities led Mosnic to expatriate the management of its financial assets to Western portfolio managers. Above all, the Western investment environment was viewed more stable and safe. Hence, the stakeholders gained more security by externalizing their investment management.

Also Mosnic did not think it would be feasible to recruit full time Western portfolio managers. They eliminated `internalization' from their options because of the difficulty involved in keeping internal portfolio managers' skills up-to-date. In addition, the President believes that:

"More foreign agents means better attendance to information necessary for managing strategic uncertainties. However, to benefit from the foreign agents we must have the right person to interact with the agents to get the maximum possible information."

The challenge was therefore how to select, de-select, and maintain an appropriate portfolio of agents. This

challenge involved evaluating their performance in handling discretionary investment portfolios. For that reason it was decided to recruit a corporate controller. He was appointed to develop a better system to choose and control agents.

4. THE NEED TO RECRUIT A CORPORATE CONTROLLER

It can now be seen how the use of external agents by Mosnic triggered the need for both a corporate control system and the recruitment of a controller to boost the efficiency of strategic management. Previously, the appraisal and selection of the agents, the most important financial decision, was taken without rigorous pre-decision analysis. There was no corporate control department in Mosnic to engage in agent selection or portfolio performance evaluation. There was no system to regulate the appraisal of the agents. It also seemed clear that it would not be easy to provide such a system. The Advisor did not document agents selection processes. Agents' misjudgment and imprudent investment decisions were not easy to discover without detailed involvement in decision-making with agents. Information on agents' performance was processed and developed by the agents themselves. It needed somebody inside Mosnic to monitor and understand in more depth the information provided by the external agents.

The President of the company emphasized the need for a Corporate Controller as follows:-

" The agents are supposed to be our investment managers. It is risky to depend on them as our information managers. We need to establish a corporate financial control cell, to regulate agent selection and their performance monitoring processes."

5. RECRUITMENT AND JOB SPECIFICATION OF THE CORPORATE CONTROLLER

The President of the Board clearly stated the three dimensions of the task to be undertaken by the new controllership function:

"The in-house Financial Control Department is needed for:-

1. *Interacting with the current agents to make the corporate strategy more efficient.*
2. *Providing information necessary for selecting the agents.*
3. *Post-investment monitoring of the portfolios and controlling of the agents."*

But it was not clear to the Chairman how to go about achieving these goals. The Chairman could not provide a detailed job description for the Corporate Finance Controller (CFC), alternatively called 'the Controller'.

The Controller had worked as a senior audit manager with Arthur Young International (AYI). While practicing with AYI, the Controller was introduced to the Chairman of Mosnic. The occasion was an audit assignment to AYI by the Chairman. Over five years of serving the Chairman (a client of AYI), the Controller gained the former's trust. Eventually, it became a mutual trust and a friendly relationship. The Chairman seemed impressed with the experience, the performance, and the personality of the AYI Audit Manager. This resulted in the Chairman approaching

the Audit Manager to join Mosnic as a Corporate Financial Controller. As said before, the Chairman was not very clear about the detailed job specification of the Controller. He just indicated to the latter that there were three main dimensions to the job, as indicated above, and he trusted that the Controller could develop a role to achieve those ends.

DEVELOPMENT OF THE CONTROLLERSHIP JOB DESCRIPTION

Mosnic's financial success was dependent to a great extent on the success of the agents in achieving high performance in terms of the bottom line ROI produced. Accordingly, the choice of the appropriate asset managers seemed to be the most significant financial decision. Appropriate agent selection had to be followed by both monitoring their performance effectively and realistically measuring portfolio performance. However, as already stated, details of the tasks to be undertaken by the Controller were not yet clear in the minds of the stakeholders who looked to the new Controller to help in developing his own role.

After some deliberation, the Controller and the Managing Director developed the following job description:

(1) Provision of information necessary for selection of agents and for corporate strategic planning.

(2) Designing and implementing an internal control system which would:

(i) set financial strategies and goals for agents.

(ii) determine the information needed to control each agent;

(iii) design the appropriate control system for monitoring each agent;

(iv) measure the performance of each discretionary portfolio;

(v) convey stakeholders' views to the agents;

(vi) recommend, if necessary, to de-select any agent;

(vii) monitor the implementation of the corporate strategy; and

(viii) recommend, if the need arises, a re-allocation of corporate assets.

Indeed, the Controller could not get a clear explanation from the management about who actually claimed the responsibility for formulating the strategic investment decisions. It was clear that the management had a role beside the discretionary agents. In the absence of formally prepared strategic plans, and considering the negative views the principals had already formed against value of formal quantitative models for selecting securities* the Controller found himself in the dilemma of what strategy to monitor and who was to be held accountable for the investment decisions. This prompted him to understand the decision levels in the organization to distinguish between them.

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* The stakeholders did not object to the use of formal quantitative models by the agents. However, they would not accept the agents' proposals without debate and negotiations. The Controller was not clear about the nature of these negotiations. It needed time to understand what the principals would like to tell the agents.

(B) THE DECISION LEVELS IN MOSNIC

A number of problems faced the Controller in attempting to move from the job specification to its implementation. It was not clear to the Controller how investment decisions were being taken.As stated before,the Controller observed that decision processes in Mosnic were not programmed. The whole operation was a dynamic management process. The allocation of the corporate assets was verbally negotiated among the directors.The Controller was required to formalize the decision making processes. The necessary information for monitoring the agents was controlled and processed by the asset managers themselves. Hence, the Controller was required to determine whether the data provided by any agent was appropriate without a very clear specification of what was meant by "being appropriate." No one could tell the Controller what would be considered as effective investment strategy. It became crystally clear to the Controller that understanding the strategy formulation processes could not be achieved without studying the case of each individual portfolio manager. However, the Controller had to try understand the decision classes as a first step.

As stated previously, decision classes, the decision making processes, and the implementation of decisions were not clear. The division of responsibilities between Mosnic and its agents needed to be clarified and explained. Yet, at that time; the Managing Director could not describe them. As a consequence, the Controller began to study the

decision levels and processes as described in the forthcoming pages. Sections (6) and (7) of this Chapter describe the corporate decisions and their problems. The following pages emphasize the strategic decisions taken inside Mosnic.

6. LEVEL (I) DECISIONS

(CORPORATE DECISIONS TAKEN BY THE PRINCIPALS)

The corporate investment decisions in Mosnic stemmed from the broad strategies set for achieving the corporate goal which was the maximization of the stakeholders' wealth. Fig 3.2 shows the hierarchical nature of the corporate decisions in Mosnic. It shows how decisions at one level feed into subsidiary decisions. To give a brief idea about the nature of the corporate strategic decisions I will select few decisions from figure 3.2 to discuss them.

(i) <u>The Decision to Invest in Marketable Securities/ Financial Markets (Fig 3.2).</u>

With regard to the general strategy of investing in the global financial markets, it was not clear what form of investment should be undertaken. The investment could be in marketable securities, real estate, direct investment in companies and projects and so on. Mosnic invested in all these forms of assets. But the majority of investments were in marketable securities which is the focus of this thesis. This decision was taken when Mosnic was incorporaated. The decision was primarily taken by the founders of Mosnic. (As this thesis is coming towards end, this decision is undergoing fundamental revisions).

The decision to invest predominantly in securities in the world financial markets was not based on any sophisticated financial analysis nor were any capital budgeting techniques applied. The stakeholders simply saw a potential in the Western securities markets and they wanted to hold financial assets which were easily convertible into cash. As argued earlier, the limited local investment opportunities, the local currency (diversification problem) and the local environment risks were possible reasons which convinced the stakeholders to invest in the relatively more secure Western financial markets.

(ii) The decision of allocating corporate Assets (Fig.3.2)

Fig 3.2 also shows the allocation of assets by type of the security and by the broad currency category. The stakeholders set a guideline that at least 70% of the portfolio should be denominated in US Dollars. The stakeholders were used to earning their income in US Dollars and spending in US Dollars. Hence, there was lower currency risk in adopting this policy. Once again the decision to allocate 70% of the corporate portfolio to US Dollars was not a result of sophisticated analysis. The stakeholders simply saw safety and conservation of the invested funds in the US Dollar.

The reason behind allocating a major part of the assets in the portfolio to fixed income securities and a small portion to shares was to avoid the stock market uncertainties. High exposure to equities was felt to be a sign of aggressive investing. This was not based on rational analysis. In fact, the problem of earning

interest on fixed income securities was resolved by instructing the agents to sell the bonds before maturity. However, allocating most of the portfolio to the bonds was not the end of the resources allocation problem. Even within the category of bonds, Mosnic had to worry about allocation of assets:

- By currency
- By industry
- By country
- By sector
- By Bond quality
- High yield or zero coupon etc.

Hence, the need for the agents was inevitable to run even pure bond portfolios.

On the other hand, the investment strategy of the company was dynamic. Asset mix by instruments was continuously shifted in response to changing market conditions. There were, therefore, different levels of decision-making in allocating funds to assets. The Chairman stated:

" We set the asset mix policy. Agents on our behalf tackle asset allocation in individual portfolios."

To understand properly the different roles of stakeholders and agents, one needed to see two types of decision making:

1. The policy asset allocation decision
2. Dynamic strategic decision-making
3. Tactical asset allocation decisions.

The policy asset mix decisions were characterized by being long-term. They were primarily taken by the stakeholders who certainly consulted the agents, but used their advice to formulate a general strategy on the types of assets to be held in order to maintain their total wealth within an acceptable risk-return profile. In

FIG. 3.2
CORPORATE STRATEGIC DECISIONS AT LEVEL 1

STRATEGY	DECISION	TAKEN BY
INVESTMENT IN THE FINANCIAL MARKETS (ORGANIZATIONAL ACTIVITY	TO DEAL IN THE MARKETABLE SECURITIES	THE STAKEHOLDERS
DIVERSIFICATION OF THE ASSETS (ASSET ALLOCATION)	i] ALLOCATE CURRENCIES INTO US $ 70% OTHER CURRENCIES 30% 100% ==== ii] ALLOCATE SECURITIES INTO FIXED INCOME 77% EQUITIES 23% 100% ====	BD BD
EXTERNALIZATION OF THE PORTFOLIO MANAGEMENT (DECENTRALIZED STRUCTURE)	CHOOSE THE APPROPRIATE ASSET MANAGERS	MD,IPC,CFC
MAINTAINING AN ORGANIZATION SMALL IN SIZE, WITH LIMITED NUMBER OF IN-HOUSE EMPLOYEES	INTERNAL OVERHEAD EXPENSES MUST NOT EXCEED US$300,000/	BD
ESTABLISHING FIDUCIARY RELATIONSHIPS WITH THE AGENTS BEYOND THE FORMAL ASSET MANAGEMENT AGREEMENTS	SPEND UP TO US$1,500,000 TO MAINTAIN THE FIDUCIARY RELATIONSHIPS I.E. ALLOWED ASSET MANAGEMENT FEE	BD
INTERNALIZATION OF AGENTS MONITORING	ESTABLISH THE CORPORATE FINANCIAL CONTROL DEPT.	BD
DIVERSIFICATION OVER THE AGENTS AND MAINTAINING AN APPROPRIATE PORTFOLIO OF AGENTS	SELECT: 5 AGENTS FROM SWITZERLAND 2 AGENTS FROM LONDON 2 FROM U.S.A. 1 BAHRAIN - MANAMA 10 TOTAL ==	BD

(Fig. 3.2 Shows examples of corporate decisions steming from the corporate strategy. Those decisions were "corporate", in the sense that they were taken inside Mosnic apart from the direct involvement of agents).

addition, and as stated previously, policy asset mix decisions generally aimed at adopting a very safe approach. Safety meant accepting modest return opportunities whereas long-term rewards tended to be more speculative. The stakeholders retained the responsibility for balancing those conflicting goals. Such a process involved the interaction of the principal with the current and intended agents.

In contrast to the long-run strategic mix of investment types, dynamic strategic decisions dealt with reconstructing the corporate portfolios in response to the markets' shifting uncertainties. For example, when the stock crash occurred in October 1987, the stakeholders intervened with the portfolio managers to formulate the post-crash strategy. One of the major dynamic corporate decisions taken at that time was to stay out for some time to recover part of the unrealized book losses of shares and then refraining totally from equities to park funds in short-terms and AAA bonds. The stakeholders expressed to the agents their high concern about that defensive strategy. Views of the agents were different. However, the stakeholders were very clear about their interest in avoiding any further problems in the stock markets as a result of the crash.

The following memo is an example of how Mosnic conveys its dynamic asset allocation policies to the agent while giving the agents the discretion to design and implement the tactical asset allocation procedures as necessary.

"Dear Sirs,

To follow on the strategy matters, the following are your guidelines to re-construct our portfolio when you see appropriate and time is viewed opportune by yourself.

1. *Eliminate short-terms (fixed deposit holdings) from the allocation of the assets, unless there is a tactical need for parking the assets in cash.*

2. *Allocate 100 % of the portfolio to the most secured fixed income instruments, such as, AAA governmental bonds, state treasury bills, etc.*

3. *Refrain from inclusion of any types of equities in the portfolio. We are not yet certain about the stock markets.*

4. *Within the above broad guidelines, tactical re-allocation of the assets remains your total discretionary responsibility.*

5. *Despite our spiritual concern about interest and usury, temporary fiduciary placements and their returns are not prohibited within the portfolio management process. However, permanent short-term investments in fixed deposit accounts must be avoided.*

We confirm that the above are not rigid instructions. If you see otherwise, please let us exchange opinions.

In spite of the fact that the above proposed allocation of resources represents our intended strategy, timing and details of implementation remain within your total fiduciary management responsibilities."

The need for the dynamic re-allocation of the assets arose as the stakeholders interacted with the markets. Dynamic asset allocation decisions, in technical terms, were formulated by the agents whose views were considered by the stakeholders in taking the policy asset allocation decision. Dynamic asset allocation decisions were negotiated within the principals-agents fiduciary relationships. The agents were part of the actual decision-making process within a continuous agent-principal iterative process.

Moreover, this could, on occasions, lead to an amendment of the policy asset allocation decision.

In contrast to the higher levels of decision-making, tactical asset allocation decisions, related to individual portfolios and they were solely the responsibility of the discretionary asset managers. They reflected how agents opportunistically shift the asset mix of portfolio in response to short-term changing patterns of reward available in the financial markets. The principal-agent interaction helped the agents to reflect the principals' requirements in the tactical asset allocation decisions, but agents dominated the actual short-term adjustment decisions.

(iii) STRUCTURE OF MOSNIC BY DECENTRALIZATION TO AGENTS (Fig. 3.2)

Fig 3.2 also shows that externalization of portfolio management was an structural problem to Mosnic as an organization. The previous sections emphasized that Mosnic was structured in a way that the external portfolio managers represented responsibility centres. The earlier section on the need to operate through agents showed why the founders decided on that type of structure. The strategic decision of structuring Mosnic in that way led to the following: (i) The establishment of a network of fiduciary relationships with a number of agents. (ii) The need to internalize controllership. (iii) The need to manage a portfolio of different agents.

Indeed, fig 3.2 shows numerous types of corporate decisions. The following are examples taken from fig. 3.2. (i) How much to spend on internal overhead expenses, was a corporate decision; (ii) how much to budget for asset management fee was negotiated and authorized by the Director; (iii) establishment of a corporate finance department; (iv) the number of agents to be contracted with; and (v) how much funds were to be exposed to each agent? These were the types of strategic decisions taken by the Director and the Board in coordination with the Investment Policy Committee. The Corporate Controller also had a significant role to play in all those corporate decision processes.

7. PROBLEMS AT LEVEL-I DECISION

According to the Corporate Controller, the major control problem was found to be the fast movement in and the unpredictability of the financial markets. The previous section highlights the difficulty of adopting a formal investment strategy. As a result, the strategic control system faced the problem of monitoring volatile strategies. Strategic uncertainties were extremely high. To make the investment strategy effective, Mosnic had to attend frequently to market information provided by the agents which was mainly the job of the Controller. But Mosnic did not have a formalized system to attend to market information. Thus, the required interaction with the agents was not specified to the Controller.

Furthermore, Mosnic's structure of decentralizing its investment to agents made the task of the Controller difficult, particularly how to evaluate the performance of external responsibility centres.

In addition, the stakeholders' risk management approach was not programmed. Therefore, organizational effectiveness was not precisely defined. Due to that, the notion of designing an effective corporate control measurement system under dynamic management circumstances seemed paradoxical. Indeed, the problem was what to do after measuring ROI. The market uncertainties were never the same. They would hardly repeat themselves in the same order of the past.

Moreover, the Controller did not find a strategic control system to accommodate the specific control needs of all agents. This seems to have been the case despite the recognized role of the agents in the corporate strategy process. i.e., strategy formulation and implementation were externally decentralized to agents leading to strategic control problems.

At any rate, detailed aspects of the investment decisions taken by the agents seemed to be critical and a key factor for the Controller to consider if he were to tackle the control problem. The detailed aspects of the decisions assigned to the discretionary agents will be presented in the forthcoming stages of the research. The

next section gives the reader an idea about this type of decision.

8. LEVEL II DECISIONS (INVESTMENT DECISIONS BY THE AGENTS)

Agents work closely with the principals in an interactive process. The agents' task involved decision making and controlling processes. They performed their fiduciary investment responsibilities at the risk of the principals. This is portrayed in Fig. 3.3 which describes the processes involved in working with agents. It is important to recognize that figure 3.3 shows the relationships of different activities to each other. However, there is a 'never-ending' continuous exchange of views between Mosnic and its agents with the possibility of decision and actions at one level feeding back to decisions and actions at other levels.

It should be recognized that at this stage of the research we did not know yet how those processes in fig. 3.3 were performed by each specific agent. It was possible to find a lot of differences between agents if one studied each agent separately.

Boxes 1 to 4 in Fig 3.3 show the stages and processes of portfolio decision making by agents. Boxes 5 to 7 describe the agents role in performance monitoring. The following is a general explanation of the processes in Fig. 3.3.

However, the reader will appreciate that one can hardly understand the details of agents pre-and-post investment processes before studying specific agents cases.

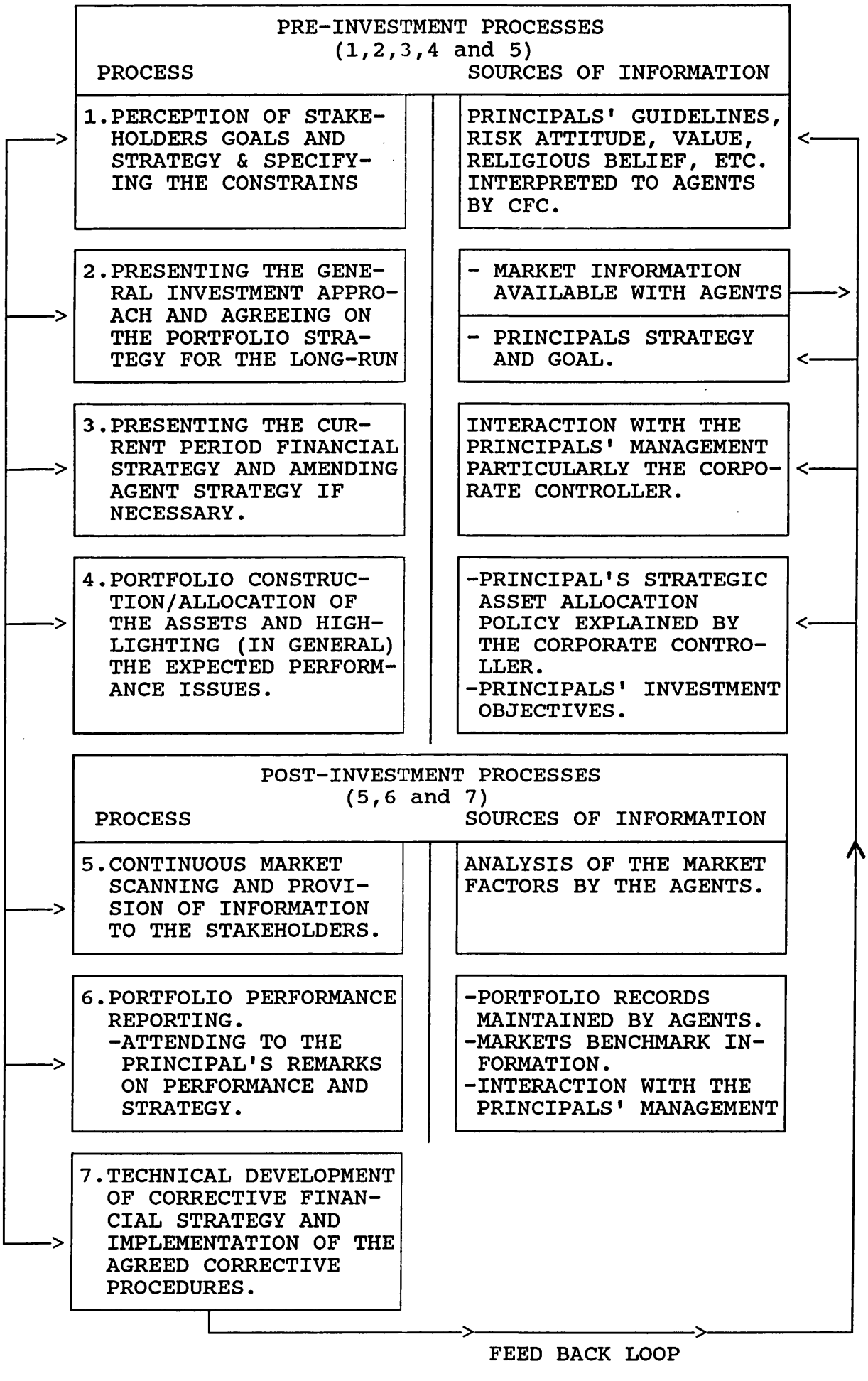
[1] UNDERSTANDING THE PRINCIPALS' OBJECTIVES (BOXES 1 TO 3 FIG.3.3.).

To formulate a specific portfolio policy, agents have to understand the principals' objectives which stemmed from the broad organizational goals. Hence, agents needed to understand the specific requirements of their principals under different environmental conditions. This meant that they needed to liaise with the Controller (the interpreter).

[2] INTEGRATION OF MARKET EXPECTATIONS WITH THE PRINCIPALS OBJECTIVES (BOX 4 Fig.3.3).

Agents needed to analyze the expected rate of return for each of the asset categories and individual securities. By integrating the expected market outlook with the principals' objectives, agents worked towards optimizing the portfolio combination from the available choices. The end product of these processes usually could lead to certain asset allocation to be taken as a financial strategy for the agent. Hence, the role of the Controller became important in this asset allocation process. In addition, the allocation of the assets in each discretionary portfolio was the prime job of the designated agent. However, agents were required to attend to both the principals' strategic asset allocation policy and dynamic asset allocation views as the principals interacted with the financial markets.

FIG. 3.3
LEVEL (II) INVESTMENT DECISION PROCESSES OF AGENTS



[3] **PORTFOLIO MONITORING AND PERFORMANCES MEASUREMENT BY THE AGENTS (BOXES 5 TO 7 FIG 3.3.).**

The constant monitoring of the various factors which tend to affect the composition of the portfolio held by each agent was done by the agents themselves. Agents used to relate their performance to the risk level generally perceived to be acceptable by the principals. They used to measure their own performance and provide a report on that together with a commentary to Mosnic. They were required to provide comparative statistics to disclose what had been achieved relative to the market as a whole. Agents were sensitive to the feedback on performance from the principals.

9. CONCLUSION TO THE DECISION LEVELS (AN INTEGRATED VIEW OF THE INVESTMENT PROCESS)

The study of Mosnic's decisions and strategy and the description of the general role of agents have disclosed two levels of strategy and decision-making. In fact, they are complementary and both are taking place simultaneously and are related to each other. In this section we try to combine the corporate strategic decisions at level I (fig. 3.2) with the agents role (in fig 3.3) to find out who is dominant in affecting the investment performance of Mosnic.

Notwithstanding the clearly different features of the corporate strategic decisions at level I and the agents' discretionary investment decisions at level II, in practical terms they could hardly be performed separately.

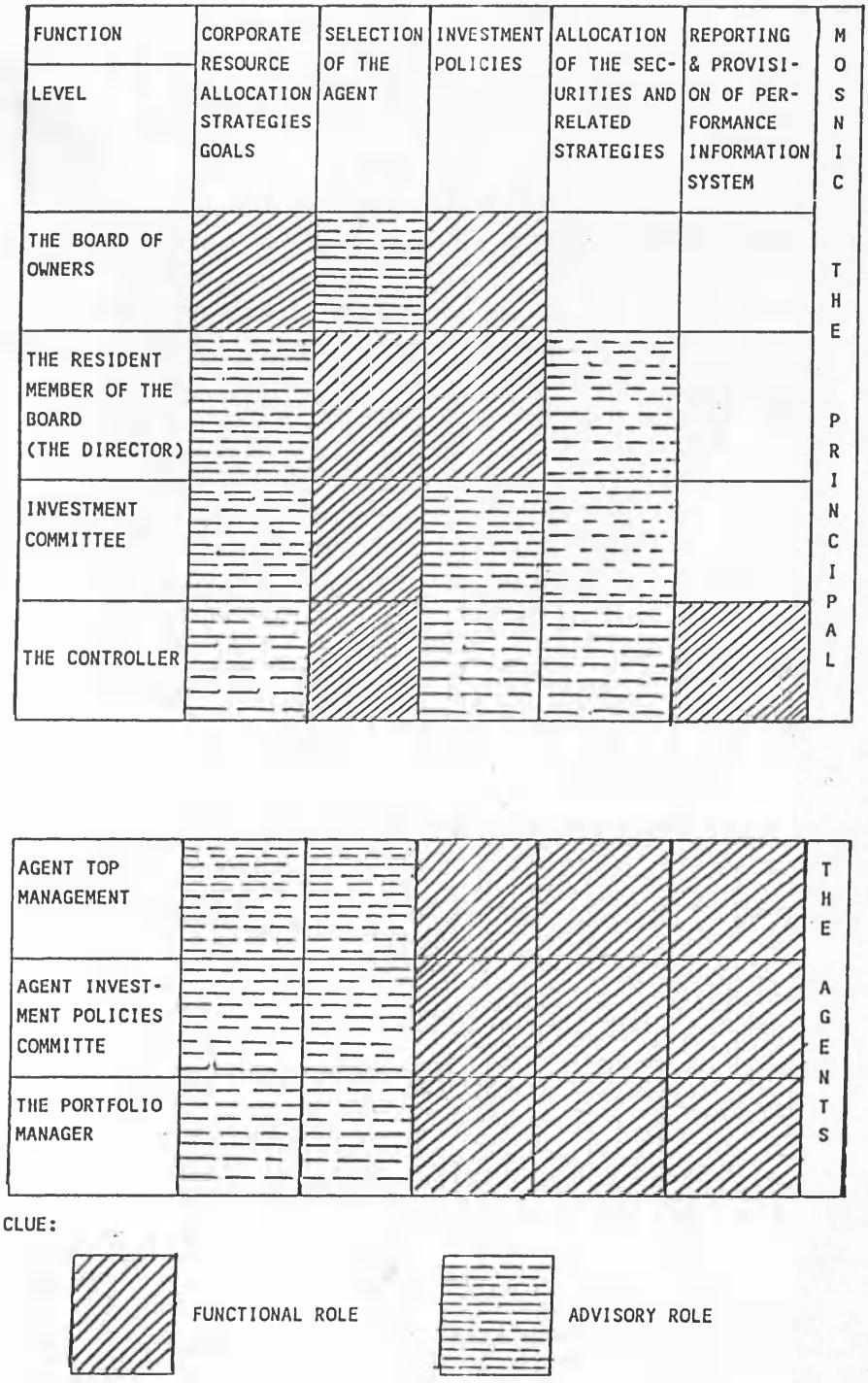
The principals and the agents worked close with each other to achieve one goal. Hence, the two decision levels were interrelated. Fig. 3.4 is an attempt to integrate fig. 3.2 and fig. 3.3.

WHO DOES WHAT IN THE DISCRETIONARY INVESTMENT MANAGEMENT PROCESSES (FIG.3.4)

We can now see the two decision levels in Mosnic. Indeed, it is a process whereby the agents undertook a functional and advisory role in the complicated portfolio investment processes. Indeed, fig. 3.4 is an attempt to show the different emphasis at the two decision levels in Mosnic. It portrays who does what in the discretionary investment process. The two decision levels draw a clear line of demarcation between what Mosnic did and what its agents did. This seems to be inappropriate. It distorts the fact that decisions at both levels were taken through a process of extended principal-agent negotiation.

Principal-agent interaction was important, encouraged by both parties and was the major factor for efficient management investment. In addition to that interaction, there was an iterative process inside Mosnic divisions. An example of what took place inside Mosnic could be the work of the investment policies committee in terms of negotiating what view was to be conveyed to the agents. The board members also made a contribution to the major strategic decisions such as determining the main categories of securities to be held in the corporate portfolio. Thus, Mosnic took some responsibility for performance along with

FIG. 3.4.
PRINCIPAL AGENT WHO DOES WHAT IN THE INVESTMENT PROCESS



the discretionary asset managers. But how much of the total responsibility related to the portfolio performance and how much was to be charged to corporate management was left vague.

(C) CONTROLLER'S PRELIMINARY THOUGHTS AND HIS PERCEPTION OF CONTROL PROBLEMS

(i) Agents Selection Problems (Pre-Investment).

The study of decision problems in Mosnic has generally highlighted, in different places throughout the case study, the significance of agents selection as a fundamental pre-investment process. The problem of selecting agents is critical to both resource allocation and the monitoring of appropriate problems of agents. Hence, it is a central theme to this research. Given the significance of the agent selection problem, it is imperative to go back through the case study and examine its major aspects.

It became evident to the Controller that working with agents was clearly central to Mosnic's operations. Nevertheless, upon being appointed, the Controller could not see clearly how agents were selected nor was there a formalized system that described how to select agents. There were no clear attributes for the selection of agents.

The stages of appraising agents were not clear. The financial markets influence on the corporate strategy and

goal was a problem which needed to be understood by the Controller. The stakeholders seemed unable to fix a goal to be pursued without changing it. Consequently, the Controller was not definite about the financial management approach that he could adopt. The market uncertainty also made it difficult for Mosnic to stick to one strategy. Pursuant to the strategy and goal setting problems, the Controller could not tell what kind of strategic plan or a corporate investment model to forward to the intended agents to see the latters' input and to test their capability of implementation.

How to design a control system for each intended agent without studying their structure and processes was a delicate issue. It was difficult for the Controller to tell in advance what kind of strategic control procedures would be necessary to monitor the system of each intended agent. The Controller saw a potential problem in strategically controlling heterogeneous financial institutions (agents).

The worldwide market for agents also seemed too big to understand fully. Accordingly, the Controller was not sure if any particular agent that would be selected would prove to be appropriate for Mosnic or not. It was clear to the Controller that it was not cost effective to have all the necessary and relevant information about all the agents with whom Mosnic could approach to explore the possibility of appointing them as its agents. Yet, it was

inevitable to select a number of agents from the wide range of available agents to conduct Mosnic's investments on its behalf.

The Controller's principals placed great store on past performance results in guiding their choice of agents. However, the Controller perceived that historical performance statistics could be offered by agents as a bait to catch the fish. It was possible that the historical performance might be deceptive. This could possibly be avoided if the company had the ability to examine the performance of every intended agent. Moreover, one could not believe that agents who had done well in the past could repeat the same performance in an extremely variable and volatile environment.

The Controller was not given a clear guideline in terms of how many agents to deal with. Thus, he could not know the maximum portfolio of agents to be maintained. Moreover, the Controller was not clear when an agent could be de-selected. All this could involve potential problems for the diversification of the corporate portfolio. It was difficult to tell exactly how.

There was also a possibility of conflict between the principals and the intended agent. The agent could use the minimum possible resources to manage the portfolio. On the other hand, it could be to the interest of the principal that the agent used the optimal resources relative to the fees paid. Such a conflict could not be removed by

carefully wording the asset management agreements. There was no standard form of contract to be drawn up with each agent. As a result, the task of the Controller was made more difficult in securing the interest of the principals in the pre-contracting negotiation processes.

The delicate issue of the management fee was a problem to be considered by the Controller before entering into any agency relationship with the fiduciary portfolio managers. The Controller was not aware of how to apply the asset management fees as a means of controlling the behaviour of the intended agents. He discovered that a fixed contracting system was applied by the company to acquire the services of all its agents. It was not easy for the Controller to design an agent reward system in the presence of the fixed fee asset management agreements. It was obvious to the Controller that, once the intended agent was awarded the contract, he (the agent) would draw a fee that varied with the value of assets held by the agent. The ex-post calculations carried out by the Controller indicated that portfolio performance variations had an immaterial impact on agents' fee. (e.g. 1/2% of say of a 4% increase of ROI equals only to 0.0002% of the portfolio. It was too small to control agents' behaviour).

As said before, the Controller needed to have clarity about the agent's attributes as criteria for selecting the appropriate fiduciary relationships. It was unclear to the Controller whether the current agents were good for Mosnic

or not. To make a judgement, the Controller needed to interact with each agent to discover each one's style, strategy, structure and processes. This seemed to need time.

Apart from the formal asset management agreement, the stakeholders seemed to have different degrees of trust in their agents and yet the basis for trust was unclear to the Controller. The pattern of their relationship with each agent was not clear to the Controller.

The stakeholders investment `personality' and their perception of risk lacked clarity. Yet, the lack of clarity in the principals' own risk perception could be a source of the agents' lack of clarity. It could even cause ambiguity in terms of agents' future accountability.

(ii) Performance Measurement Problems (Post-Investment).

Another central theme to be examined in this research is the post-investment control system. The Corporate Controller arrived at a general conclusion that the corporate control system was not effective. His judgement was based on the problems found in measuring the corporate portfolio performance. He observed that the financial measurement of an agent's performance was the last stage of the investment control process although it emerged as part of an on-going operation.

The portfolio managers were hired by Mosnic with the aspiration of achieving superior performance. At the same

time, the Chairman of the board urged the Controller to maintain the right to know what sort of performance was actually being attained. The interactive involvement with the agents and urging them to boost tactical management of the portfolio was viewed by the Chairman as a means of mitigating the problem of controlling dynamic goals. Thus, the paradox of operating a dynamic strategy and simultaneously worrying about the achievement of financial goals was present. Besides this, the Controller was not clear about: (1) his involvement with the principals and the agents; and (2) his independence in spite of this involvement in the decision process.

With this situation it was obvious to the Controller that his first major problem was how to obtain reliable information on the measurement of performance. Information technology was still primitive in the Middle East. The Corporate Controller had to be careful because he operated as a gate-keeper between the principals and the agents. In particular the Controller was worried about measuring agents' performance inappropriately because of possible wrong interpretation of stakeholders' interest to agents. Mis-interpretation could also negatively impact the agents' decision making style.

The Controller was not clear about the post-investment monitoring processes Mosnic carried out to control the agents. As explained in the case study, agents were assigned a wide role in assessing their own performance.

The Controller was worried about agents' bias in reporting their performance. An investment manager, by measuring and diagnosing his or her own performance, could manipulate sources of strength or weakness. Thus, the Controller faced the responsibility of looking into each agent situation to tackle this problem in corporate performance measurement. To do that, he had to understand how each agent operated. This seemed to take a long time before getting familiarized with each relationship.

The Chairman (the President) could not provide the Controller with criteria for resuming or terminating the relationship with any particular agent. It seemed difficult for the Corporate Controller to separate performance resulting from an agent's skill from that due to mere luck. Yet, switching from one agent to the other on the basis of minor differences in short-term performance, involved the risk of incurring considerable corporate transaction costs in terms of evaluating new agents and also the change of agents due to unsatisfactory performance might not guarantee improvement of performance. Despite the existence of that problem, the company did not have clear set of policies and procedures to tackle each poor performance situation. Poor performance was not even clearly defined. For example, when the stock market crashed on 19th of October 1987 and substantial losses were incurred, no agent was de-selected. As a result, poor performance determination was not an easy process to understand from a first glance. As said earlier, it was

not clear whether the stakeholders required bottom line measurement or benchmark measurement of performance to be achieved by the discretionary portfolios. Thus, there were no clear cut rationally set models to tell when to switch from an agent. This meant the Controller had to understand each agent's situation and to handle it accordingly.

The Controller could not execute post-investment control procedures independently from agents because information necessary for evaluating the corporate portfolio performance was processed by the agents and then passed to Mosnic. That could be one of the decentralization problems. The Director could not explain the dimension of this problem at the level of each agent to the new Controller.

The lack of clarity in the stakeholders' risk perception led to the lack of clarity of objectives to be pursued by agents. Hence, the risk of stakeholders' objectives being misconceived by agents was high. That could make holding the agents accountable for their performance problematic.

It was not clear to the Controller how the enforcement of corrective actions on agents should be done in the absence of a line relationship between Mosnic and its agents. Consequently, it was still vague to the Controller how the company's structure (decentralization to agents) could affect the control system to be designed for measuring agents performance.

At any rate the final assessment of the situation by the Controller was that the problem needed to be studied in further detail within a clear framework. Such a framework had to be used to gain insights of the problem at the level of each specific agent.

10. CONCLUSION TO THE CASE STUDY

The initial case study of Mosnic which is presented in this chapter aims at describing how the company operates and highlights its major characteristic. Part (A) is a basic description of Mosnic. It has projected the fact that Mosnic deals in the world financial markets which are volatile. The volatility of the financial markets has made setting of strategic goals, assessment of investment risk, and the formulation of investment decision dependent on the stakeholders' reaction to an extremely turbulent environment. Part (A) also discusses the need to operate through discretionary agents. It is argued that for a number of considerations Mosnic has opted to externalize the management of its investment portfolios to a group of global asset managers. As a result, a unique structure emerged in Mosnic. In this structure the external agents represent the accountable units for the corporate management of Mosnic.

Part (A) also argues that Mosnic needed to recruit a Corporate Controller to help in managing the complicated process of formulating the corporate investment strategy,

implementing it and then facilitating the operation of agents' accountability system. Thus, this Part (A) is a basic description of Mosnic plus the initial case study of the Corporate Controller which describes the processes of the recruitment and the difficulties involved in specifying the job of the Controller who should be involved in a complicated decision and control processes. Part (B) has reflected on the complexities involved in identifying the decision levels in Mosnic. Part (C) has described the Controller's preliminary thoughts and his initial perception found in Mosnic. The thoughts of the Controller at this stage are general. They do not reflect detailed insights of the problem. These problems need to be put into a clear framework for the Controller to further his understanding of them.

Hence, chapter (4) will be concerned with the analysis of the initial case study to generate specific working hypotheses which are hoped to help in developing a framework for pursuing the study of the initial case of Mosnic.

CHAPTER-4
ANALYSIS OF THE INITIAL CASE STUDY AND DEVELOPMENT OF THE RESEARCH CONCEPTUAL FRAMEWORK

Objectives and Outline of the Chapter

Part (A) of this chapter analyzes the initial case study to give general indications of the nature of controllership in Investment Houses. These general indications will be summarized and used as working hypotheses to be pursued later in the research.

Part (B) is mainly concerned with developing a conceptual framework for the research. Clarity about the relationships between the contingent variables is a prerequisite to build-up such a conceptual framework which would help in understanding the interrelationships between the contingent variables which pertain to the specific features of controllership in Investment Houses.

The Major Characteristics of Mosnic

First, the Corporate Controller of Mosnic also served as Finance Director. This meant that he had direct contact with the stakeholders and had direct involvement in the strategic decision processes.

Second, Mosnic operated under uncertain financial market conditions which made it difficult to adopt a programmed approach to goal setting and decision making. The environmental uncertainties led Mosnic to adopt an extremely dynamic investment strategy. As a result, the

Controller did not observe any formal quantitative models for the selection of securities based on a clear strategy. The Controller also observed that Mosnic did not have one formal stable strategy. It seemed that strategy was what emerged as part of the on-going operations to cope with fluctuating markets.

Third, Mosnic strived to Islamize its investment while operating in Western Financial markets.

Fourth, Mosnic operations were delegated to external agents. This meant that it was decentralized within a network which was rather different from divisionalization within a large company.

Fifth, agents' selection was a complicated decision, but it was the most important. How each agent was selected or de-selected could not be clearly understood from the case study of Mosnic. One needed to examine how specific agents had been selected.

Sixth, evaluation of discretionary portfolios and monitoring of agents involved problems stemming from the inter-organizational structure of the Mosnic-agent network. These problems were characterized by lack of clarity of risk perception, mix of benchmark approach with bottom line approach in performance assessment. However, those characteristics alone did not in themselves provide clear suggestions for control systems in Investment Houses. Hence, this Chapter examines the inter-relationships between the relevant contingent variables to see how they

may affect the design of controllership and control system in Investment Houses.

(A) ANALYSIS OF THE INITIAL CASE STUDY

4.1. INTERACTION OF CORPORATE STRATEGY WITH THE ENVIRONMENT

This section argues that the financial markets in which Mosnic operates influenced the design of the control system and the functions of controllership which were also influenced by the Islamic religion and technology of communication and information.

(i) The Financial Markets

This part of the analysis studies the features of controllership emerging from the stakeholder's interaction with the unpredictable, fast-moving and the uncertain financial markets. The argument in this section suggests that Mosnic and its agents could not set investment goals regardless of the current situation in the markets.

Mosnic needed to adopt dynamic investment policies. For example, when the financial markets experienced severe turmoil, the stakeholders were content with capital preservation as a realistic target in lieu of profit maximization. Consequently, wealth maximization became a broad but a highly dynamic and relative goal in Mosnic. Beside the continuous shift in the stakeholders' goals, information necessary to amend the corporate investment goals was not easy to obtain. The circumstances of the world financial markets, the agents future outlook, and the specific requirements of the stakeholders were all relevant sources of information to be attended to for the purpose of setting realistic investment targets.

It was obvious that Mosnic did not have clearly quantified goals which could be compared with what had been attained nor did it have a formal long term strategy. Also, the stakeholders did not want to depend on formal quantitative models or techniques for formulating their investment strategy. On the other hand, they would not mind if the Controller discussed with the agents, the quantitative models which they used to support their rather more general financial and economic analysis. However, the Controller was definite about the fact that, to the principals, portfolio management was not the pure application of "scientific" concepts and quantitative techniques. Rather, they wanted their requirements to be closely attended to so that they could explain to the agents on a timely basis their perception of the markets' uncertainties and how they should be responding to them at present.

Required investment targets were relative to what could be achieved within the available opportunities without putting the stakeholders' capital into a jeopardy. Towards that end, the stakeholders had a tendency to amend the corporate strategy which they thought suited the situation in the financial markets. This was executed through re-allocating the corporate fund resources. Thus, tactical change of the corporate financial strategy emerged as a significant aspect of control. It was difficult to distinguish between strategy and tactical decisions. Both seemed to have merged in one operational

activity which followed the trends in the financial markets.

The interaction of stakeholders goals and strategy with the financial markets also influenced the strategic control system and the functions of the Corporate Controller. **First,** The Corporate Controller had to be recruited to deal with market information from different sources and to make the role of the stakeholders more effective in formulating the investment strategy. During the time of the investment Advisor, the stakeholders involvement in risk management was negligible. **Second,** the corporate control department had to design strategic monitoring procedures which ensured that the corporate asset allocation policy set by the stakeholders was implemented by the use of agents who were supposed to have better expertise in reading the financial markets. These procedures had to be flexible to match the dynamic financial strategies to be monitored. **Third,** timely information necessary for measuring the performance of the corporate portfolio was not available inside Mosnic. This was needed in order to make sure that investment strategic goals were in the process of being amended and achieved. The role of the Controller was important to overcome that problem. The market performance information necessary for the controllership function to exercise strategic assessment of the corporate portfolio performance had to be acquired from the agents and interpreted by the Controller. **Fourth,** the financial forecasting of

performance in the turbulent financial markets was not an easy thing to be done accurately. Thus, the company had the problem of identifying measurable goals to be achieved by the corporate investment strategy. The process of determining which types of realistic goals to be pursued in the financial markets required an active role to be played by the Corporate Controller.

Thus, in Mosnic, the interaction of the stakeholders' strategy and goals with the turbulent, fast-moving and unpredictable financial markets influenced the features of the control system and the functions of controllership.

Hence, the previous arguments suggest the following working hypothesis:

> *"The turbulence of the financial markets in which investment houses operate tend to influence the way stakeholders formulate investment strategy and goals. This, in turn, is likely to affect the control system and the controllership function in investment houses (Working hypothesis # 1.1)."*

(ii) Influence of the Principal's Religious Ideology on the Corporate Strategy and Goal

The religious beliefs of the stakeholders influenced the way in which the resources of Mosnic should be invested in the Western (non-Islamic) financial markets. All Muslims are required to make sure that their investments are compatible with the Islamic precepts. For example, the receipt and payment of usury (interest) is prohibited in Islam. Hence, the Mosnic strategic control

system had to ensure compliance with the Islamic religious guidelines.

The Corporate Controller had difficulties in ensuring compliance with these guidelines for a number of reasons. **First,** the global financial markets operate on an interest basis. **Second,** the agents do not fully understand the concept of usury. **Third,** the information to be used by the Controller for classifying the portfolio income into revenue from interest and non-interest income is processed and controlled by the discretionary agents i.e. outside Mosnic. **Fourth,** although the definition of interest is established by the Muslim religious experts, the stakeholders still have differences about which financial instruments involve interest and those that do not. As a result, views were divided in terms of how to separate interest from the income of the corporate portfolios. **Fifth,** it was not clear whether the degree of compliance with the principals' religious beliefs was an attribute to measure the quality of the agent. Before recruiting the Controller, the question of how to invest in the West according to the Islamic precepts was not discussed rigorously with the Western Agents. The Advisor was not interested to raise the issue and the principals had little contact with their agents.

These arguments clearly indicate that in the investment houses, which adhere to their Islamic faith, religion impacts the design of the management control system and influences the functions of strategic control-

lership. Moreover, corporate controllers are expected to play a key role in making the religious beliefs of the principals understandable to Western Agents.

Thus it can be hypothesized that:

"The religious beliefs of the stakeholders impact the management control system of investment houses and influence the function of the controller. (Working hypothesis # 1.2)"

However, it has to be recognized that one does not know yet how each Western agent tackled the principals' religious requirements. In this respect, agents could be different. Such a difference could lead to operating different control processes for different agents. This issue will be teased out in depth in the specific agent's case studies presented in Chapters (5) and (6).

(iii) Impact of Technology on Controllership and Management Control Systems

The modern communication technology made it possible for Mosnic to operate in the Continental financial markets despite the geographical distance from the agents. Mosnic has its portfolio managers thousands of miles away from the Middle East. Nevertheless, they are readily accessible and controllable. The technology of communication has made it possible for investors all around the world to keep in touch with their brokers and agents and to be updated on the daily situation in the financial markets. Modern information systems (cable television, telefaxes, radio, etc.) now serve to link the world investment markets. The Controller had to come to terms with this changing scene

Controller had to come to terms with this changing scene and decide which technology was needed to maintain links with both agents and principals.

The historical background of Mosnic showed that the use of information to select agents or to evaluate portfolio performance was confined to what the previous investment Advisor wanted to utilize. Given that the Advisor placed high trust in the agents, he was not anxious to dig for information about them or their past performance records in a rigorous manner. Consequently, his use of information technology was limited. As a result, he used a crude information system. He did not differentiate between agents according to their differences in the use of communication technology. This seemed critically important to the newly recruited Controller in ranking the intended agents. In other words, the use of communication technology by agents was an important attribute for the Controller to construct a portfolio of reliable agents. The information required by the Controller in performance evaluation ranged from regular information on bottom line performance to detailed benchmark data prepared by the agents about their performance.

Hence, the Controller started to appreciate that both an agent's communication technology and the information technology available for Mosnic helped to determine which agent to select and how to evaluate his performance. Moreover, it seems that the information technology applied

influence the level of sophistication and the efficiency of the control system.

> Hence, *"The implementation of modern information technology by investment houses operating in international financial markets through external portfolio managers influences the design and efficiency of the organization's control system (Working hypothesis # 1.3)."*

4.2. THE INTERACTION OF ENVIRONMENT, PRINCIPAL'S RELIGIOUS BELIEFS AND TECHNOLOGY WITH AGENTS' STRATEGY, STRUCTURE AND PROCESSES.

(i) The influence of the Financial Markets and Technology on Agents

The objective of Mosnic's case study was not to describe how each particular agent could be structured and what kind of investment strategy each agent would suggest. Nevertheless, it was obvious that an agent's structure and style of investment (i.e. the agent's methods and means) reflected the pattern of his interaction with the markets. But one cannot study in one thesis why all agents are structured in different ways. What mattered to the Controller was to see whether the intended agent's structure can impact the decision to select him or not. This will be pursued further in subsequent cases developed specifically to examine how agents' attributes impact on Mosnic control systems.

The asset allocation policies described in Chapter (3) referred to tactical and dynamic asset allocation policies. Mosnic decision types and levels indicated that agents played a significant role in (1) the tactical

agents played a significant role in (1) the tactical management of the portfolios; (2) scanning the financial markets; and (3) interpreting them to the principals. Hence, it was important to know the structure of the agents to ascertain the appropriateness of their investment decision processes.

The agents' role led the Controller to consider their influence on the corporate investment strategy process. For example, the involvement of the agents in the investment strategy process obviously indicated that the strategy, structure and processes of agents could be key factors which Mosnic would need to consider in selecting any agent. On the other hand, any agent's investment management model (system) would be influenced by how that particular agent reads the financial markets.

Based on the initial general survey, the Controller could observe that different portfolio managers have different uses of communication technology to scan the financial markets. The Controller also observed that investment management banks adapt their structure to (1) the investment market requirements, (2) the competition in the agents markets; and (3) the local market regulations. These were clear in the general survey conducted by the Controller to form a general idea about agents. Indeed, this was general information which the Controller would need to examine further with specific agents.

At any rate, the Corporate Controller started to appreciate the following potential problems of designing a control system for Mosnic. (1) The investment approach suggested by an intended agent could possibly be an outcome of how that particular agent reads the financial markets to develop the investment model, interprets the market information, and communicates it to the principals through certain means/technology of communication. (2) In doing that, different agents could depend on different types of communication technology. (3) Due to (2), different agents come up with different types of strategy and investment models and recommend them to Mosnic to be adopted. (4) different agents could interact differently with the financial markets and their domestic environment. Hence, agents' organizational structure could be different. This meant to the Controller different indications for Mosnic investment strategy process.

Up to that time, the Controller had not yet gone to the depth of understanding the principals' relationship with each particular agent. Hence, he could come up with only general indications to the corporate control system. These are: First, the way agents interpret the financial markets determine their style of investment, the strategy proposed by them, their risk-taking attitude, the way they structure their firms and their internal control processes. Such relationships and how they differ between agents are of importance to the design of Mosnic's own control system.

Secondly, the technology applied by agents also affected their organizational structure, strategy and processes. The Controller presumed that agents' internal structures could also affect their processes. These processes were assumed to be key factors for the strategy and processes of Mosnic. In fact, the initial case of Mosnic alone does not provide an adequate picture of the influence of the financial markets on agents' structure. To research this facet of the controllership problem, the following working hypotheses were developed:

2.1.a. *"The way intended agents interact with financial markets influences <u>their</u> strategy, structure and processes (i.e. their methods and means).*

b. *Consequently, investment houses operating through a portfolio of agents would tend to formulate their corporate strategies by utilizing a number of heterogeneous sub-strategies.*

c. *Thus, the corporate control system emerges from a number of different strategic control sub-systems.*

d. *These systems could be more effective by using an "involved controller."*

2.2.a. *"The level of information and communication technology used by intended portfolio managers influences their strategy, structure and processes.*

b. *Hence, operating through a portfolio of agents leads to the emergence of a number of control sub-systems tailored to meet the specific control needs with regard to each agent."*

(ii) The Impact of the Principal's Religious Ideology on the Agents' Strategy, Structure and Processes.

In the previous section, it was argued that the religious ideology of the stakeholders influence their corporate investment strategy and goals. This section attempts to demonstrate that the principal's religious ideology also influences the agents' strategy, structure and processes.

Investing in the Western financial markets according to Islamic principals has always been a challenge facing Mosnic. The Controller expected to find Western agents unaware of how Muslims define interest. This is mainly because the financial environment in the West is dominated by the concept of interest. Agents' portfolio management systems were designed for investors whose income from interest is not prohibited. The Corporate Controller had to judge which of the agents was showing signs of cooperation to meet the religious requirements of the principals.

The Controller was required to ask agents to modify their processes to separate interest from other returns generated by the portfolios. In some aspects, the effectiveness of Mosnic strategy was judged by the extent to which agents complied with the Islamic religious rules of earning income. Thus, the effectiveness of the strategic control system can be evaluated in terms of its success in monitoring the corporate strategy to ensure the latters' compliance with the stakeholders' religious

guidelines. The challenge that faced the new Controller in monitoring the implementation of the investment strategy from an Islamic perspective was to convey the right interpretation of the stakeholders' religious requirements to the Western portfolio managers and to help them how to Islamize the investment of the funds entrusted on them in a manner that would not violate the principals' faith. Hence, it can be hypothesized that:-

2.3.a. *"The religious beliefs of the stakeholders of investment houses influence agents' strategy, structure and processes. This in turn influences the control sub-systems to be designed for controlling a portfolio of different agents.*

b. The role of corporate controller in investment houses in interpreting stakeholders religious precepts to their agents is important."

4.3. THE INTERACTION OF AGENTS' STRATEGY, STRUCTURE AND PROCESSES WITH THE PRINCIPAL'S SYSTEM OF MAINTAINING THE PORTFOLIO OF AGENTS

A pre-requisite to understand better the inter-connection of agents' strategy, structure and processes with the principals' system of maintaining the portfolio of agents is to document in minute details how specific agents work. This issue is examined in more depth in the specific agents' cases presented in Chapters (5) and (6). However, the analysis in this section suggests that agents' investment approach, strategy, structure and processes have interrelationships with the system of agents' selection and de-selection implemented by the principal. Strategy, structure and processes can be the

criteria that determine whether to select or to de-select an agent. These interrelationships can have a number of meanings to strategic controllership in the Investment Houses. Based on the knowledge built from the Mosnic case, these interrelationships involve two variables. **The first** one is agents' strategy, methods, structure, and processes. **The second** variable is the principals' system of maintaining the portfolio of agents which has two aspects, namely the selection of portfolio managers and their de-selection.

The initial case study does not show how a particular agent is selected or de-selected. This will be examined in the following stage of the research. However, it was previously argued that the major success factor of Mosnic was the selection of appropriate agents. The Corporate Financial Controller was recruited to ensure the selection of competent agents who could contribute to the achievement of the stakeholders' goals. The major task assigned to the Corporate Controller in the process of maintaining an appropriate portfolio of agents involved the evaluation of intended agents investment strategy, internal structure, and processes.

As a result of the recruitment of the Controller, the de-selection of agents (i.e. the termination of the fiduciary relationship with any particular agent) was based on more factors than just measuring the financial performance using the ROI produced by the agents. Relationships with agents in terms of continuity depended

partially on the achievement of financial objectives and mainly on uninterrupted satisfaction of the principals with the strategy, structure and processes of the selected agent. In other words, there was general flexibility in agents' accountability depending on the principals' satisfaction with the way agents operated using the necessary methods for each market situation. As a result, agents' performance measurement emerged as a process of interaction between Mosnic and its portfolio managers.

It was natural to expect to see different patterns of interaction with different agents which meant different control processes. The operation of the latter highlighted the importance of the presence of the Controller. As indicated by the initial case study the Controller did not find in Mosnic a formal investment strategy. It appeared that the strategic investment decisions were tackled in a continuous process through maintaining the portfolio of the discretionary agents. This meant to the Controller that the means and the methods of the discretionary agents could be critical to the corporate investment decision processes concerned with allocating the fund resources of Mosnic. In fact, the Controller needed to look into this problem in all the agents situations. It was clear that there could be complicated and different processes by which the strategic decision segments could emerge with each one of the ten agents. The initial case study alone could not help us to understand the insights of the problems.

Also, the initial case study (Mosnic and the Controller) indicated that agents performance evaluation in Mosnic depended on the appropriate treatment of the information provided by a portfolio of agents. Thus, the Controller could generally interpret that the information system of the intended agent was an important attribute when examining agents' processes. In other words, for selecting an agent it seemed important to examine how efficient the expected agent's information system could be. Moreover, for maintaining a portfolio of agents, the Controller had to determine the necessary procedures to monitor each specific intended agent. As a result, the Controller induced that the corporate control system could be a product of a number of sub-systems which were dependent on numerous agents control processes and different information sub-systems. However, the Controller developed the belief that life could be a lot more complicated if each agent case was studied.

In fact, the recruitment of the Controller indicated that the stakeholders were not content with the informal system of the Advisor in monitoring the agents. The Advisor vested equal trust on all agents. The Corporate Controller observed that agents might not be the same in terms of their methods and means i.e. structure, their strategy, and their processes concerned with formulating the investment strategy. Depending on the variations between agents' tasks and methods, the Corporate Controller contemplated designing a diversified control

system that would meet the specific control needs of each agent. The potential effectiveness of the system to be designed seemed to depend on studying the characteristics of the fiduciary relationship with each particular agent in the portfolio. This could be indicated by understanding the means and the methods of the intended agents.

Based on the preceding arguments one can hypothesize that:-

> " *Agents' strategy, structure and processes influence the pre-investment processes carried out in investment houses to maintain an appropriate portfolio of agents. (Working hypothesis # 3).*"

More light will be shed on this hypothesis when we investigate in Chapter (5) how the attributes for agents selection interacted with the processes of maintaining a portfolio of agents.

4.4. THE RELATIONSHIP OF AGENTS' SELECTION PROCESSES WITH THE DESIGN OF CONTROL SYSTEM AND THE EVALUATION OF DISCRETIONARY PORTFOLIO PERFORMANCE.

The initial case study of Mosnic demonstrated that the control system had two objectives. **First,** the pre-investment system should ensure that an appropriate portfolio of agents was structured. **Second,** to operate a system for the evaluation of portfolio performance. These objectives were clear throughout the initial case study. For example, the job description of the Corporate Controller involved the regulation and the formalization of the agent selection processes. Moreover, the Corporate

Controller had to evaluate agents' performance and to be aware of the control features of each agent to tailor the system that could ensure their effective monitoring.

After his involvement in the management of Mosnic, the Controller observed that a control process could not be operated without determining in participation with each agent some short-term financial strategy to be pursued. In establishing the latter, the Controller assumed that this can take place simultaneously while designing the monitoring procedures for the intended agents. However, the Controller was not sure how this could be done without studying the specific control needs of each intended agent. This also meant that the objectives defined for intended agents were to be set in the latter's selection stage. In addition, before selecting any agent, the Controller felt that the stakeholders' risk perception and the extent to which they would like to be involved in the control of the intended agents had to be defined.

Indeed the corporate control system aimed at managing the risk of the stakeholders in a process agreeable to their requirements. The presence of the Corporate Controller in future agents selection or de-selection procedures was a key factor to ensure risk management in a manner compatible to the principals' perception of different types of risk.

Hence, it can be hypothesized that:

"The processes of maintaining the portfolio of agents in an investment house influence the design of the corporate control system to monitor the agents (Working hypothesis # 4)."

4.5. THE IMPACT OF THE PERFORMANCE EVALUATION SYSTEM ON MAINTAINING THE PORTFOLIO OF AGENTS

In Chapter (3) the discussion of the feedback loop problems showed that Mosnic had to negotiate with the each agent any corrective actions needed. The control cycle in such a process would complete its loop by viewing whether the agent concerned would be ready to amend the relevant investment strategy to rectify the unsatisfactory result or not. This process also might involve changing the financial strategy which had already been negotiated with that agent, i.e. ascribing the low performance to the uncontrollable financial markets. An alternative procedure might be to call for de-selecting the agent.

These arguments propose that the principals' system of evaluating the portfolio performance can influence the selection and de-selection of agents. Moreover, it can change the investment strategy and consequently the strategic control. Hence,

> *" The process of appraising agents' performance has a feedback effect on the process of maintaining the portfolio of agents used by an investment house (Working hypothesis # 5)."*

4.6. SUMMARY OF THE WORKING HYPOTHESES.

Table 4.1 summarizes the working hypotheses developed from the analysis of the initial case study.

Summary of the Research Working Hypotheses

1.1. The turbulence of the financial markets in which investment houses operate tend to influence the way stakeholders formulate investment strategy and goals. This, in turn, is likely to affect the

control system and the controllership function in investment houses.

1.2. The religious beliefs of the stakeholders impact the management control system of investment houses and influence the function of the controller.

1.3. The implementation of modern information technology by investment houses operating in international financial markets through portfolio managers influences the design and efficiency of the organization's control system.

2.1. a. The way intended agents interact with financial markets influence <u>their</u> strategy, structure and processes, (i.e. their methods and means).

b. Consequently, investment houses operating through a portfolio of agents tend to formulate their corporate strategies by utilizing a number of heterogeneous sub-strategies.

c. Thus, the corporate control system emerges from a number of different strategic control sub-systems.

d. These systems could be more effective by using an "involved controller."

2.2. a. The level of information and communication technology used by intended portfolio managers influences their strategy, structure and processes.

b. Hence, operating through a portfolio of agents leads to the emergence of a number of control sub-systems tailored to meet the specific control needs with regard to each agent.

2.3. a. The religious beliefs of the stakeholders of investment houses influence agents' strategy, structure and processes. This in turn influences the control sub-systems to be designed for controlling a portfolio of different agents.

b. The role of the corporate controller in investment houses in interpreting stakeholders' religious precepts to their agents is important.

3. Agents' strategy, structure and processes influence the pre-investment processes carried out in investment houses to maintain an appropriate portfolio of agents.

4. The processes of maintaining the portfolio of agents in an investment house influences the design of the corporate control system to monitor the agents.

5. The process of appraising agents' performance has a feedback effect on the process of maintaining the portfolio of agents maintained by an investment house.

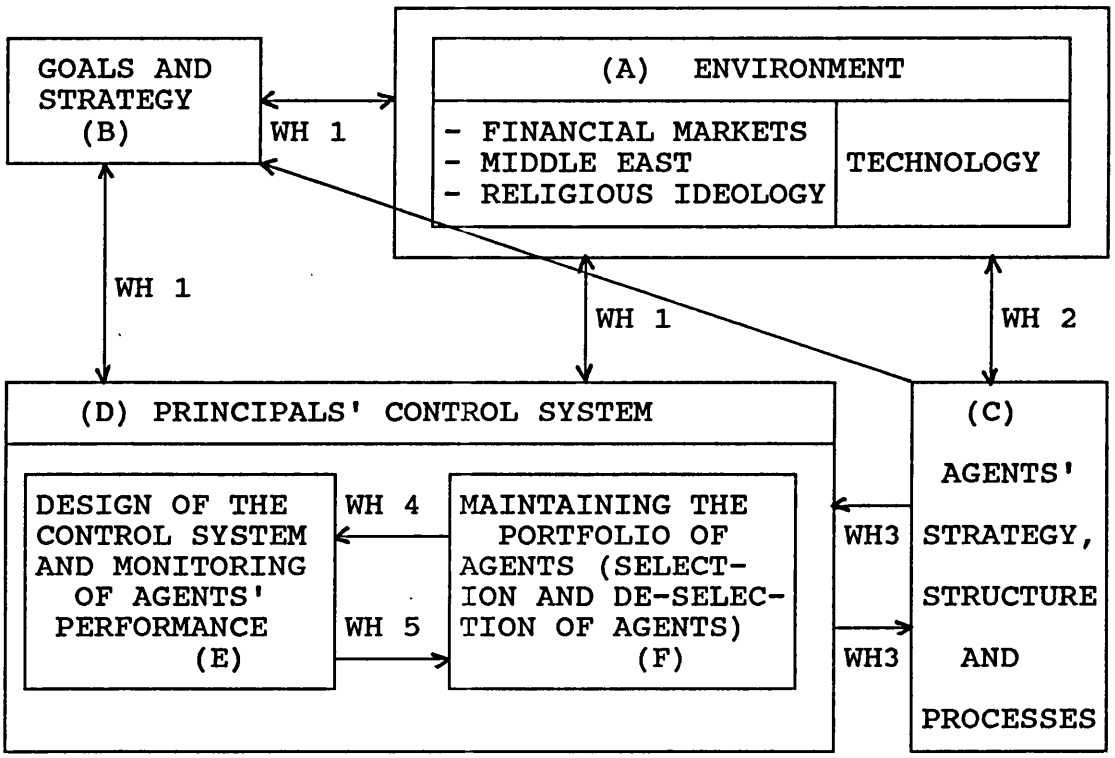
The above hypothesized relationships are presented in Fig. 4.1. This represents the general conceptual framework of the research which is discussed in Part (B).

PART (B)
THE GENERAL CONCEPTUAL FRAMEWORK

4.7. THE GENERAL CONCEPTUAL FRAMEWORK DERIVED FROM THE INITIAL CASE STUDY

Fig. 4.1 is developed from the five working hypotheses summarized in section 4.6.

Fig. 4.1.
The General Conceptual Framework of the Research



The main contingent variables of the conceptual framework are variable (B), which represents the principals' goals and strategy, and variable (A) which represents a number of environmental factors which influence the management control system in investment houses. These environmental factors are: (i) The financial markets; (ii) the domestic environment of Mosnic i.e., the

Middle East; (iii) the stakeholders' religious ideology; and (v) technology.

As said previously, the domestic environment of Mosnic (The Middle East) was separated from the stakeholders' religious ideology because there are organizations in the Middle East which do not adhere to the Islamic precepts. For example, the secular commercial banks (which are not governed by any religious beliefs) outnumber the Islamic banks in the Middle East. However, in the case of Mosnic, the religious beliefs of the stakeholders is an influencing variable which impacts the investment process.

Box (C) represents the agents' strategy structure and processes (means and methods). Variable (D) stands for Mosnic's (the principal's) control system. Boxes (E) and (F) are the components of the corporate (the principal's) control system. The latter variable represents the system of maintaining the appropriate portfolio of agents while the former signifies the design of the control system for specific agents and the performance evaluation process. The components of these two sub-systems will be further examined in Chapters (5) and (6) which address specific agents' pre-investment and post-investment selection and monitoring processes, respectively.

4.8. THE NEED FOR AND THE LIMITATIONS OF THE CONCEPTUAL FRAMEWORK

The general conceptual framework developed in Fig. 4.1. will be used to guide the preparation of case

studies for specific agents. As stated in the research approach chapter, the conceptual framework is needed to confine the description to the aspects of the cases which are relevant to the research.

It is obvious from the approach to this practitioner research (see Chapter 2) that further cases will be used to explain and give further insights to the initial case study. This means the trend of the research is moving towards the description of detailed and complicated processes. These processes are endless. Different sets of people from different organizations are involved in the pre-investment and post-investment processes indicating that the processes to be described could be variable also. The researcher (the Controller) is part of these processes. The amount of information he has about the research problem is extremely detailed. The conceptual framework is hoped to help the practitioner conducting this research to present the problem in a relatively simple form to all the audiences of the academic issues inherent in this research.

However, a conceptual framework may not highlight all the processes of the phenomena to be studied in this context. For example, investment decisions are taken in an iterative process of interaction and through frequent negotiations between the agents and the principals. Such a process has no formal boundaries as the conceptual framework suggests. Thus, the conceptual framework shown in Fig 4.1 is not more than a simple diagram that attempts

to represent the broad contingent variables. The hypothesized relationships between the contingent variables are shown by connecting lines which do not fully portray the principal-agent interactions nor fully reflect the control system changing processes and their minute details.

Another limitation of the conceptual framework diagram is that it cannot accommodate the whole constructs of each contingent variable in this research. Sometimes the constructs of the variables themselves may be complicated processes.

Another problem of the conceptual framework is that this research is devoted to one investment category i.e, the marketable securities. It would not be possible for one conceptual framework to reflect real world decisions and control problems of organizations investing through agents in other investment products. Hence, this conceptual framework may need adjustments if it is to be used by other investment houses operating in different investment products.

One of the main reasons why the conceptual framework is needed at this stage is to guide the research in conducting further case studies to advance our understanding of the general relationships between the contingent variables mentioned in the five working hypotheses.

4.9 THE NEED FOR ADDITIONAL CASES ON SPECIFIC AGENTS

As argued before, in order to further our understanding of the hypothesized relationships, an additional five case studies on specific agents will be presented that demonstrate Mosnic's pre-investment and post-investment processes in dealing with portfolio managers. In particular, these case studies attempt to shed more light on the five working hypotheses. Table 4.1, shows the processes that require further investigations. The agents' cases to be studied are shown against each aspect of the control system.

Table 4.1
Specific Agents Cases Selection Framework

MOSNIC CONTROL SYSTEM [Variables (E) & (F) in Fig. 4.1 (The Conceptual Framework)].		
Processes (Systems) to be better Understood	Agents to be Studied	No.of Cases
(a)Maintaining Portfolio of Agents variable (F):	Pre-Investment Cases:	
(i) Selection of Agents.	(1) Selection of MIP Bank as an Agent.	1
	(2) Selection of BJ-S Bank as an Agent.	1
(ii) De-selection of agents.	(1) Vontov Bank De-Selection	1
(b)Evaluation of Agents Performance [variable (E)] and design of control sub-systems for specific agents.	Post-Investment Cases:	1
	(1)MIP Bank Monitoring	
	(2)BJ-S Bank Monitoring	1
Total Number of Cases.....		5

4.10. DATA COLLECTION

All the relevant information of the selected asset managers is under the custody of the researcher. Also, the agents were very cooperative in providing the researcher with additional data. The business trips and the working relationship between the researcher and the agents also have facilitated the collection of data. For example, the agents used to voluntarily provide the researcher with new publications in the professional literature on the selection and monitoring of portfolio managers.

Selection of Cases

The cases on agents were selected from the following total population of agents that were dealt with by the researcher.

Total number of Agents evaluated with a view to selection over three years is around..... * 50

Total number of Agents de-selected 3

Agents currently in service..... 10

The selected five case studies were intended to be representative of the other cases. This was helped by the fact that the Controller had been involved in all the selection, de-selection and performance evaluation processes for the last four years since his appointment. The logic behind selecting the same banks for the pre-

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* Out of the 50 agents offering their services about 35 were dropped after the preliminary evaluation tests. 15 were able to stand the detailed analysis. Currently only 10 are assigned business with Mosnic.

investment and post-investment stages was to provide the reader with a comprehensive picture of the control process involved in dealing with each specific agent.

4.11 CONCLUSION

In this Chapter the initial case study was analyzed and specific working hypotheses were generated and developed into a research conceptual framework. The latter shows the hypothesized inter-relationship between the contingent variables (principals' goals and strategy and environmental factors) which influenced the design of the management control system of Mosnic. These relationships will be teased out in the five case studies presented in Chapters (5) and (6). It is to be remembered that while the cases on specific agents were used to describe the pre-investment and post-investment processes, the role of the Corporate Controller was projected throughout the description.

CHAPTER - 5
MAINTAINING THE PORTFOLIO OF AGENTS
(Pre-Investment Case Studies)

Objectives and Outline

This Chapter aims at improving our understanding of the working hypotheses generated from the analysis of the initial case study.

The analysis of the initial case study shown that maintaining an appropriate portfolio of asset managers was an important aspect of the control system in Mosnic. However, it is necessary to examine the insights of the processes and relationships which affected the appropriateness of diversification over agents. This is the objective of the three case studies presented in this chapter which deals with the selection of agents. The pre-investment (selection of agents) cases explain important aspects of the investment strategy formulation through interaction with the intended agents. It is also one of the objectives of the agent selection and de-selection case studies to reveal whether agents depended on a purely security analysis approach to formulate the strategic investment decision or whether they interacted in a flexible manner with the principals to understand the latters' opinion on risk and investment objectives.

The study of agent selection aims at projecting the potential problem of the control system resulting from differences between agents in terms of methods and means. Such differences seemed to have made it necessary to ope-

rate a number of strategic control sub-systems to be tailored for controlling heterogeneous agents. The case studies show how the Controller determined how to monitor each specific agent as part of the complicated pre-investment analysis process carried out to choose the discretionary agents. The issue of ROI standard setting is also considered in the pre-investment case studies.

This chapter also discusses the question of market inefficiency in the market for agents in informing the investors about the best agent who would expend the optimum method and means to maximize the welfare of the principals. This is followed by a description of how the principal (Mosnic) went about selecting MIP bank to be a discretionary asset manager. That is done in Section 5-A. Section 5-B describes the selection of BJ-S bank as an intended agent; while the Vontov Bank case study presented in Section 5-C gives the reader a picture about the complicated processes involved in the de-selection (termination of the fiduciary relationship) of a discretionary agent.

Section 5-D is concerned with the emerging issues from the three case studies. It emphasizes the Controller's further thoughts about the critical problems in maintaining the portfolio of agents i.e. the complications involved in the agents' selection and de-selection processes.

At the end of each agent appraisal process the Controller reflected on the criteria and the results of the three appraisal processes to show the complications involved in measuring the qualities (the methods and the means) of the intended agents.

SECTION 5-A
THE CASE OF MIP BANK SELECTION

1. THE PROBLEM OF AGENTS' SELECTION

Rosenberg (1986) estimated that between 1970 and 1984 the amount of money under professional management jumped tenfold from approximately $100 billion to $ 1 trillion and the number of registered investment advisors rose from 3,060 to 9000 (2,000 joined the field in 1984 alone). The portfolio managers also believed that the explosively growing field of investment management was riddled with questionable practices that made it difficult for even the most sophisticated clients to tell the deceivers from the performers. As a result, finding the best person or the best organization to invest their money was one of the most important financial decisions. It was also one of the toughest. This was because selection had to be made in a world where professional investors had access to the same information -sometimes too much of it. At the same time it was extremely difficult to ascertain the decisive advantages which a portfolio manager would have had over others.

Each time Mosnic needed to invest some of its surplus funds through a new agent, it did not have a system which would give (at a glance) a list of the available portfolio managers from which to make the choice. In fact, Mosnic did not possess the necessary information about the global markets of the agents. It was almost impossible. However, every investor may suffer this limitation. Thus, MIP had

to seek and choose from an extremely wide market of global portfolio managers. In fact, even before the recruitment of the Controller, Mosnic had some agents selected by the ex-Advisor. But, the criteria followed to select the agents were not clearly set. As explained in Chapter (3), Mosnic started with some reputed brand name commercial and investment banks which reported disturbingly poor performance mainly resulting from unsatisfactory methods and means. These brand name banks also had the least understanding for how the stakeholders perceived the financial markets' uncertainties. The Advisor did make some minor changes in the portfolio of agents maintained by Mosnic by establishing fiduciary relationships with some of the European private investment banks. However, the Controller found out that the stakeholders were not satisfied with the degree of compatibility between their risk perception and the investment style of the agents appointed by the Advisor.

In the case of MIP, the general guideline of the stakeholders was to deal with one of Geneva's private investment banks. Thus, the difficult question of scanning the global agents market was substantially moderated by this guideline. Otherwise the Corporate Controller would have had to enter the whole world of portfolio manager's market to choose a winner; a market characterized by being too wide. In fact, the Controller knew that, regardless of the opportunity which might have been lost, the stakeholders decided to make their selection within Geneva

private investment banks. There was a general belief in Mosnic that Geneva private investment banks were conservative, experienced, soundly structured, enjoyed reliable internal control systems, and had high technology application. That was beside the general conviction that Switzerland is neutral, politically stable, and allows secrecy of banking. Hence, within those parameters, the Corporate Controller had to orchestrate an agent (MIP bank) selection process.

2. INTRODUCTION TO THE SELECTION OF MIP

When the Corporate Controller was assigned the responsibility of organizing the selection of MIP to operate as an agent for Mosnic, he was more or less clear about the factors which should determine the fiduciary relationship with this Swiss private investment bank. He knew that agents' means and methods could be complicated attributes to follow for making the choice. However, as a guideline to ensure that MIP strategy, structure and processes were properly studied, the Controller needed two things: First, the agent strategy, structure and processes (ASSPQ) questionnaire (see Appendix 5.1 p. 169). Second, to set a framework for the selection stages in a diagrammatic form as in Fig. 5.1. The ASSPQ (Appendix 5.1) was to be used as a checklist that would ensure proper coverage of attributes to examine MIP strategy processes, structure and processes. The ASSPQ was first developed by the Controller. Actually, the ASSPQ reflected the initial technical approaches to control the

Controller wanted to adopt. Given his Arthur Young firm auditing background of using checklists to ensure the quality of implementing procedures, the Controller assumed that the ASSPQ would be the formal solution for the agent selection system to be adopted by Mosnic. Later on he discovered that the ASSPQ alone could not resolve the problem. Intended agents appraisal proved to be much more complex and involved the formulation of investment strategy through a fluid stream of interaction with the suggested agents.

FIG. 5.1
STAGES, PROCESSES AND ATTRIBUTES (FACTORS) INVOLVED IN SELECTION OF AN AGENT (PRE-INVESTMENT PROCESSES)

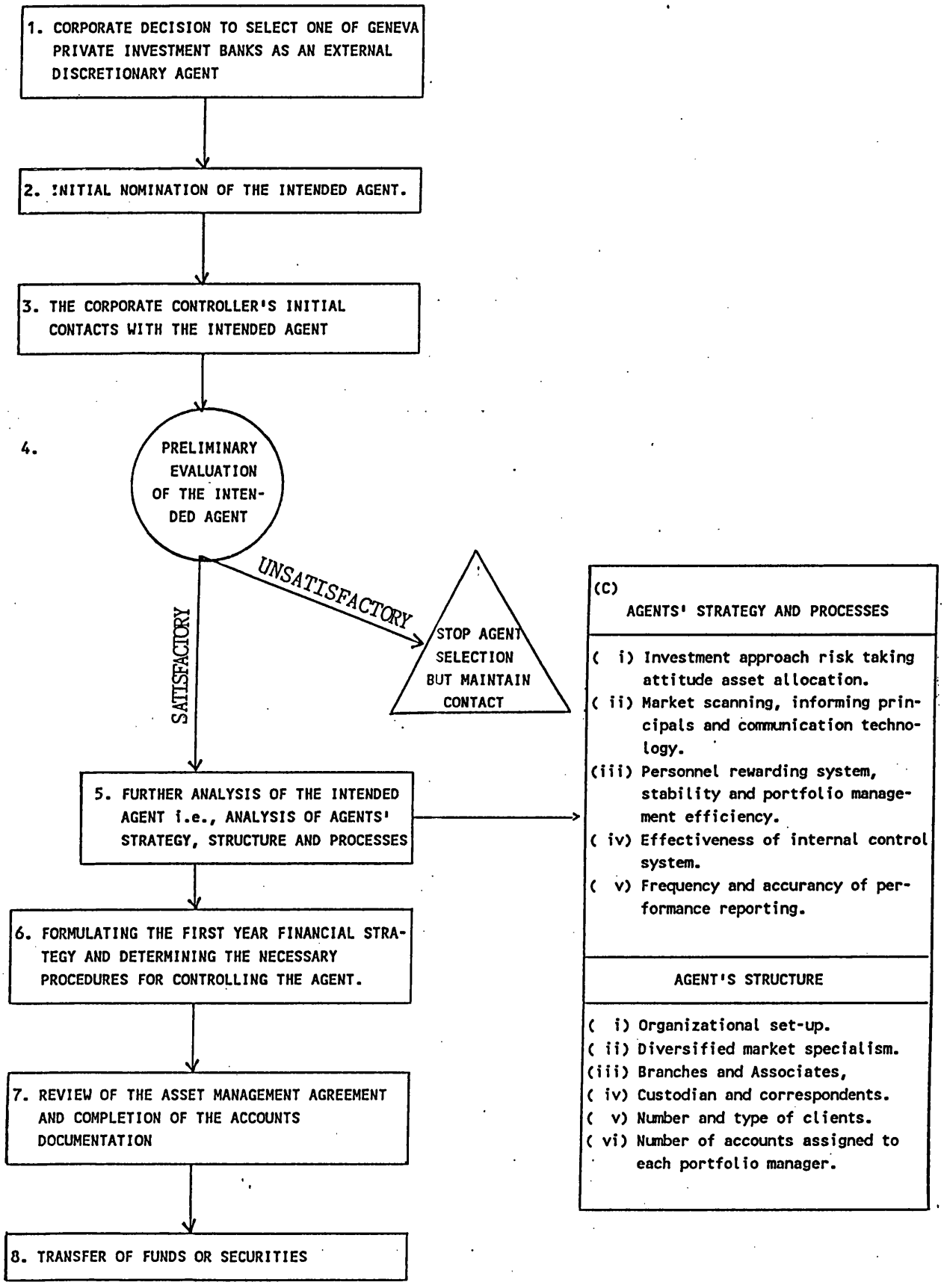


Fig 5.1. is an attempt to simplify in a diagrammatic presentation the chronological processes which took place to select MIP. It starts by restating the corporate strategic decision of externalizing portfolio management to external agents. It then portrays (briefly) processes involved in selecting the agent together with the formulation of strategy with the agent. The reader will appreciate that a simple diagram cannot give a complete picture of all the human and inter-organizational processes involved in selecting an external agent while also formulating investment strategy.

Notwithstanding the tidiness and the systematic flow of stages shown in Fig. 5.1, the MIP selection process was not done in a pre-determined systematic manner. The Corporate Controller and the Director were the main actors from the side of Mosnic to conduct most of the analysis. Both of them were aiming to cover all the aspects emphasized in the ASSPQ. The analysis process was not even in the same order of the ASSPQ. The Director had his own style of analyzing the agents by touching on different aspects of the intended agent. Nevertheless, the Corporate Controller was cautious to look into the agent's structure and processes as in the ASSPQ.

3. MIP SELECTION PROCESSES

History of MIP Bank

MIP Bank introduced itself as a bank that was founded in Geneva in 1810 after the French Revolution. Geneva was

under French occupation at that time, and for many people it was a period of great uncertainty. In the years following the Napoleonic wars, however, the commercial opportunities available in the wider international field were to be discovered. Just as Geneva grew in importance as a financial centre, MIP has become, over the years, one of the world's leading private investment banks, developing its expertise in its principal area of activity: international investment management.

This history attracted the Controller towards MIP. Thus, he decided to meet with MIP.

THE INVESTMENT APPROACH

The Controller said to the representative of MIP:

" *The historical background you gave on MIP is quite* **interesting.** *Can you please brief us on the MIP approach of investment?"*

MIP Representative answered:

" *Our approach:*

Today in a world made smaller by highly sophisticated communication technology and the easy flow of information, the management of investment assets is a complex business. At MIP the constant objective is to preserve client's capital by achieving superior levels of investment performance. This can only be done by taking a worldwide approach to investment, seeking out and capitalizing on the best opportunities available in the market. If our investment philosophy, built on 180 years of global experience remains consistent in stressing quality without compromise, our investment approach is re-adapted periodically to a changing environment. It is then carried out through a systematic and disciplined investment procedure."

The Controller:

" *How do you build-up the investment strategy for your client's assets? Can you describe how the investment decision is formulated, and how flexible is your investment strategy?"*

MIP Representative replied:

" *Investment strategy is based upon a rigorous analysis of world markets. Each week, several regional investment policy meetings take place between the partners, the senior manager in charge of portfolio strategy and the specialists of the geographical area under study. A top-down approach is used, starting with a review of the international economic situation, that of the particular country on the agenda, then the foreign exchange outlook. Decisions are taken as to the asset allocation and finally as to the selection of securities which have been proposed by the bank's investment research staff. An investment strategy report is published internally defining guidelines and listing specific recommendations. In addition to this, research meetings are held every morning in Geneva, at which all partners, investment managers and research staff are present."*

MIP ORGANIZATIONAL SETTING AND MARKET SPECIALISM

The Controller:

"How is MIP Set-Up for investment decision making?"

MIP Representative replied:

" *MIP Research Department consists of a team of fifteen senior analysts in Geneva and one in Tokyo. Each analyst is a specialist in a particular geographical area or investment medium. The world's major economies, currencies industries and companies are closely analyzed and monitored. Frequent visits are made to principal world markets and detailed studies and reports published. Furthermore, our Research Department is one of Switzerland major sources of primary research on the Swiss Financial markets."*

ESTABLISHMENT OF FINANCIAL STRATEGY

The Controller Asked:

" *I presume your bank has its investment strategy and internal policies to preserve. Does your*

strategy contradict with the specific guidelines and requirements of different clients? I mean, how flexible is MIP in retailoring its investment model to be compatible with the investors' different objectives?"

MIP Representative:

" *In all MIP has more than fifty investment managers in its various offices around the world, the majority of whom are located in Geneva. All are multilingual, travel extensively abroad, and are both experts in both the equity and fixed interest securities markets. The challenge facing them is to adapt our investment strategy guidelines to each clients specific requirements, while achieving superior levels of return. They also provide tailor-made reporting and other banking services.*

MIP success relies on a combination of highly automated investment management systems, experience, and professional staff.

Institutional portfolio management has become an increasingly important aspect of our investment services. A highly specialized group of investment officers are responsible for the management of pension funds, corporate cash, insurance company assets, and domestic or foreign government funds. They adhere to strict legal, administrative, and fiscal rules imposed both by the government regulatory authorities and the funds themselves. In addition, they act as consultants to many of the international organizations in Geneva. Our management team works closely with MIP U.K, Ltd. and MIP-LEM Ltd. located in London. As a result, we have established a cohesive and methodical approach to portfolio management, as well as providing the necessary reporting services, both of which are tailored to the requirement of the clients. Accounts are managed quantitatively, so that the analysis and evaluation of performance and the administration and verification of reporting practices and procedures are continually upgraded to improve our services."

The Director:

" *Can you predict specific ROI that you can produce in the first years, should we leave certain funds under your discretionary management.?" In other words, are you comfortable with a specific method of measuring performance you would achieve for us?"*

MIP Representative:

" *Forecasting ROI in the financial markets is difficult. Money Managers cannot assume control over the environmental independent factors.*"

The Director:

" *What is the investment strategy recommended by MIP to Mosnic?*"

MIP Representative:

" *As discretionary asset managers we do not have a universal investment strategy. Our general investment policy is flexible enough to accommodate a wide range of clients' objectives. However, we propose to our clients specific risk classes.*

Some managers follow the quantified strategy format disclosing figures, which is very seldom. We depend on the narrative format in its very general term, either in a short or a long statement. Then specifics can be added depending on what the client requires. We depend on the open interaction with our clients to understand their requirements."

The Director commented to the Controller:

" *The reason why the discretionary portfolio managers avoid promising a guaranteed rate of return to be achieved through a clearly formulated strategy, is that those agents are completely uncertain about the future. Their sophisticated security analysis systems are unable to help them to forecast the future. Their investment models change so frequently.*"

ASSETS ALLOCATION STYLE

The Controller said to the Director:

" *I have requested MIP, as an intended portfolio manager for Mosnic, to provide an assets allocation formula to cope with the forthcoming year, indicating how the securities are to be allocated by:*

- *The types of the investment instruments.*
- *By the portfolio currencies.*
- *By industries*
- *Geographically, showing how such proposed asset allocation will lead at the end of the year to a certain quantifiable return on the assets. MIP gave a number of reasons why they cannot do that.* "

The Director:

" *How to allocate the assets in the portfolio, in my view, depends on what we want in Mosnic, and how much risk we are prepared to take. If you succeed to clarify those two aspects i.e. goals and risk, MIP can provide a proforma assets allocation schedule special for Mosnic. However, you never know the markets. Even after the agent allocates the assets to our satisfaction at a particular point of time, we may intervene if we see a market turmoil or any unforeseen crisis. The stakeholders may even change their desires.*"

The Controller:

" *The discretionary portfolio managers will use their delegated power to change the asset allocation wherever they feel, to the best of their belief and knowledge, a change is needed to preserve the interest of Mosnic.*"

The Director:

" *Do you then agree with me that asking the intended portfolio manager to work out a long-term investment strategy formulated in its minute details is unfair and unrealistic?*"

The Controller:

" *Some guidelines in the form of how the intended manager analyzes the factors making the future uncertain is possible, but not more than that. If Mosnic insists on a certain asset allocation as a guide to MIP for a year to come, Mosnic may be releasing MIP from being accountable for any low performance in future. Moreover, MIP must have the power for tactical allocation of resources to manage the portfolio opportunistically,*"

The Director:

" *Don't you think that completely entrusting the allocation of the assets in the portfolio to MIP, leaves the door open for the manager to concentrate on, say, equities where they can trade more and earn at the cost of Mosnic more brokerage fee? I need a way not to involve ourselves in individual securities analysis while we still control MIP.*"

The Controller explained the worry of the Director to MIP.

MIP responded:

" *That is not true for a number of reasons. First, MIP aims at long-term relations, and continuity. Second, MIP cares much for its professional future. We must not forget that such reputable organizations route their investment policies through highly sophisticated internal organizational set-up. We believe that our bottom line performance will bring the relationship to the real test. Of course it is not practical to involve Mosnic in the individual securities selection process. However, to manage the portfolio to your satisfaction we encourage understanding the process by which your investment objectives shift. This is an important input for MIP processes of analyzing the different securities to make the selection."*

The Controller and the Director, however, wanted to be more definite about the investment approach of MIP.

PRELIMINARY EVALUATION OF MIP INVESTMENT APPROACH

Responding to the requirements of Mosnic to reflect on the investment strategy to be followed, MIP bank gave the following statement as part of a long report.

" *There is an uncomfortably high possibility that security value could fall further in the atmosphere of uncertainty generated by volatile exchange rates, conflicting policy statements, and a U.S. presidential election campaign."*

Then rather more briefly in the view of its market judgements, MIP summarized the strategies as follows:

" *As a result we feel it is only prudent to take some defensive steps"*

MIP summarized these steps as follows:

" *1. Though we seldom hold cash as a matter of policy, there seems to be little opportunity cost to holding cash over the next few months.*

2. Bonds seem attractive, especially since we would be willing to hold them through short periods of higher interest rates.

3. Equities almost certainly will remain volatile."

The Director commented:

" *The investment strategy presented by MIP is not more than a general investment philosophy of the firm. Therefore, I suggest we make sure that our guidelines, goals, and objectives can be served by MIP investment strategy. They have to be more specific.*"

Then the Controller proposed to the Director to make more specific inquiries about MIP processes. He said:

" *Before releasing the investment guidelines to MIP, we need to know more about MIP investing style. i.e.:*

(i) Specific Approach to Investment

1. *What kind of current income from investments shall Mosnic expect i.e. high current income, medium current income or total return investors.*

(ii) Risk

2. *Risk taking: Which type of investors is MIP designed to serve - high risk investors or medium risk investors?*

3. *Specific Investment styles/Management style. Is MIP most comfortable with:*
   - *Growth stocks*
   - *Lower P/E stocks.*

4. *What is MIP philosophy regarding the use of cash in the portfolio?*

(iii) Performance

5. *What are MIP investment objectives? i.e. Do they aim at exceptional performance.? at what risk?*

6. *Do they have varying goals under the different market circumstances. i.e. when the markets are abnormally strong, normal or volatile?*

7. *How does MIP communicate? In writing, written report, planned number of visits by both parties, etc.*"

The Director:

" *I propose you take a further step and request MIP to reply to your inquiries and provide you with the proposed form of fiduciary relationship which MIP would like to have with Mosnic. We can then carry on analyzing MIP while looking into the proposed agreement.*"

The Controller then addressed the following telefax memo to MIP.

" You are kindly requested to provide Mosnic Investment Policies Committee with the following:

1. *About MIP.*
   - *The kind of current income you plan for.*
   - *MIP risk management approach.*
   - *MIP investment style.*
   - *MIP performance objectives.*
   - *MIP tactics under the different market circumstances.*
   - *How big is MIP?*
   - *The volume of the assets managed by MIP.*
   - *MIP reporting lines and communication with Mosnic.*

2. *Specimen format of the proposed asset management agreement together with the account opening forms."*

The representative of MIP responded as follows:

"Generally speaking, most of the information you have asked for is provided in the literature we have passed to you. However, our policies are flexible enough to adjust to the maximum specific requirement you have to tell about your portfolio. For further knowledge of your goals and specific requirements try to answer the following inquiries. We may need your highlights on Mosnic philosophies and objectives such as:

1. *Your current income requirement.*
2. *Your risk tolerance.*
3. *Your investment style. Do you mind leaving the determination of your investment style at our discretion. ?*
4. *Some written guidelines if possible.*
5. *Description of the characteristics of the accounts we are supposed to manage.*
6. *Do you have in mind specific allocation of the assets by the type of securities and by currencies ?*
7. *For how long do you think the account will remain without withdrawal?*
8. *Any specific requirements or restrictions you may see important to be taken into consideration by us."*

The Formal Fiduciary Relationship and Authority

In response to the request of the Controller to explain the type of relationship it contemplated to

establish with Mosnic, MIP responded as follows:

> *"Once you take us as Asset Managers in MIP we believe in serving our client beyond any formal limits. You feel free to tell us anything you may require in specific."*

DISCRETIONARY AUTHORITY AND AGENT RESPONSIBILITY

The following quotations from the documents sent to MIP, explains the limit of authority requested by MIP.

> *"The agreement confirms the appointment of MIP as investment adviser to supervise, manage and direct the investment of and for the above captioned Account (the account), with authority as agent and attorney-in-fact on behalf of the account, when MIP shall deem the same appropriate (a) to purchase, sell, invest, re-invest, exchange, convert, trade in and otherwise deal with such assets of the account, and (b) to place orders for the purchase or sale of portfolio securities for the account with or through brokers, dealers or issuers selected by MIP or designated by the Client.*
>
> *It is further understood that MIP may deliver to any securities brokerage firm executing transactions on behalf of the Account, or to the Custodian for the Account, a copy of this document as evidence of its authority to act for and on behalf of the Account. "*

INVESTMENT MANAGEMENT AGREEMENT

Mosnic was to employ MIP to provide investment advisory services for an Investment Management Account to be established on behalf of Mosnic (the Account), in accordance with the following terms and conditions:

> *"(1) Authority:*
>
> *MIP will have the following power and authority with respect to the Account:*
>
> *(2) Discretionary Account.*
>
> *MIP shall have discretion to supervise, manage.*

and direct the assets in the Account and, as agent and attorney-in-fact with full power and authority on behalf of the client MIP may, without prior consultation with the Client and at such times when MIP deems appropriate, (a) purchase, sell, invest, re-invest, exchange, convert, trade in and otherwise deal with such assets; and (b) place all orders for the purchase or sale of portfolio securities for the account with or through brokers, dealers or issuers selected by it or designated by the Client. MIP may vote the proxies solicited by or with respect to the issuers of securities in which assets of the Account may be invested from time to time.

(3) Brokerage.

Brokers or dealers may be selected to provide brokerage and/or research services to the Account and/or other accounts over which the Investment Manager or its affiliates exercises investment discretion. Brokers or dealers who execute portfolio transactions on behalf of the Account may receive commissions which are in excess of the amount of commission which other brokers or dealers would have charged for affecting such transactions. In order to cause the Account to pay such higher commissions the Investment Manager must determine in good faith that such commissions are reasonable in relation to the value of the brokerage and/or research services provided by such executing brokers or dealers, viewed in terms of a particular transaction or the Investment Managers' overall responsibilities to the Account or its other discretionary.

(4) Investment Restrictions.

It shall be Mosnic's responsibility to advise MIP of the investment objectives for the Account and as to any modifications of objectives as they may occur.

(5) Fees.

Compensation to MIP for its services shall be 0.5% per annum on the assets under management. The fee shall be paid quarterly in advance.

(6) Custody of Assets.

MIP shall not act as custodian for the Account or take or have possession of any assets of the client.

(7) Limit of Liability (Accountability).

It is understood that MIP shall act in good faith and shall not be liable for any loss incurred in connection with recommendations or investments made or other action taken on behalf of the Account due to errors of judgement or by reasons of its advice, including action taken or omitted prior to a written notice of termination. MIP shall not be excluded from liability for losses occasioned by reason of its wilful misfeasance, bad faith or gross negligence in the performance of its duties here-under. MIP shall not be responsible for any loss incurred by reasons of any act or omission of the Client, a custodian or any broker or dealer.

(8) Assignment.

This Agreement may not be assigned without the prior written consent of the Client or MIP.

(9) Termination.

This Agreement may be terminated at any time by the Client or MIP by thirty (30) days notice. Fees paid in advance here-under will be pro-rated to the date of termination and any unearned portion thereof will be refunded to the client.

(10) Notices.

Unless otherwise specified herein, all notices, instructions and advices with respect to security transactions or any other matters contemplated by this Agreement shall be deemed dully given when received in writing by MIP, or when deposited by first class mail addressed to the client to the address appearing below and to any custodian designated by the client, at such address as it may specify to MIP in writing, or at such other address or addresses as shall be specified, in each case, in a notice similarly given.

(11) Governing Law.

This Agreement shall be governed and implemented in accordance with the laws of Geneva Cantoon. If some assets are managed by MIP London, then where relevant the agreement shall be governed and construed in accordance with the laws of England."

PRELIMINARY EVALUATION OF THE PROPOSED INVESTMENT MANAGEMENT AGREEMENT

On receipt of the proposed management agreement, the Controller raised the following comments:

"Discretionary Account/Fiduciary Relationship (Limit of Authority):-

MIP suggests to have discretion to supervise, manage and direct the assets in the account and, as agent and attorney-in-fact with full power and authority on behalf of the client (Mosnic), without prior consultation with Mosnic and as such times when MIP deems appropriate, I suggest to add:

1. *Attaining and abiding with portfolio diversification objectives.*

Profit-taking

- *Maximum values whenever reached to liquidate and cash the securities to avoid loss of value in cases of market crises. (See investment restrictions).*

2. *Certain level of consultation, exchange of opinions must be maintained among the client and the manager*

Brokerage

Paid brokers commissions have to be reported separately, for us to keep track of our costs.

Custody of Assets

1. *The agreement must give a magnitude for costs we may undertake for custody of assets with other custodians.*

2. *What procedures will MIP provide to ensure safety of assets kept with other custodians ?*

3. *MIP has to nominate the custodian.*

Fees

0.5% p.a. on the asset under management.

(i) - *Mosnic will need to discuss reduction of this fee with MIP. The stock market rally is slowing downward, a depression in bonds is expected. Accounts may not perform as before. All managers have to be requested to consider cut-down in their fee rate.*

- *No fee should be paid in advance.*

ii) Any fee or commission to be charged to our account must be preceded by a detailed bill showing particulars of fee computation so that a track of costs can be kept by us.

Limit of Liability

The agreement states that MIP shall not be responsible for any loss incurred by reason of any act of omission of a custodian or any other broker or dealer.

Suggestion

MIP has to be discussed in the ways and means we follow to exercise physical control over our securities with the custodian chosen by MIP.

General Remarks

1) The fee side of the agreement has to be more detailed showing:

- *Custody fees.*
- *Commissions levied on security transitions.*
- *Management and administrative charges.*

Suggestions

2) The expense shall be charged to the accounts in June and December and computed from an average between the evaluation of the two previous quarters.

Adequacy of Reporting:

Since we contemplate, central complete general ledger and other records keeping in the Head Quarter, we need to consider with the asset manager how the reports will look, their contents, and the frequency of reporting.

Currencies Translation and the Accounting Methods:

Mosnic is a U.S. dollar-based client. The manager will hold securities in currencies other than the dollar. Meaning that, all securities in currencies other than the U.S. dollar will be translated into the reporting currency. We need to consider with the concerned MIP portfolio manager, the currencies translation methods.

Advanceable amounts against pledges of each form of Assets:

I understand that Mosnic may need to arrange loans against the securities. It is imperative that we understand if MIP can extend loans and advances, establish letters of guarantee, etc., and type of collateral might be required."

On lending issue MIP said:

"*If we get the required information, we have the due expertise to make arrangements.*"

Then the Controller expressed his worry as follows:

"*I understand Mosnic does not entrust management of its assets to banks involved in commercial lending and suffering in their financials, the problem of non-performing loans. So, can we be assured of the Financial strength of MIP*"?

MIP Fees:
The Controller further inquired:

"*Compared to the others, are they reasonable or excessive?*

Past track record of Performance:

Before hiring MIP we need to know what did it achieve for other clients?. i.e., Historical performance record."

FORMAL ACCOUNTABILITY PROBLEM

Indeed, the limit of MIP liability for performance was, in the Controller's view, the most significant aspect of the proposed asset management agreement. It was obvious that MIP would not take the responsibility for setting pre-determined financial targets to be the base for future accountability. When the Controller raised his concern about clause No (7) of liability and accountability, both MIP and the Director of Mosnic mostly agreed that the agent could not be formally punished in case of poor performance. The Director commented:

"*once you choose the agent and assign the portfolio management there is nothing formal that you can do about unsatisfactory performance. The only weapon the principal may have is to pull the business from the agent in case of unsatisfactory performance. However, we do not use that so easily. There are a number of considerations and may be lengthy processes that you may need to carry out before pulling-out from the agent.*"

Thus, the Controller was convinced that he had to identify how the fiduciary relationship would work in the post selection stage.

MANAGING SHIFTING OBJECTIVES

The Director referred to the points raised by the Controller on the proposed Asset Management agreement and to the recent requirements of MIP and said:

> *" The proposed asset management agreement has taken us more steps forward to understand what type of relationship we may have with MIP. Our concern is to make sure that our shifting requirements and goals can smoothly be accommodated by MIP investment strategy and there will arise no contradictions with MIP internal policies."*

Depending on his knowledge about the general guidelines of the Corporate Investment Policy, the Controller released the following to MIP:

> *" 1. Current income is not a problem for the owners, and may not need to withdraw funds frequently.*
>
> *2. Growth is the goal, however realization of value at levels the manager sees reasonable is important.*
>
> *At any rate standard setting of these two objectives is very difficult. In times of crises, which you cannot predict nor you can manage through your sophisticated analysis technique, the principals may intervene heavily, as they see appropriate for the particular turmoil situation.*
>
> *3. Capital preservation is a prime objective.*
>
> *4. To Mosnic's view, being fully invested in equities means aggressiveness. Therefore, MIP must not take more than 40% equity exposure. If MIP has any objection the stakeholders would be glad to hear about it.*
>
> *5. 60 % of the holdings is recommended to be in fixed income securities. However, MIP has the*

freedom of tactical changes of the portfolio composition in consultation with Mosnic. The stakeholders have restrictions on interest taking. You may need to understand this restriction.

6. *The selection of the individual securities and allocation by the type of the instrument and by currencies are the responsibility of MIP.*

7. *Mosnic hopes for expected ROI to be at least more than the money market price measured by U.S. dollar rates of interest over the performance period.*

8. *Cash can only be temporarily parked in the fiduciary placement accounts with AAA banks until that time it is re-invested. You know our stance from interest income. Thus, it is prohibited to keep funds in fixed deposit money markets accounts as a permanent type of investment.*

9. *Investment in securities of companies dealing in alcoholic products is not allowed.*

10. *The style of investment i.e. high, medium, or low capitalization companies, etc. selection is left at the discretion of MIP.*

11. *As explained in (6) diversification and securities allocation geographically and by the type of securities is the responsibility of MIP as a discretionary portfolio manager.*

12. *Selection of the right custodian, is the responsibility of MIP. However, the stakeholders would like to keep a list of the custodians used by MIP.*

For further reflection on the above guidelines and specific requirements, let us meet as early as your convenience."

ASSESSMENT OF THE RELIABILITY OF MIP'S INTERNAL CONTROL SYSTEM

The Controller hinted to the Director that investors rely, to a certain extent, on the agent's control procedures. Thus, the Director showed interest in knowing about the effectiveness of MIP controls over the contracted assets. MIP was requested to provide a list of controls it would exercise both to safeguard the assets and to ensure that all the operations would be correct and complete. Specifically, the Controller wanted to be sure about the following: 1. all transactions related to the assets were accounted for; 2. all transactions were real; 3. all transactions were properly valued; 4. all transactions were entered on a timely basis; 5. classification was accurate; 6. summarization was correct; and 7. posting was accurate.

For MIP to identify the required internal controls on the contracted assets, the Controller emphasized the following applications and transactions and other aspects of the accounting system:

1. Sale of Securities.
2. Purchase of Securities.
3. Commission related to trading in securities thru our accounts.
4. Withdrawals and Transfer of Funds.
5. Direct charges to the Current Accounts.
6. Unrealized gains.
7. Realized gains.
8. Accrued interest on bonds.
9. Dividends/Coupons
10. Valuation of Assets.
11. Commitments and Liabilities related to Mosnic accounts.
12. Currency translation to the reporting currency (US Dollars), i.e. The source of information and the mechanism of translation.

13. Cut-off procedures related to Trade of Securities.
14. Method and policy of valuation disclosing in details the formula how:

    - Weighted average invested capital is computed.
    - The reported rate of return is calculated.
    - Market value for historical cost concept is implemented.

15. Areas of MIP management judgement affecting the valuation.

MIP INTERNAL CONTROL SYSTEM DISCLOSED

MIP reflected on its specific internal control reliability as follows.

" *In general, the controls are implemented by two different institutions (MIP - London as Manager and MIP - Geneva as custodian), using two separate and independent staffs and computer based systems. These two sets of records are reconciled against one another providing an important basis for double checking and error correction.*

Having said that, the responsibilities of the custodian and the manager, though they overlap to a large extent, are somewhat different for practical reasons. For example, it is the custodian who has exclusive control over transfer into and out of your account, who has exclusive direct control over all assets, and who is responsible for activities directly connected with the proof of ownership of the assets, such as dividend collection. By contrast, the manager is responsible for making and implementing decisions to buy and sell securities, to control brokerage commissions, and to report to your performance.

MIP - Geneva system is a complete overview of our controls and procedures, which are very comprehensive.

Complemented by the additional controls of MIP - Geneva as custodian, these procedures provides a sophisticated system or separation of responsibility, double checking automated quality control, and objective determination of prices and value. We believe our system is among the very best currently in use in the world."

The following is a summary of the control process claimed by MIP as safeguarding the interest of the principals.

MIP - London does not have direct control over your assets. All assets are held by MIP - Geneva. All purchase and sale transactions are normally delivered against payment. We do not authorize any third party payment instructions. All entries over your account at Geneva (i.e fees, charges, monies received or withdrawn on your instructions, dividends, etc) are mirrored over our record keeping system.

Details of Controls

1. MIP carries out a weekly cash reconciliation between our system (Impart) and Piclink, received from MIP - Geneva. A monthly reconciliation of assets held at MIP - Geneva and on Impart is our method of identifying any differences.

2. Purchase and sale transactions are only entered into the system on receipt of an authorized ticket from the Fund Manager.

3. Ticket details include the previous night's closing price of the security. Impart alerts us to any significant divergence from this price when the transaction is executed.

4. A weekly review of open orders identified brokers who need chasing. Upon receipt of the Brokers execution telex, the details are entered to Impart and instructions telexes to the custodian are automatically created.

5,6. The London Stock Exchange 'SEDOL' code book is used to identify accurate security descriptions.

7. Any differences raised under No. 1 above are investigated and corrected.

For the control over the sale and purchase of securities, MIP referred the Controller to (1) and (2) above. MIP response to the Controllers' inquiry 1-15 came as follows:

3. Impart has defaults for each country with provisions to enter special negotiated rates. Impart alerts us to any divergence.

4. Transfer and withdrawal instructions to the custodian bank (MIP - Geneva) are reflected over our records. We have no control over their execution.

5. All charges of any nature are passed by the custodian. We have no control over their execution, but reflect them over our records.

6. MIP monthly valuation reflects the book-cost and market valuation in U.S. Dollars.

7. Realized gains are reported in our Quarterly Summary Report, together with details of income and charges received during the quarter.

8. Interest accrued is reflected in the value of the relevant bond on our monthly valuation.

9. Dividends are received by the custodian and upon credit to the account, we reflect them on our records. We do not monitor dividends due, as this is the responsibility of the custodian.

10. All month-end prices are entered using Data stream, Reuters, or by contacting a market maker.

11. Not applicable.

12. Impart is a multi- currency system. Exchange rates are entered daily from Reuters.

13. MIP reports are on a "Transacted" basis, so we enter on the system all trades that occurred prior to month-end.

14. Weighted average capital is calculated by time-weighting cash flow to the exact day received/ withdrawn. The rate of return is calculated monthly and linked to build quarterly, annual or other period rates of return. All returns use market value, not book cost.

15. Valuations are objectively determined using external pricing services, so management judgment does not affect the end result at all.

SELECTED ADDITIONAL CONTROLS AND PROCEDURES

MIP Geneva as Custodian have a computerized accounting and record keeping system. These records reflect security holdings by client, together with details of the depository where the shares in Nominee Name.

MIP also is required to satisfy its internal auditors, external auditors and Swiss Banking Authorities as to the accuracy of its records.

Other specific features of interest are:

(a) For all purchase and sale instructions received from MIP, securities are normally delivered or received against payment. MIP therefore, have either Cash in the account or the Security.

(b) All instructions for Withdrawal or Transfer of Funds would have to be duly authorized before MIP would effect them.

(c) MIP computer system aids their Dividend Department in the monitoring and collection of dividend/CPNS due on equities and bonds.

(d) MIP generates their monthly valuations based on instructions received prior to month-end. They receive their month-end pricing information from Telekurs.

It was not convenient for the Controller to request MIP to allow him to enter the bank premises to check whether the system was working as described by MIP. This was not usual practice. The Director did not encourage it. It was then agreed in the Investment Policies Committee that the Controller would assume that MIP internal control system would be operating as described. Accordingly, the Controller considered designing the corporate specific control procedures which would meet the needs for controlling MIP.

MIP STABILITY, STRENGTHS, PERSONNEL REWARDING SYSTEM AND RISK MANAGEMENT (MEANS AND METHODS)

The Controller proposed to the Investment Committee to investigate more about MIP's organizational structure, the stability, drawbacks, etc. to be more clear about the risk Mosnic would take on MIP. The Director argued that the intended portfolio managers might give some information but not all. However, the Controller made further inquiries about MIP emphasizing the following:

1. Has MIP come across a crisis where it needed to effect fundamental personnel changes?

2. Does MIP arrange commercial loans, Letters of Guarantees, letter of credit, etc. If any, what kind of Department and personnel does MIP maintain to control that type of activity?

3. What is the salary structure and the other compensational aspects MIP offers to:

   - The Portfolio Managers.
   - The key Investment Strategists
   - The Research Analysts.

4. Does MIP conduct research and development? and are the research and development final reports accessible to MIP clients?

5. Has MIP ever suffered from taking strategic investment decisions and how did MIP rectify the mistake and overcame the shortfall?

6. How does MIP keep up-to-date with competitions by other investment?

7. How do MIP portfolio managers select stocks?

8. What is the role of the computers in the stock selection process and the portfolio management?

9. What internal departmental links does MIP maintain?

10. What ensures that the decision makers undertaking the investment management function are on top of the events in the investment markets?

11. Who or which department conducts the final review of the reports despatched to the investors (the clients)?

12. Can you quote on situation where an internal review conducted by MIP revealed mistakes and the mistakes had been corrected in a retroactive manner?

13. How do you notify your client under such circumstances i.e.. if a mistake on his account is subsequently discovered?

14. Who are MIP independent auditors?

15. What is the scope of their examinations on the clients accounts?

16. Have they ever discovered mistakes and irregularities?

17. How do you ensure periodically to your clients that their securities are physically available with the custodian and that the securities are free of

charges, pledges and encumbrances?

18. What are the standards MIP applies in selecting the custodians for the investors securities?

19. Does MIP use its parent MIP company as the custodian for the investors securities held with any one of its branches.

20. Does the fact that - if it happens-MIP may use its own parent company as the custodian, for Mosnic securities result in any risk on the side of Mosnic?

21. How does the follow-up on the investment decision occur in MIP in the post-investment phase?

22. Can MIP provide Mosnic with a write-up on how MIP as an organization formulates the investment decision?

23. Can Mosnic have a chart of organization that describes MIP investments related departments and functions ? plus a narrative description of the organizational structure.

24. How often does MIP review the investment policies and strategies?

25. How does MIP cope with situation where the revised investment policies contradict with the client guidelines?

It was difficult for the Controller, at that stage, to adopt quantitative criteria for assessing the result of testing all the above attributes to the selection of MIP. The replies obtained and the information disclosed and tested through a lengthy process of interaction with the intended agent, made Mosnic management feel comfortable dealing with MIP.

At the end of this description, the criteria for evaluating the agent selection process is discussed.

ASSESSMENT OF MIP PERSONNEL, AND THEIR EFFECT ON THE INVESTMENT DECISION

The Controller suggested to the Director that before

entering into any commitment with MIP, it would be necessary to discover something about the quality and capabilities of MIP personnel, manager quality, staff satisfaction and the position of the portfolio manager in the firm.

Thus, the Financial Controller requested MIP to provide the following information:

" *1. The owners of the firm.*

2. Are any partners take an effective part in management?

3. Describe the organizational structure of the Investment Department?

4. How is the investment decision taken? Collectively or individually?

5. How many analysts work for the firm? And what are the major areas of their specialization?

6. How many portfolio managers do work for the firm?

7. What is the average age of the portfolio managers?

8. How many years have they spent in the professional money management

9. How many years of service do they have with MIP?

10. Are the portfolio managers overloaded by the clients i.e. how many client meetings are annually scheduled for each portfolio manager?

11. Can the portfolio managers render service other than investment and mere portfolio management."

Based on the literature provided by MIP and the replies given by the representative of MIP, the Controller was convinced with MIP personnel in terms of experience,

qualification, satisfaction, and the readiness of the portfolio managers to liaise with Mosnic without any restrictions.

4. MIP RISK MANAGEMENT APPROACH AND STRATEGY FORMULATION PROBLEM

The Director made it clear to the Controller that risk assessment had always been their major problem in setting their investment goals. Neither the Director nor the Controller were clear about how to approach the risk management problem with MIP. Both assumed that even sophisticated risk analysis may not be capable of adequately dealing with the markets unpredictable movement and the corresponding shift in the principals' objectives. The Director commented that there was a risk taken on any agent since Mosnic could not know who was the best manager in the world. Thus, the issue of risk and asset allocation were reiterated.

The Director said:

> *"The experience of Mosnic with the portfolio managers has proven that managers given the same guidelines, operating in the same environment, charging the same fee and located in the same geographical area, have shown varying rates of performance. Either their undisclosed risk attitude is different, or the markets are not equally efficient for them."*

While discussing the risk which would be taken on MIP the Controller asked:

> *" 1. If risk is akin to all forms of investment, can Mosnic assess it in the pre-investment phase? How much money it might expect to lose or make with choosing MIP rather than any other manager?"*

2. *Is it economical to jump from a portfolio manager to the other following poor performance?"*

The Director further commented on the risk issue as follows:

" *The surrounding uncertainties are so numerous, even beyond all the analysis of the portfolio manager. Therefore, I doubt MIP representatives can come up with a strict figure for the expected returns under the investment markets uncertainties."*

The Controller said about risk associated with decisions:

1. *"By setting certain investment objectives to the portfolio managers, did Mosnic lose money which could have been made if the objectives were not the same?*

2. *Have we considered having in-house portfolio managers and establishing a research and development department to do the investment business ourselves?*

3. *Have we tried to quantify money lost or money made by choosing a specific portfolio manager among the alternative selections Mosnic had?*

4. *Have we tried to assess money lost by Mosnic as a result of hiring managers rather than doing by itself the investment ?*

5. *In general, how does MIP plan to manage risk?"*

The Director made the following counter comments:-

" *Mosnic, a long time ago, decided to go for portfolio management externalization for the following reasons:*

1. *Mosnic being geographically far away from the investment scene, it is unable to get timely information to conduct security analysis.*

2. *The cost associated with keeping in-house a huge number of portfolio managers and markets analysts. Mosnic's business is relatively small.*

3. *The Western portfolio managers are reluctant to live in our environment. Beside that, there is risk in depending on individually taken decision. Mosnic is better off depending on*

other financial institutions concerning risk analysis. This analysis will need to consider the process by which the stakeholders change their objectives.

4. *The time lag between the international securities trading markets will need three teams of management by Mosnic. Imagine the cost. The fact that Mosnic may lose money by choosing a certain manager from the international selection available has been lengthy considered in the light of: -*

   (i) The American portfolio managers are aggressive due to job instability and competition, while Mosnic goals are capital preservation and a reasonable rate of growth and capital income.

   (ii) Switzerland has proved to be the safest country during the political turmoils and upheavals in the international economic and political bilateral relations. Due to job stability, the Swiss portfolio managers are also less aggressive.

   (iii) MIP and the other Swiss private banks enjoy stability and continuity.

   (iv) The Swiss private banking conventions have proven to be reliable.

However, I think your inquiries on risk management are quite valid. Let's try to remain diversified in all respects, manage risk through close interaction with our agents, and I believe risk measurement is difficult, complicated and can not guarantee healthy decisions without the Controller's input."

MIP STRUCTURE FOR RISK MANAGEMENT AND ASSET ALLOCATION

The Director commented that it could be a very complicated exercise to get involved with MIP in individual securities risk measurement issues. He recommended a study of MIP investment style in general with emphasis on how MIP managed risk on behalf of its principals. Having gone through the literature on invest-

ment strategy provided by MIP, the Controller was more convinced that risk measurement by the agent would be a fruitless exercise due to the tendency of the stakeholders to change their attitude towards risk taking in response to their perception of the market situation. Thus, the Controller thought that the best way for practical management of risk was to leave MIP deal with level II decision which involved individual securities analysis. It was clear from the negotiations with MIP that they would need the maximum possible information on the stakeholders' shifts in their perception of risk. MIP thought the Controller could be the best mechanism by which to ensure timely interpretation of the stakeholders' perception of risk. The Controller made it clear to MIP that he could help in formulating the investment decision by reflecting the true requirements of the principals on condition that MIP would not consider this participation as a release from accountability for their portfolio performance. MIP totally agreed to take the responsibility on condition that it would be satisfied with the amended investment objective.

However, MIP was not enthusiastic to defend one way of risk measurement to formulate the appropriate investment decision. The readiness of MIP to be flexible about investment risk joint management meant that it would not mind openly interacting with Mosnic. Indeed, MIP repeatedly promised to amend its models, policies and risk measurement assumptions parallel to the objectives of the

principals to be conveyed by the Controller.

At any rate the Controller proposed to MIP to provide a proforma asset allocation to be studied and used as a guideline by Mosnic. The Director stated that it would be useful to form an opinion about the MIP risk management approach. The Director agreed with the Controller to interact with MIP to convey the maximum possible stakeholders' input without arguing with MIP about how to analyze risk attached to the selection of individual securities. The Controller then decided to give general asset mix policy guidelines to MIP and to interact later on in the post-investment phase with MIP to manage asset allocation problems while closely monitoring the performance of the portfolio. Thus, the Controller requested MIP to highlight its risk management approach before Mosnic could enter into any agreement.

MIP disclosed its organizational structure for risk management as shown in Fig. 5.2. MIP was organized in a way that each portfolio manager was a regional specialist and all clients accounts were being managed by the appropriate team, dependent upon the investment mandate. MIP representative made an argument that their structured approach utilizing the Portfolio Management System (PMS) could provide the basis for successfully operating a risk class approach.

MIP representative also asserted that they used to maintain portfolios structured on the basis of client risk

tolerance because they recognized that different clients might have different requirements.

The representative of MIP further added that risk could be defined by their institution as residual risk i.e. the difference from the appropriate index i.e. the relevant market benchmark.

MIP APPROACH TO RISK CONTROL AND RESPONSIBILITY FOR IT

The following is a brief summary (based on Fig 5.2) of the investment process as explained by the representative of MIP.

(1) Input: Input to the investment decision would be through "In-house" research and strategy formulated by the head office.

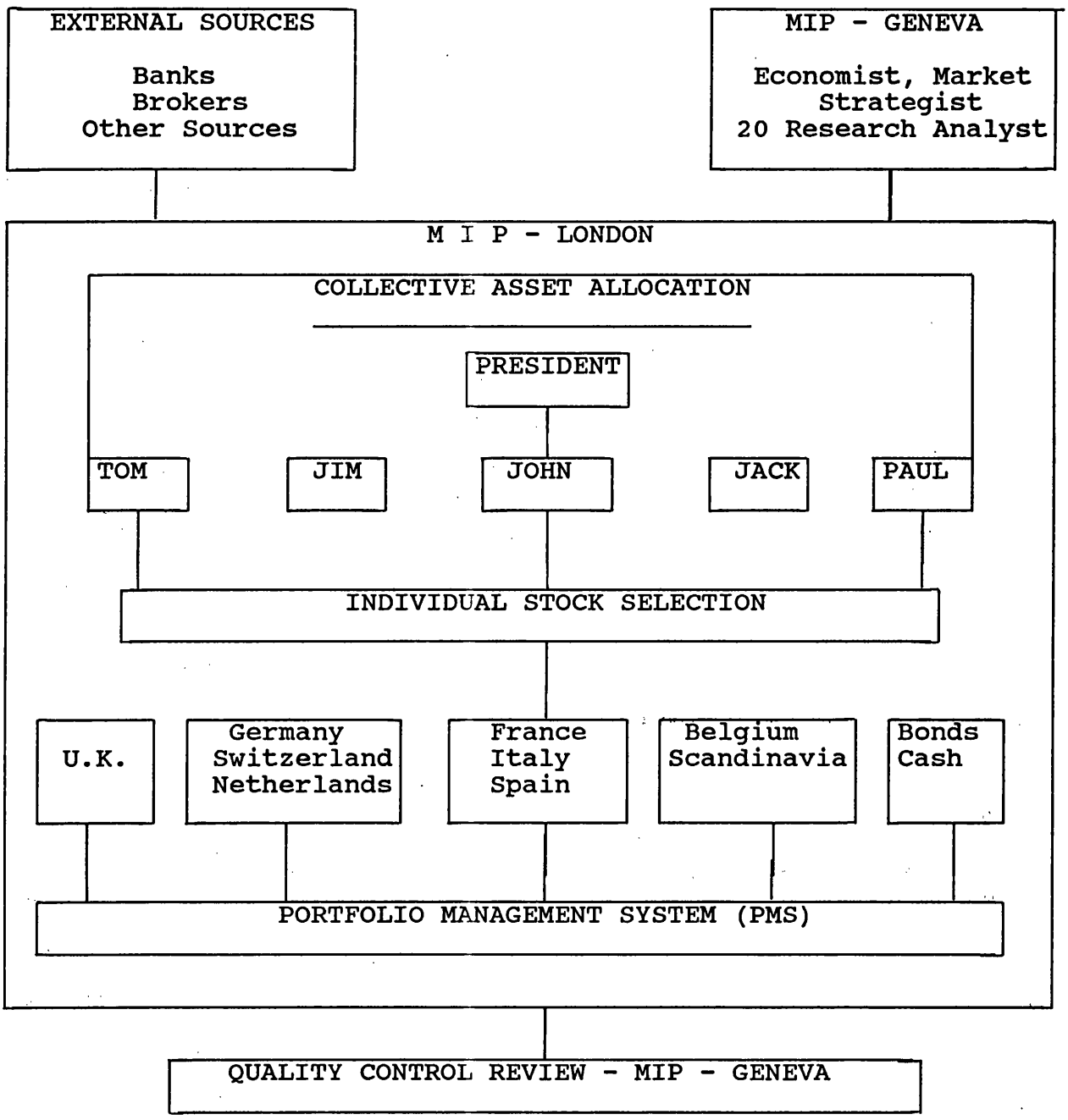
(2) Asset/Country allocation: Would remain under collective responsibility of the team.

(3) Stock Selection: Would be the individual responsibility of country specialists within the team.

(4) Portfolio Management System would be: "Hands-on" control beside the decision implementation.

(5) Quality Control: As shown in Fig. 5.2 implementation of investment strategy would be cross checked with the Head Office.

FIG. 5.2
MIP STRUCTURE FOR RISK MANAGEMENT



MIP's representative also said that his firm uses five standard risk classes (A) to (E) as shown on Fig. 5.3. Clients choose which category they want and according to the choice, the client gets a portfolio constructed as shown in Fig. 5.4. Mosnic was asked which of the categories (A) to (E) it preferred.

In fact, Fig. 5.3 shows the investment models (strategies) which emerged from the rational, economic, financial and securities analysis carried out by MIP. Mosnic would not accept any one of the risk classes proposed by MIP without negotiation. As, I am going to describe in the post-investment case studies, the emerging investment strategy developed through negotiation with MIP was fundamentally different from the risk classes (strategies) initially proposed. Indeed, the major factor leading to the difference was the stakeholders' perception of risk which MIP had to take into consideration.

To help the reader understand Fig. 5.3 the following are some explanations and clues:

(1) EAFE stands for Europe Asia and the Far East. In fact, EAFE is a sub-index of the Morgan Stanley world index.

(2) In Fig. 5.3 Europe is also a sub-index of the world index.

(3) 789 refers to the number of <u>stocks</u> in the EAFE index.

(4) 550 refers to the number of <u>stocks</u> in the Europe index.

(5) 16 refers to the number of <u>countries</u> in the EAFE index.

(6) 12 refers to the number of countries in the Europe index.

MIP representative commented on the risk classes approach (Fig. 5.3) as follows:

> *"To report on your portfolio performance we will provide you with 'impact charts' which show the percentage points differences between country weightings in your portfolio and, say, in the EAFE index, to help identify where we are making significant asset allocation 'bets' versus the passive index."*

Fig. 5.4 is an attempt to illustrate how the MIP risk classes approach is applied to country allocation of equities. In Fig. 5.4 the reader can see EAFE includes the highest level of shares. Class (C) includes fewer shares; while class (E) is the alternative structure which includes the least number of shares. Thus, the investor who wants the least exposure to the stock markets would select class (E), which also proposes certain country allocation.

Indeed, the stakeholders and the Controller viewed this approach as too mechanistic. Its bed-rock seemed to be theoretical measurement of risk and expected ROI. In fact, the Director commented on the risk classes as follows:

> *"If we select one risk class, this will mean blindly following how MIP perceives the markets' uncertainty. This is not acceptable. We can work with MIP. But we have our own worries and views. They have to be taken into consideration to formulate a good strategy."*

FIG. 5.3.
MIP RISK CLASSES

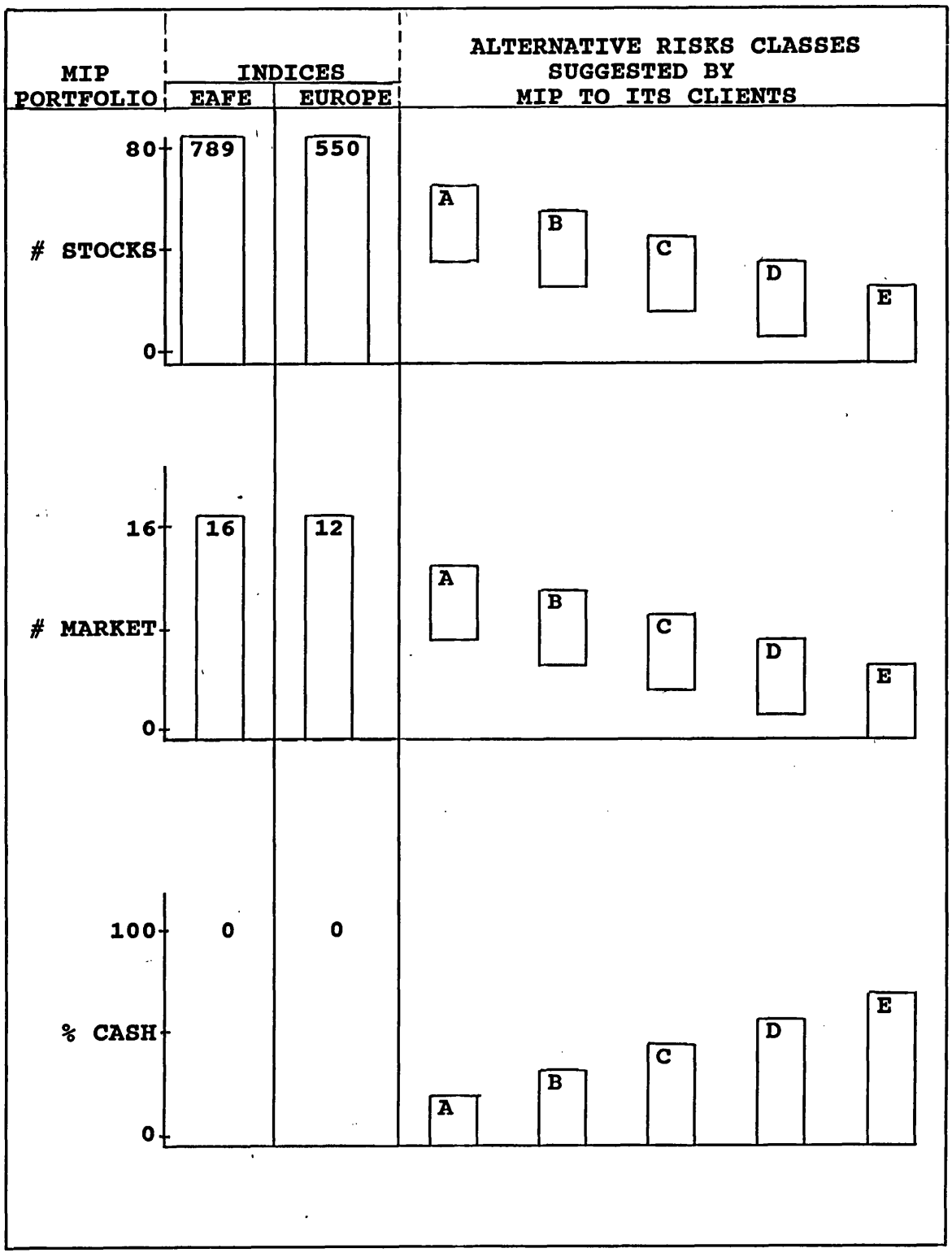
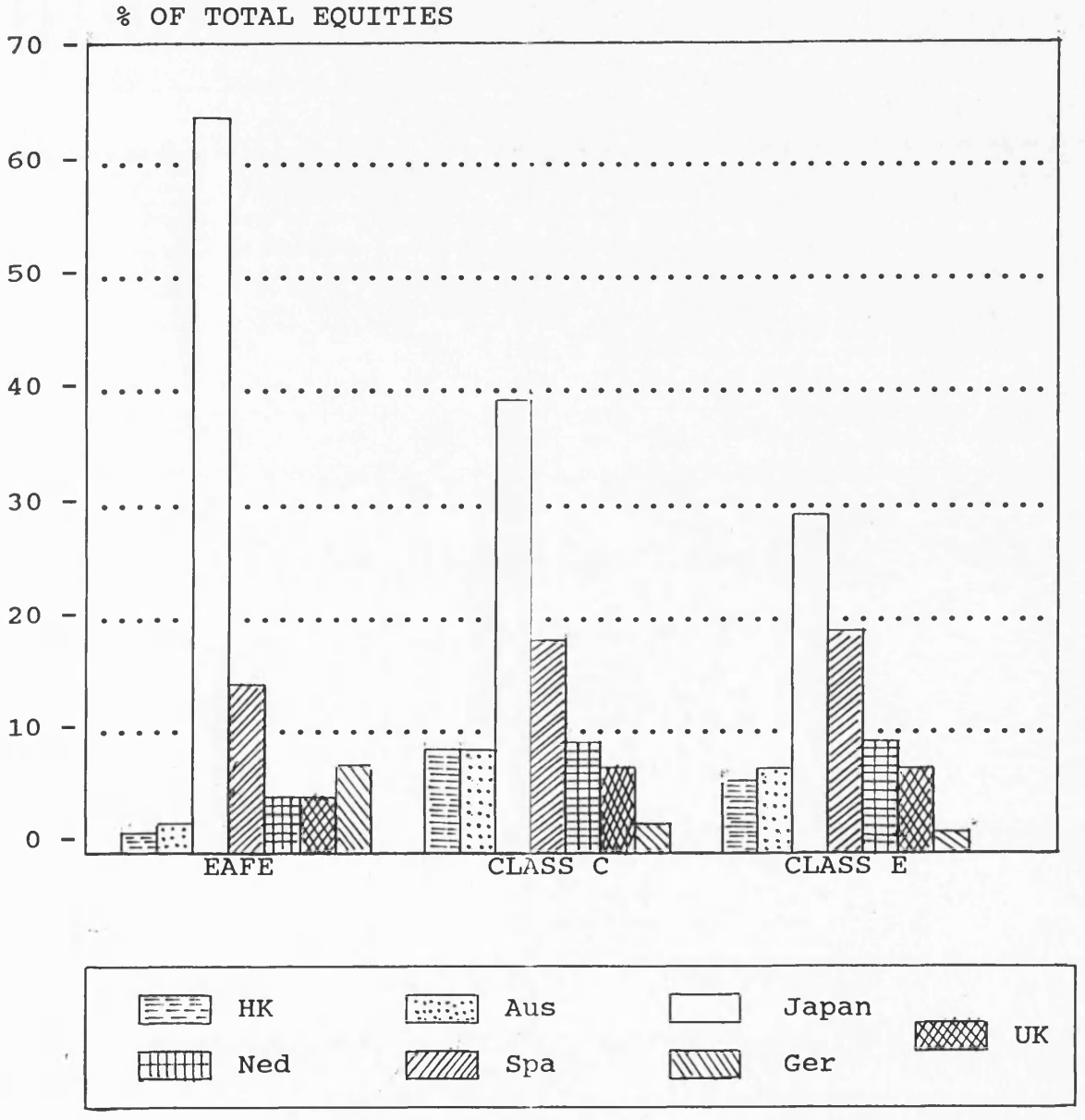


Fig 5.4
COUNTRY ALLOCATION
(By Risk Class)



Referring to the five risk classes offered by MIP, the Controller hinted to the Director that: *"This approach seems too mechanistic. The principals' change their objectives so frequently."*

The Director commented:

> *"You will need to tell MIP what we require. MIP's model can be a general basis for our negotiations with MIP. It is not a bad framework to start with. You have to help them develop a special risk class for Mosnic. This may require from you going through a long process liaising with MIP."*

The representative of MIP added that the investment process and portfolio structure for which they could tolerate risk, may vary according to: (1) level of exposure in international; (2) number of international managers, and (3) risk profile of total fund. He concluded that:

"Risk" is defined as residual risk - "Bets away from the index."

The Controller reflected on this definition as follows:

> *"We may not totally agree with this definition. You may need to convince us that the characteristics of the market portfolio relating to the index has the same characteristics of Mosnic portfolio. We need to make sure that Mosnic's portfolio structure considers greatly the specific objectives of the stakeholders. You will need to be patient with us. The process of understanding what we need may not be easy. What we need may also be unique. It may be shifting as well."*

METHOD OF RISK CONTROL - (MIP'S MODEL)

MIP representative made a comment that,

"aggressiveness would be achieved through concentration. High risk category = fewer stocks and fewer markets. Potential for cash exposure could be increased by risk category (the index has no cash).

ASSETS ALLOCATION BY COUNTRY IN MIP INVESTMENT PROCESS

MIP representative said *"in our risk management system, countries are ranked and quantified. Negative views about countries are reflected in progressive underweighting of countries.*

* *Most Preferred Market:-*
  - *U.K. 8 percentage points overweight in risk C.*
  - *And 10 Percentage points overweight in risk E.*
* *Least Preferred Market:-*
  - *Japan 20 percentage points underweight in risk C.*
  - *And 30 percentage points underweight in risk E.*
* *Views on all markets reflected in a progressive over or underweighting by risk category."*

STOCK SELECTION

Key Considerations relating to stock selection by MIP were the following.

(*) Accelerating earnings growth.

(*) Growth not fully reflected in market expectation.

(*) Improved outlook not yet reflected in the price.

MIP Method of Implementation of this policy.

1 - Concentration: Risk (E) holds less stocks than risk (C) (40 versus 60).

2 - Stocks in risk (E) represent larger positions than risk (C) (55% versus 35% of stocks, each being over 2% of the total portfolio).

The Controller reflected on the stock selection method presented by MIP as follows:

> *"You will appreciate that at this level of the portfolio decision making we do not intervene to tell you how to analyze the securities and to select the high growth or the high income ones. However, you may need to understand that the end result of your analysis conducted to select the appropriate securities will need to account for the process of shifting the stakeholders' requirements parallel to the markets."*

The risk categories in MIP's model ranged from (A) (least aggressive, most diversified) to (E) most aggressive, most diversified) to (E) most aggressive, most concentrated). It was understood from the presentation made by the representative of MIP that normally Risk (A) account would hold between 40 to 80 stocks versus, for example, the EAFE index at 800. The risk (E) account could hold between 0 and 400 stocks.

In terms of markets, the model proposed by MIP also indicated the number of markets held. Again, risk (A) is most diversified, yet more concentrated than the index. The risk (E) is significantly more concentrated.

The final component in MIP's investment model was the potential to hold cash. MIP's index would hold no cash.

The risk (A) would have a cash parameter between 0 and 25%. The representative of MIP asserted that should Mosnic wish to vary the cash parameters, MIP would not mind amending its model to do that.

MIP RELUCTANT TO SET ROI STANDARD

In terms of expected performance, the representative of MIP claimed that their history had shown that the higher the risk class, the stronger the performance. Thus, in its market portfolio mandate accounts where MIP had investors in all the classes of risk from (A) to (E), performance had progressively improved from risk class (A) through to risk class (E), consistent with the increased aggressiveness. However, MIP did not want to agree on setting a forecast target for ROI to be produced if Mosnic would select one class of risk from MIP's model. The representative said:

> *"It is unrealistic to promise you a specific ROI that we can produce. We are dealing in unpredictable financial markets. However, we assure you that if you select one of our risk classes we will hopefully outperform the market index."*

PROBLEMS OF STRATEGY FORMULATION BESET IN MIP'S MODEL FOR RISK MANAGEMENT

The risk classes model proposed by MIP had a number of implications for the Controller in terms of strategy formulation. First, the Controller expressed to MIP that while Mosnic was becoming satisfied with the abilities of the bank, the stakeholders would not agree to be either fully invested in stocks or allocate their resources

between stocks and cash. This was because they believed that the stock markets could be more risky than the bond markets. Concerning cash, the stakeholders were concerned not to take interest. With regard to these, MIP confirmed that it could amend its model to satisfy the specific requirements of Mosnic. Their only condition was to interact with the Controller to understand exactly the objectives of the stakeholders and their stance from the risk of investing in the volatile financial markets.

Second, both MIP and Mosnic arrived at an agreement that security analyses for the selection of the individual assets based on risk reward approach, beside the use of the market index to measure the portfolio performance, could be only one block in the complicated process to manage the discretionary portfolio. The Controller asserted to MIP that the stakeholders did not want to be involved in the rigid mechanism followed by MIP in deciding which individual security to select. However, he re-confirmed to MIP that Mosnic would like to be sure that the shift in the stakeholders' perception of risk would be taken by MIP from the Controller as an extremely important input to any investment decision MIP would take on behalf of Mosnic.

Third, both parties became convinced that ROI pre-determination might be inappropriate due to the financial markets' volatility. It was agreed that the portfolio performance evaluation would be carried out through a process which could involve: (1) evaluation of MIP's

prudence in all the decision processes relating to the different market circumstance. In this sense even if ROI was negative Mosnic would not blame MIP before assessing the appropriateness of actions taken by MIP. (2) Both parties arrived to the common understanding that the bottomline assessment of the ROI would be a significant way of evaluating MIP performance. However, a period was not fixed to carry out the bottomline assessment. (3) It was also made clear that the involvement of Mosnic management with MIP would be intended to give information on the specific requirements of the stakeholders, but under no circumstance this would release MIP from accountability.

5. THE CRITERIA FOR EVALUATING MIP'S MEANS AND METHODS

Based on the continuous feedback process managed by the Controller, the investment policies committee decided to take MIP as a discretionary portfolio manager.

Indeed, it was difficult to set quantitative measures for assessing the acceptability of MIP strategy, structure and processes. The selection process went through a complicated qualitative process. However, it was necessary to set a criterion for determining the principals' level of satisfaction with the MIP investment strategy, structure and processes.

The Controller sat back and thought again about the process by which MIP was selected and ended-up with the

following criteria.

(I) **MIP METHODS**

(i) Clarity and Consistency of investment strategy/model. MIP was found satisfactory in:

(a) Clarity in identifying major trends and their implications for the investment decision.

(b) MIP was clear in weighing risks and uncertainties.

(c) MIP was ready to watch stakeholders' perception of risk and the other possible inflection points and alert signals.

(ii) Portfolio Allocation and the Financial Markets.

(a) MIP seemed capable of reading/identifying major trends and in assessing the risks of deviation. This would determine the key investment strategy and the precautionary measures in case of unexpected problems and crises which markets might not be efficient to inform about.

(b) MIP confirmed not to dissociate asset allocation from currency allocation.

(iii) Quick and Effective Decision Process.

MIP was qualified and equipped with the right caliber of executives in setting up investment strategy and if necessary to amend the strategy weekly.

(iv) Clarity and Efficiency at all the Organizational Levels.

Analysis and communication processes within MIP and with the outside, selection of the custodians and the external advisors, information to Mosnic, organization of internal investment meetings and portfolio management were found satisfactory.

(II) ADEQUACY OF MEANS

MIP was found satisfactory in terms of the following.

(i) Highly integrated research team.

(ii) Personalization and dedication of portfolio management services.

(iii) Sophistication of the technical backing.

(iv) Satisfactory integration with other banking services.

(v) Application of reliable internal control system and accurate reporting.

(vi) High flexibility of the investment model/strategy and potential compatibility with Mosnic's corporate strategy.

6. IDENTIFICATION OF THE SPECIFIC CONTROL NEEDS TO MONITOR MIP

The Controller made the measures which would ensure that MIP aggressiveness would not put the stakeholders' interest into any kind of jeopardy. The control strategy set by the Corporate Controller was to boost the intervening of the stakeholders (without weakening agent accountability) and the IPC with MIP in the tactical assets re-allocation processes. That process was intended to control over-aggressive investment in shares. In addition, the Controller proposed to the IPC to set a conservative profit-take policy for MIP. MIP did not like it and made fair arguments about the impracticability of this approach.

7. CONCLUSION TO THE SELECTION OF MIP

The selection of MIP was completed through intensive consultation and exchanging of opinions between the Managing Director and the Corporate Controller. The role

of the Controller was vivid in interpreting the information presented by the agent to the principal and vice versa.

The selection process involved studying all MIP structure and processes in a detailed but in a selective rather than systematic manner. The selection process discussed strategy formulation in interaction with the intended agent. The analyses were qualitative. Involvement of the Controller in the analysis process gave comfort to and made the principals happy about the decision to be made. The selection process included evaluation of MIP strategy, amending it and agreeing on a financial strategy for the first year. Nevertheless, management planned to allow MIP room for tactical re-allocation of the asset to be coupled with close monitoring by the Controller to reflect on the specific requirements of the investors.

Mosnic management was not convinced that equities (stock) markets out-performed the fixed income securities in the post-war era. Therefore, the standard policy of MIP of remaining fully invested in shares had been viewed by management as a sign of aggressiveness, which Mosnic (as a conservative investor) did not agree. Thus, considering the other merits of MIP in terns of strategy, structure and processes, the Corporate Controller took the following controlling measures to compensate for the unsatisfactory aspects of MIP. First, ensuring that MIP changed its asset allocation style to take into count the principals' guideline by reducing the exposure to shares.

Second, to monitor MIP more frequently. Third, to make sure that shares of cyclical nature were not included in the composition of the portfolio. Fourth, to resolve through principal-agent negotiations (to be orchestrated by the Controller) the issue of growth shares or high cash income shares. With the above controlling precautions MIP was selected. The financial strategy was agreed and the Controller made sure that it was in consistency with the corporate investment strategy.

In Section 5-B another agent selection case is studied to find out, in comparison with the case of MIP, the differences in the intended agent's methods and means and what these differences meant to strategy formulation, investment decision, and control.

* APPENDIX 5.1

AGENTS' STRATEGY STRUCTURES & PROCESSES QUESTIONNAIRE (ASSPQ)

A]	1. Years in global businesses. 2. Branches/subsidiaries/affiliates. 3. Staff: (Number, qualification, experience) (-) Portfolio managers (-) Analysts (-) Economists (-) Finance and administration (-) Traders (-) Internal Auditors (-) Managing partners 4. Personnel turnover 5. Legal entity 6. Ownership 7. Clients: (Assets and number, total assets) Institutional Personal trust Mutual funds Individual investors 8. Number of accounts assigned to each portfolio manager.
B]	1. Investment approach 2. Investment strategy 3. Investment philosophy 4. Investment management style B1, B2, B3 and B4 cover: - Technology of communication - Re-adaptation to the environment - Strategy formulation - Asset allocation policy: a] STOCKS: (-) Market timing (-) Emphasis on (income, growth, assets, large companies, small companies,market place) (-) Does the manager intend to outperform market? (-) How? (-) Does the manager has alternative risk levels to be selected?

	b] BONDS: (-) Turnover : High or Low? (-) Coupon : Currency/discount? (-) Quality : (AAA,AA,BAA under BAA) (-) Maturity : 10 -20 years or less 10 -20 years over 20 years (-) Issue Type: U.S. Treasuries U.S. Government Agencies European Government
C]	ORGANIZATIONAL SETTING FOR INVESTMENT DECISION MAKING: (-) Who sets the investment policy? (-) How does the agent decide on the pro-forma asset allocation? (-) Does the agent develop list of approved securities for all the portfolio manager? (-) Who sets bonds maturity or issuer types? (-) Who will be in-charge of Mosnic portfolio i.e., an individual manager or a team?
D]	PORTFOLIO DIVERSIFICATION AND CONTROL: (-) How many securities will be held in Mosnic portfolio? (-) How does the agent control risk and diversification? i.e. is it quantitative or otherwise?
E]	AGENT'S SOURCE OF INFORMATION FOR INVESTMENT DECISIONS: (-) How does the agent get informed about: i) Stock market situation ii) Industry trends iii) Bond market iv) Economics v) Common stock selection vi) Bond selection vii) Portfolio models (-) Does the agent use internal or external sources? (-) In case information is provided by external source who provides it? and, why that particular source?
F]	AGENT INTERNAL CONTROL RELIABILITY: (-) What kind of accounting reports does the agent provide? (-) Can the agent provide report be in harmony with Mosnic internal reporting system?

	(-) Is the agent internal control set-up sufficient to safeguard the investors' assets? (-) * How does the agent select the custodians? i.e the custodians selection formula. * Who are the agent custodians? (-) Does agent provide adequate information on performance? (-) How does the agent report the portfolio performance? i.e. - Total portfolio performance - Bond performance - Equity performance - Time weighted - Dollar weighted - Comparison (-) How frequent can the agent meet with the principals? (-) Is the agent prepared to negotiate the fundamental investment decisions with the principal before implementation? (-) Is the agent ready to put on effect the principals' with the investment strategy before implementation. (-) How efficient is the agent in taking the corrective action negotiated with the principal? (-) How efficient is the agent in reporting: - The periodic portfolio valuation. - Sale and purchase transactions. - The realized/unrealized gains. - The current account cash movement. (-) How does the agent ensure that the asset held through different custodians are free of liens, charges and encumbrances?
G]	<u>AGENCY (ASSET MANAGEMENT) FEE AND OTHER COSTS CONTROL:</u> (-) What form of asset management agreement does agent proposes in relation to fee? (-) Is the agent interested in the short-term fee generation or longer term relationship.

	(-) How does the agent ensure optimal resources use to promote the principal's interest? (-) How does the agent understand optimal resources utilization? (-) Does the agent accept fee forfeiture if the principal points to poor resources application by the agent? (-) Does the agent accept being interfaced with other agents to negotiate varying opinions on the same issue of investment decision?

* ASSPQ in Appendix 5.1 was developed by the Controller to study the agents analysis underlying factors considered by Mosnic. There was no formalized approach to follow in choosing an agent. The Controller observed that the principals and the advisor had some underlying factors to look for in appraising an agent. Those factors were not systematically analyzed. Occasionally, the principals would consult other agents about the intended agent capabilities. With a view to that situation, the Controller developed his own questionnaire in the ASSPQ as a checklist. The ASSPQ aims at the coverage of all the attributes to the means and methods of the intended discretionary agents.

SECTION 5-B
SELECTION OF BJ-S BANK

The Need for BJ-S Bank

On November 1, 1987, the Director said to the Corporate Controller:

"The rally in the financial markets is over. Our goal has to be set more realistically. My colleagues in the Board are provisionally abandoning the idea of out-performing the markets as targets for our agents. We have already made enough selection of Geneva group of six private investment banks to be our agents. Having received fresh funds for investment, take my word as your authorization to look for a conservative, of stable track record of reasonable performance, well-structured, highly reputed and experienced Swiss Bank to invest those funds with. BJ-S Bank has been recommended to me. If you do not see any sign of incompetence in BJ-S bank liaise with it, analyze it and let me know. Ask two of our current port-folio managers their opinion on BJ-S. If it is fine go ahead. Explain to them about the lessons learned from October 19, 1987 Black Monday. You know well how we have reconsidered our investment objective to cope with the post-crash era."

1. Establishment, Volume of Assets Managed, Formation, and Internal Setting

In response to the request of the Controller to their 1) Establishment; (2) volume of assets managed; (3) legal entity; (4) branches and affiliates; (5) size of personnel employed, BJ-S feedback as follows:

BACK GROUND

BJ-S has its origin in 1890. Its banking activities started with foreign exchange transactions from a small office in Switzerland.

THE CLIENT'S OBJECTIVES

Obtaining details of the client's objectives is based on a close personal relationship with the client, where business is never conducted simply for the sake of doing business. The overiding service principle is that the client's objectives take precedent over all other considerations.

BELONGING TO PRIVATE BANKING

There's also a personal pride in belonging to one of the most prestigious professions, private banking, which demands identification with the clients wishes, total integrity and financial expertise.

COMMERCIAL CREDIT SERVICES

In addition to its commercial credit business, the bank rapidly expanded into other specialized activities with bond dealing and stockbrokering becoming major sources of revenue.

SEATS IN INTERNATIONAL STOCK EXCHANGE

The bank was among the first sixteen Swiss institutions to have a seat on the Zurich Stock Exchange. The bank quickly extended its arbitrate business to all the world's major stock exchanges. This early involvement in international stock broking was the bank's initial strength which set the stage for moving into portfolio management some 40 years ago. This service was added to provide a total money management capacity to customers

whose capital needed safe custody and prudent investment.

PRESENCE IN THE U.S.A

In 1940, the bank established a subsidiary in New York to seek a safe haven for capital outside war torn Europe.

PRESENCE IN LONDON

As early as the late sixties, BJ-S established its presence in the Euromarket by forming a merchant bank in London.

MANAGEMENT INTEGRITY

The BJ-S bank family still plays, however, a very active role in the management of the bank which remains largely privately owned.

VOLUME OF MANAGED FUNDS AND THE CAPITAL BASE

Assets held in safe custody and managed funds have reached several billion dollars, of which the specialized BJ-S Bank investment funds account several million U.S. dollars

GLOBAL MONEY MANAGEMENT EXPERTISE

BJ-S believes that money management cannot be handled by computers alone, but requires the expertise, flair and broad experience of human beings.

PERSONALIZATION OF SERVICE

Private clients as well as institutional investors expect personalized service, capable evaluation of

individual investment objectives and development of strategies that take fully into consideration differing personal financial needs.

NUMBER OF STAFF AND THE INVESTORS

BJ-S bank is an integral part of the Swiss private banking heritage. The bank employs a staff of approximately 750 and is responsible for the assets of some 10,000 investors throughout the world.

GLOBAL NETWORK

BJ-S maintains full service facilities in Zurich, London and New York, with a global network and representatives."

To decide on BJ-S bank as a potential asset manager, the analysis was done in an untidy process because different sets of people were involved. BJ-S showed appreciable co-operation in providing data and in explaining facts. The appraisal process was completed in two simultaneous directions, (1) Mosnic/BJ-S interaction and negotiations, and (2) Mosnic in-house discussions. The role played by the Controller was significant. Agent analysis factors of obvious nature which could be traced in BJ-S brochures were not discussed in the selection process. The Controller's experience in appraising the portfolio managers helped in shortening the selection process.

2. The Appraisal Process

The Director confirmed his interest in BJ-S by stating:

" *The opinion of our ex-Advisor was negative on BJ-S. I suggest you study the means and methods of BJ-S to consider appointing this bank as one of Mosnic's discretionary agents. We need to diversify further over the portfolio of asset managers constructed by the ex-Advisor."*

Thus, the Controller telefaxed BJ-S Bank - Geneva, as follows:-

" *Our group is considering the utilization of your bank in the management of an investment portfolio. You are kindly requested to provide the following for the preliminary assessment of BJ-S methods and means:-*

1. *The bank directory - if any-or a write-up outlining your investment approach, philosophy etc.*

2. *The bank structure for investment decision making.*

3. *Copies of the bank yearly reports disclosing performance in the clients accounts during the last five years.*

4. *The staff and their capabilities.*

5. *Classes/names of some of your major clients.*

6. *The Management fee structure."*

BJ-S Bank feedback was as follows:

" *I duly noted your interest in our portfolio investment management service which BJ-S Bank Group provides to clientele - individuals and international institutions - Worldwide. May I invite your attention to the booklet International Investment Management and, in particular, pages captioned "Performance Comparison of a US Dollar Based Client" and "Pin (various funds)" which clearly demonstrates the performance and the growth of assets of the portfolios of individual institutions. Incidentally, Pin Funds are published daily in the Financial Times and these are managed by us on a fully discretionary basis. Broadly, the major international markets have fallen by 30% approximately, which compares rather favourably with the decline in the value of assets managed by us. The fees for managing a discretionary portfolio of US $ 10,000,000 will be 0.5% per annum and any amount exceeding this figure will be*

levied at 0.25% per annum. You should also note that for such managed accounts we do not charge safe custody fees and coupon collection fees."

The Controller As An Interpreter (between the principals and BJ-S)

During the negotiations with BJ-S Bank, the Corporate Controller kept the principals updated on most of the details and developments taking place. In the negotiations with BJ-S, the ASSPQ (Appendix 5.1) was used as a guide by the Controller. The Controller took a further step and confirmed with BJ-S bank the following general points which were orally discussed:

" *1. You will not charge any fee for holding U.S. Government Treasury Bills, we contemplate to transfer from another bank to be managed by BJ-S.*

2. You will not charge any cost for sale/purchase of the Treasury Bills.

3. Your bid and offer basis cost related to the U.S. government Treasury Bills shall be quantified to give an idea roughly how much it will cost.

4. Your management fee for handling the investment portfolio on a discretionary basis shall be determined while considering the volume of business which I speculate to grow big.

5. You will set-up a fixed fee structure when we come to the stage of formalizing the agreement.

6. You shall alternatively present London versus Geneva asset management cost figures for us to compare and choose between your affiliates.

7. In case we start our mutual fiduciary relationship, you will keep a reporting line to enable us monitoring the portfolio performance.

8. Should we start accounts in Geneva, you will explain the chargeable commission on the returns of the Fiduciary placements.

9. At all times at our request a portfolio manager will be at our disposal."

Description of the Principals' Investment Objectives

For more explanation about the specific terms and requirements of Mosnic, BJ-S requested the Controller to respond to the following message:-

"Re: Investment objectives.

I should be grateful if you would care to give careful thought to the following, in particular to the aims and objectives, also any specific requirements the investors might have in mind, in respect of investment of the funds. Broadly, the main points which require your attention are:

A. Specific Requirements.

i) Income
ii) Growth
iii) Income and growth

B. Global Investments.

i) Currency Mix
ii) Assets Mix
iii) Geographical Spread

C. Investment Period.

i) Short
ii) Medium
iii) Long

D. Frequency of Funds Movements.

i) Injection of capital
ii) Withdrawal of funds

E. Trading.

i) Currencies
ii) New Issues/Stocks
iii) Special Situations

a) Takeover and Mergers
b) Growth companies requiring mezzanine financing

F. Projection of Liabilities.

i) Amount and period estimates only.

G. Restrictions.

i) Any restrictions and constraints should be specified in detail.

It would be helpful if you would reply to me at your earliest convenience.

The Principals' Objectives Explained to BJ-S by the Controller

Income and Growth Objective

The Controller informed BJ-S that the primary aim of stakeholders was the growth of their assets. They might not need income from their discretionary portfolios (in the short-run) to withdraw. However, the stakeholders would be a lot happier to see the high gains realized. Thus, it could be left to BJ-S to judge in terms of how to mix the portfolio between growth and income. Indeed, once the Director told the Controller that: *"global investment sometimes take you into a vicious circle. At a time the agents report high unrealized gains. A market turmoil comes. Then you are back to square one (i.e. you loose the unrealized gains to start the process again). I am convinced now to see some gains realized. How much of it? When to realize it ? and in which currency? are questions to be answered by BJ-S."*

Thus, BJ-S was informed about these views of the Director. However, the Controller emphasized to BJ-S that, depending on the markets situation, the stakeholders might change their income and growth objectives. The Controller

assured BJ-S of the timely conveyance of any shift in the principals' investment objectives.

Global Investment Objectives

(i) Currency Mix

The Controller informed BJ-S that the US Dollar should remain the major currency of the portfolio. It was set to be 70% - 80%. The remaining balance of the currency allocation was completely left to the discretion of BJ-S. The Controller also informed BJ-S that Mosnic could allow hedging cost to offset the currency risk on the portfolio. Management of the hedging cost would be left to the discretion of BJ-S.

(ii) Asset Mix Objective

The Controller agreed with BJ-S to discuss the broad categories of the assets in longer sessions to reflect adequately on the principals' views about investment risk. However, the Controller ensured BJ-S that Mosnic would not intervene in analyzing the individual securities. The Controller promised to keep observing, to interpret and to describe for BJ-S the process by which the stakeholders changed their objectives.

(iii) Geographical Spread Objective

The Controller notified BJ-S that any security selected for the portfolio should be marketable in the North American, Western European, Tokyo, Australia and Hongkong financial markets. The rest of the details were left to BJ-S.

(iv) Investment Period

The Controller informed BJ-S that Mosnic would leave its assets to grow over long periods. However, the Controller made a reservation that it would be difficult to set a standard for this objective. The markets do not always give signals about crises before they happen. Under emergencies, the principals would take any measures,even to the extent of liquidating the portfolio as protection/defensive measures to preserve the capital. BJ-S appreciated this problem and agreed to leave setting this objective to the future.

(v) Trading Restriction

The Controller made it clear to BJ-S that Mosnic did not accept speculation. Once the Director said "we are not speculators. We need real portfolio management". The Controller further informed BJ-S to keep off speculation in currencies, new issues, special situations, internal fund investments (e.g. takeover and mergers, growth companies requiring mezzanine money or any other form of direct investment which would lead to holding unlisted stocks.) The reasons as understood by the Controller were: (1) Speculation meant gambling to the principals and in their Islamic belief gambling was prohibited; (2) speculation also meant putting the invested capital under high risk-particularly with respect to the unpredictable money market volatilities; and (3) use of unlisted stocks meant losing the flexibility of changing the strategy if the need would arise. Strategies pertaining to the marketable securities were considered easily revocable.

(vi) Interest Restrictions

The BJ-S representative was kept informed about the Controller's intentions of handling the question of prohibited interest in detail if an agreement would be reached. The representative showed great enthusiasm and made a comment that he would like to learn about the interest issue since it concerned a group of his clients.

The following are some quotations from the Controller's detailed description of the stakeholders' investment objectives as telefaxed to the representative of BJ-S.

Specific Requirements

"*Regarding income and growth as requirements, maximization of profits is an ultimate objective, should it not put capital into jeopardy. Capital preservation is important.*

Gains maximization must be associated with realization. We would like the assets to grow but not only in the books. At a reasonable level of growth gains have to be cashed i.e. "profit-taking strategy". Gains must not stay in the portfolio unreasonably unrealized.

B. *Global Investment*

The currency mix, the asset mix, and the geographical spread of the assets are where the asset manager has to advise in a prudent manner to the conservative investors of Mosnic.

C. *Investment Period if a Fiduciary Relationship is Established Should be open.*

D. *Frequency of Funds Movements.*

i) *Injection of Capital.*

Conservatively speaking, injection of further funds or transfer of short-term securities shall be the function of two factors:

1) The performance of BJ-S with us.
2) The group getting more fresh funds.

ii) Withdrawal of Funds.
Not foreseen. Should be none or very minimal.

E. Trading.

It is not authorized, however, Our group would like to receive from BJ-S solid proposals regarding:

- *Currencies dealings/speculations in a reasonably secured way.*
- *New issues/stocks.*
- *Any special situations such as:*
  (-) Corporate acquisition with management buy-out.
  (-) Growth companies requiring mezzanine financing.

F. Restrictions.

As stated before, our group do not advise interest to be mixed with revenue earned. However, temporary placed deposits are allowed until the cash proceeds are re-invested in the allowable instruments.

Investment in shares of companies manufacturing or trading in all types of liquor/alcoholic products is be to avoided.

The above guidelines can be negotiated elaborately. We are careful to have you satisfied with the principals objectives."

The principals' requirements specifically described

The Controller conveyed the following guidelines to BJ-S for further negotiations:-

" We feel it is imperative to convey to you how the Board of Owners and the Directors of Mosnic view the current position of the U.S Treasury Bills to be held with BJ-S:

(1) They prefer holding the U.S. Treasury bills for the time being, as part of the current strategy of parking the fund temporarily.

(2) It is not yet opportune time to buy treasury bonds, for the bond prices are high.

(3) BJ-S Bank shall advise the right time - if there is any, within the coming 45 days time to move to the T-bonds partially.

(4) The investors still prefer the U.S. Treasury Bills for their security. That is a temporary strategy to cope with the market volatilities.

(5) *The investors do not allow permanent deposit placements as an alternative instrument. They very well know it is secured and gives higher yield than the U.S. Treasury bills. But you need to know that fixed deposits are against the belief of our investors.*

(6) *Unless notified and consulted on exceptionally attractive shares, the investors are of the opinion to:*

- *Eliminate equities from their portfolio.*
- *Raise Treasury Bills and bonds.*
- *Increase the capital preservation characteristics/measures of their holdings.*
- *Avoid interest income of fixed deposits.*

The Proposed Allocation of Assets

(7) *The following medium-term asset mix is proposed at the maturity of the treasury bills:*

Treasury Bills	*60%*
Less than 5 years Treasury bonds	*40%*
Deposits	*0*
Total	*100%*

(8) *As of today, Eurobonds - you recommend, and U.S.long-term Corporate bonds in general, do not attract the investors relative the U.S. Treasury issues, since the yield advantage for the Eurobonds is often only 50 basis points for the best names, whereas in the recent past it has been in the 120-180 basis points range. It is advised that a recession is expected in 1989, which could at some points cause spreads to widen. Investors feel they need to wait for bad news before moving out of the treasuries. How do you think?*

(9) *There is an attractive bond yield increase between three months. If opportune moment comes to buy treasury bonds, they recommend to keep maturities below 5 years, since the potential for further falls in U.S. interest rates seems limited, due to the expected increase in the borrowing requirements of the U.S. Treasury.*

(10) *Diversification out of the dollar being recommended by BJ-S Bank.*

The investors believe that the success of purchasing bonds outside the U.S. dollar depends on both the relative movement of interest rates and the change in the exchange rate. Foreign

bonds seem more attractive than U.S. bonds as regards the interest rate profile, but as the currency outlook the investors will require your justification.

The investors would like to hear from BJ-S Bank regarding diversification out of the dollar on a hedged basis and on an unhedged basis, (if Euro-bonds are recommended by you). The final decision before implementation has to be presented in a comprehensively documented report to the board."

The Controller then undertook some preliminary tests on BJ-S means and methods and the signs were promising about BJ-S bank. Thus, the Controller moved to the detailed analysis process as presented in the forthcoming pages. The inquiries were mostly around BJ-S strategy, structure and processes.

BJ-S Strategy, Structure and Processes (methods and means assessment)

The stages of BJ-S selection were not in the same order as in MIP and other banks selection. In the case of the BJ-S selection, the Director nearly gave directives to the Controller to select BJ-S if there was no clear reservation about the bank. Thus, the Controller started by deepening the understanding between BJ-S and Mosnic. Every party was then clear about what the other was looking for. Only after that, the process of analyzing BJ-S strategy, structure and processes started. In this process the Controller turned back again to BJ-S to get more highlights on the following:

1. - BJ-S cooperation with the Mosnic objectives and specific requirements.

   - BJ-S geographical spread.

2. The long-term protection of capital.
3. International diversification.
4. Currency selection.
5. Asset Allocation.
6. Investment Strategy.
7. Currency neutral strategy
8. Investment model
9. Investment performance.
10. Asset management and commission rates.

BJ-S responded as follows:- (The forthcoming details are quoted to give the reader an idea about the model and the contribution of the agent to the principal's strategy formulation process.)

INVESTMENT APPROACH (BJ-S PHILOSOPHY)

" Our approach to discretionary investment management is based on the following fundamental principles:

Client Objectives	*A full understanding of our clients' investment objectives and requirements.*
Long-Term Protection of Capital	*Adherence to the principle of long-term protection of invested capital rather than speculative and unsustainable short-term gains.*
International Diversification	*A spread of portfolio risks across the worlds major markets taking political stability, economic strength and liquidity into close consideration.*
Currency Selection	*A prudent diversification by currency,one of the most decisive investment criteria.*
Asset Allocation	*A broad asset mix of equities, straight bonds, convertible bonds and cash to achieve optimal returns in changing market conditions.*

The essence of our approach is the international diversification of investment by a country, market sector and currency. Over the longer terms, we consider that this approach will continue to provide potentially higher and more stable returns than "single country" portfolios:

- *Overseas diversification lessens the investors exposure to adverse currency and economic developments in any single markets;*

- *A wider spread and choice of overseas investment opportunities offer higher potential returns."*

The views of the Controller started becoming positive about BJ-S.

PRIVATE BANKING TRADITION

BJ-S said the following about the London banking required

by Mosnic.

"Private bankers by tradition with a personalized approach to international money management. A service supported by our:

1. *Reputation*
2. *Experience*
3. *Strength*
4. *Performance*
5. *Accessibility*

Through the London office, private investors have access to:

Discretionary Investment Management Services,
Cheque book and deposit accounts,
Loans and overdrafts in all major currencies,
Foreign exchange transactions,
Money Market Instruments
Euromarket dealings,
Securities brokerage,
Offshore trust and company management services".

DIFFERENT STRATEGIES TO DIFFERENT CURRENCIES

On their intended strategies to operate Mosnic portfolio, BJ-S said:

" *Consistent with this approach to international diversification, we formulate for our clients specific investment strategies.*

Each strategy is first related to a base currency. This is the currency in which the client thinks and calculates. It is also the currency against which our performance will be measured. Where clients have no

natural bias to any one currency, we adopt a "currency neutral" strategy. For each base currency, our strategies then project an optimal currency and international asset mix. When the appropriate client strategy has been determined, this is used as the basis on which to agree and build a personalized portfolio. This will take into account any special investment requirements, objectives or preferences the client may have. Our basic strategies are closely monitored by our group Research Department who revise them as and when our market expectations change. Our management capabilities here are also supported by fundamental equity and bond research. This is through both in-house and outside technical analysis to which our portfolio managers have direct access. The investor goal and strategy guide BJ-S to come up with strategy suitable for the situation. So, investors have presence with us."

Present suggested strategies for various currency bases are:-

CURRENCY NEUTRAL STRATEGY

Asset Currency Totals	Equities	Bonds/ Conv. Bonds	Gold	Cash	
U.S. Dollar	14	10		15	39
Yen	9	8			17
Sterling	3				3
Europe	9	22			31
Gold	—	—	10	—	10
Total	35	40	10	15	100

U.S. DOLLAR BASED STRATEGY

Asset Currency	Equities	Bonds/ Conv. Bonds	Gold	Cash	Totals
U.S. Dollar	20	15		15	50
Yen	7	7			14
Sterling	2				2
Europe	6	18			24
Gold	—	—	10	—	10
Totals	35	40	10	15	100

STERLING BASED STRATEGY (Resident)

Asset Currency	Equities	Bonds/ Conv. Bonds	Gold	Cash	Totals
Sterling	20	10		20	50
U.S. Dollar	9	6			15
Yen	5	5			10
Europe	6	14			20
Gold	—	—	5	—	5
Totals	40	35	5	20	100

STERLING BASED STRATEGY (Non-Resident)

Asset Currency	Equities	Bonds/ Conv. Bonds	Gold	Cash	Totals
Sterling	10	5		10	25
U.S. Dollar	14	7			21
Yen	8	6			14
Europe	8	17		10	35
Gold	—	—	5	—	5
Totals	40	35	5	20	100

ALTERNATIVE INVESTMENT MODELS

US $ BASED STRATEGY

EQUITIES: (35%)

USA

Bowater Inc.(Forest products)
Caterpillar Inc. (Machinery)
Digital Equipment Corp. (Computers)
Nalco Chemical Co. (Chemicals)
Time Inc. (Publishing)

JAPAN

Aoki Corp. (Construction)
NEC Corp. (Electronics)
Tokio Marine & Fire Insurance Co. (Financials)

EUROPE
Carrefour (Retailing)
Jacobs Suchards AG PS
National Westminster Bank PLC (Banks)
Royal Dutch (Oils)

BONDS: (40%)

USD Swedish Export Credit 8.625% 1991
DEM European Economic Community 5.375% 1993
DEM European Investment Bank 6.25% 1995
YEN Canada 5.635% 1993
ECU Credit National 7.375% 1990

PRECIOUS METALS: (10%)
Gold Bullion

CASH: (15%)
USD Call Deposit

STERLING BASED STRATEGY (RESIDENT)

EQUITIES: (40%)

UK

BAT Industries (Consumer Goods)
Glaxo (Pharmaceuticals)
Great Universal Stores (Retailing)
National Westminster Bank Plc (Banks)
Rio Tinto Zinc (Natural Resources)
Saatchi & Saatchi (Advertising)
Whitbread A (Breweries)

USA

Caterpillar Inc. (Machinery)
Nalco Chemical Co. (Chemicals)
Time Inc. (Publishing)

JAPAN

Aoki Corp. (Construction)
Tokio Marine & Fire Insurance Co. (Financials)

EUROPE

Jacobs Suchard AG PS (Foods)
Royal utch (Oils)

BONDS: (35%)

STG Treasury 9% 1996
USD Swedish Export Credit 8.625% 1991
DEM European Investment Bank 6.25% 1995
DEM European Economic Comunity 5.375% 1993

PRECIOUS METALS: (5%)

Gold Bullion

CASH: (20%)

STG Call Deposit

INVESTMENT PERFORMANCE FORECAST

BJ-S Bank Avoids Financial Forecasts of ROI but Discloses Historical Performance Numbers

According to BJ-S: "Some clients ask us to guarantee or predict performance levels for selected strategies. We do not do this financial forecasting. However well it is researched, it can be quickly invalidated by events - both favorable and unfavorable. What we do hope to achieve is a consistent level of performance over the longer term to protect and increase the real value of a client's assets. An indication of our achievement in recent years is shown below.

Performance of Individually Managed Portfolios

Year	Annual Percentage of Return in Local Currency US $ Strategy	DM strategy	S.Fr. Strategy
1982	14.3	13.6	18.2
1983	11.4	20.4	20.4
1984	2.7	10.7	15.1
1985	34.1	13.0	14.5
1986	23.5	6.3	5.2

These are representatives of our performance for sterling based accounts and are illustrated over the page. The data supporting these performances are a matter of public record. We know some brokers do not mind bombarding their potential clients with unrealistic or even deceptive performance data. We are not brokers."

ASSET MANAGEMENT COST AND COMMISSION RATES

While still exploring BJ-S as an intended portfolio manager, the Controller addressed the following question to BJ-S Geneva.

" *BJ-S is kindly requested to give an idea how much will it cost Mosnic to have the marketable securities managed by BJ-S Geneva?"*

The response of BJ-S was a summary of Agreement on Commission rates by the Association of Swiss Stock Exchanges.

BJ-S Means and Methods Reiterated

Following the replies provided by BJ-S, in the following meeting, the Director led the discussion and raised inquires about:

1. BJ-S investment philosophy
2. BJ-S investment decision
3. Investment policy
4. Portfolio composition

The discussion went on as follows:-

The Director:

" *Can you explain your investment philosophy and style, to see if Mosnic can be accommodated with BJ-S Bank, and how BJ-S Bank can help in achieving the capital preservation and growth goals ?*"

BJ-S Representative:

" *Our investment philosophy can be summarized as follows:*

1. *Our main task is first to understand our clients' investment objectives. Principal-manager co-operation is our style.*

2. *We always adhere to the principle of long-term protection of invested capital rather than speculative short-term gains.*

3. *We believe it is essential to spread risks internationally, taking political stability and economic strength into close consideration.*

4. *We consider currency selection one of the most decisive investment criteria.*

5. *We always aim at asset mix that takes optimum advantage of changing market conditions.*

We target at high performance relative to the market benchmarks."

Investment Policy

The Director:

" *Can you brief us on your investment policy related to portfolio management? I mean your investment decision making process?*"

BJ-S Representative:

" *You must have known by now that, for decades BJ-S has been specialized in the management of private and institutional securities portfolio. In all these years, there has been a constant growth both in the amount of funds placed under our custody and in the number of the investment managers looking after these funds.*

Logically enough, this expansion in business volumes resulted in structural adjustments involving administration, electronic data processing and information systems and also brought about changes in how investment management services are rendered. One of our key management instruments is the formulation and implementation of a uniform investment policy for the entire group. For our clients, the policy is a visible and tangible image of our business philosophy and investment strategy while constituting our identity within the Swiss and International banking community."

On the Investment policies, strategies and the decision making process, BJ-S representative added:-

" *Our investment policy is based on time-tried and conservative principles. The long-term preservation of assets is given priority over short-term profits on gains associated with increased risk. Investments are only placed in countries with stable economic and political backgrounds, surveyable foreign exchange policies and liberal capital markets."*

Portfolio Structure

On portfolio structure the representative said:

" *In our portfolios, the focus is on investments in prime fixed income securities and on shares of leading corporations with sound earnings and dividend perspective."*

About concentration on the major markets combined with diversification of Investments, the representative commented:

" *A balanced combination between the necessary diversification of investments and concentration of major markets and currencies results in clearly structured portfolios and simultaneously gives the investment manager enough liberty to devote time to personal counsel, an aspect of the job to which we still attach considerable importance. "*

Structure for Investment Decision Making

About the role of BJ-S Investment Committee, the representative stated:

" *The investment policy committee is the backbone of the decision making process needed to formulate our investment policy. Once a month, three members of the management committee get together with the heads of the private and the institutional investment management*

departments, the Research Department, and senior officers of the securities trading and foreign exchange departments."

Establishing Investment Strategy

On the establishment of investment strategy issue the representative said:

" *The committee's main responsibility is to establish the overall investment strategy, issuing guidelines for currency diversification for the asset mix for geographical risk diversification."*

Formulation of the Investment Policy

The representative stated that the final approval of the investment policy, considering the importance of portfolio management, was the responsibility of the executive committee of the Board of Directors and the Management Committee. Therefore, the investment policy had to be submitted to them. The Controller, going through BJ-S investment decision making process, proposed to the Director to request more information on the subject. Getting a green light from the Director, the Controller made the following telefax request:

" *Mosnic Investment Committee finds it interesting to understand more about your investment policy formulation/implementation and the related decision making process. We shall highly appreciate having more information on the subject."*

Control of the Investment Decision Making Process

About the structure maintained in decision making BJ-S response came as follows:

" *The actual decision making process for the investment strategy relies extensively on the analysis conducted by the Research Department. The specialists in this department submit studies which outline the political and economic background of the major investment countries and their potential impact on the foreign*

exchange, bond and stock markets. Also, the members of the Investment policy Committee each month contribute their quantitative estimates of the development of currencies, interest rates and stock markets. Based on these estimates, a total return forecast is calculated for each major stock and bond market. The scale of anticipated returns on investments supplies the basis for the weighting of the individual markets, resulting in the "currencies-neutral international investment policy guidelines."

Once this basic concept has been defined, several subsequent steps lead to the establishment of a refined investment policy grid. Modifications are made to reflect currency-related preferences of the individual private or institutional investor and the local needs of our branches in London and New York."

Implementation of the Investment Strategy

BJ-S Bank commented on strategy implementation as follows:

" *Within the framework defined by the investment policy committee, the stock and bond selection committees will implement the strategy by issuing specific investment lists. The buy lists for the key international stock, bond and convertible bond markets contain detailed and carefully analyzed investment proposals. Special quality ratings are made for bonds, and corporate studies are published on companies whose shares we recommend."*

Mosnic asks for Specific Policy

Going through the report of BJ-S, the Director asked:

" *Is the investment policy designed by BJ-S suitable for all types of clients? And how can you satisfy Mosnic special needs? How can Mosnic keep current on information produced by BJ-S investment policy committee?"*

BJ-S Bank Representative replied:

" *Of course we can retailor our policy to meet your requirement."*

BJ-S Information Technology as Management Instrument

He added:

" *The highly diversified information kits produced by our Research Department are not only available to our in-house investment managers, but are also mailed to a*

selected circle of institutional clients. Both the organizational framework of this multilevel decision making process and the detailed definition of the investment policy in writing have become indispensable tools in portfolio management. In fact, they represent a management instrument which takes into account the diversification or our business activities in terms of geographical focal points and client categories. The management responsibilities are entrusted to the top executive officer of our bank while the individual investment managers tailor the general investment policy to reflect the wishes and needs of our clients, select the financial instruments and continually monitor the portfolios."

The Problem of the Uniform Investment Strategies and Policies

The Director commented on the investment decision making process and on the formulation of the investment policy in BJ-S as follows:

" *BJ-S has the right organizational structure and the sophisticated procedures of formulating the investment policies and I think what is presented to us by BJ-S (like any portfolio manager) is a standard/uniform model which cannot be applied universally to all the investors' objectives. Will you have the patience to accept our input and amend your standard strategy."*

BJ-S Representative argued as Follows:

" *I do not fully agree with the Director. Other advantages can be derived from the formulation of a fundamentally uniform investment policy. It makes it possible for us to systematically review the implementation of the policy, to obtain comparable results among different clients and client groups, and thus to get an objective performance comparison, an important factor when addressing potential institutional clients in an internationally competitive market. However, this is not the only reason why we attach great importance to investment policy as a management tool. Our traditional business philosophy stresses the need for a uniform and positive identity of the bank in the awareness of the public as well as among current and prospective clients. A clearly formulated and implemented investment policy contributes a great deal to the attainment of this significant objective."*

BJ-S Internal Control System

The Controller observed that by using BJ-S, Mosnic would actually rely on the agent's management control

systems as the backbone for the management control system of the company as a whole. Moreover, the Controller was convinced that the principals' system for monitoring different agents could not be universal. This conviction was based on the fact that different agents would have different means and methods. In the light of the above views, and taking into count the significance of the accounting information system for monitoring BJ-S, and for safeguarding the principals' assets, the Controller decided to study BJ-S internal control system's reliability as an underlying factor to decide whether or not to select BJ-S as Mosnic's agent. The Director liked the idea and gave the Controller a 'green light' to try it. The Controller addressed the issue as follows with BJ-S.

Request by Telefax

"Re: Contracted Assets' Outside Controls

You will agree with me that investors rely to a certain extent on the asset Managers' Control Procedures related to data presented to the Manager's Report users. Moreover, the managers undertake the physical safeguard of the assets and selects the custodians. Our Board of Management would like to evaluate the effectiveness of your controls over its contracted assets. You are requested to provide a list of internal controls you exercise which ensure that:

1. *All transactions related to the assets are accounted for.*
2. *All transactions are real.*
3. *All transactions are properly valued.*
4. *All transactions are entered on a timely basis.*
5. *Classification is accurate.*
6. *Summarization is correct.*
7. *Posting is accurate.*

In listing your internal controls on the contracted assets, please consider the following Applications Transactions and other aspects:

1. *Sale of Securities.*
2. *Purchase of Securities.*
3. *Commissions related to trading in securities through our accounts.*
4. *Our withdrawals and Transfer of Funds.*
5. *Direct charges to the Current accounts.*
6. *Unrealized gains.*
7. *Realized gains.*
8. *Accrued interest on bonds.*
9. *Dividends/Coupons*
10. *Valuation of Assets.*
11. *Commitments & Liabilities related to our accounts.*
12. *Currency translation to the reporting currency (US Dollars) i.e. The source of information and mechanism of translation.*
13. *Cut-off procedures related to trade of securities.*
14. *Method and policy of valuation - disclose in details your formula how:*

    - *weighted average invested capital is computed.*
    - *the reported rate of return is calculated.*
    - *market value vs. historical cost is implemented.*

15. *Management judgment affecting the valuation. If you have English version of your policies and procedures manual you can provide copies of relevant pages. We are keen to have an idea about your machine control, i.e. EDP controls, General control, etc. Your cooperation to any extent shall be highly appreciated and will lay foundation for longer and deeply rooted further understanding. Of course it will minimize time you spend in future, responding to our inquiries".*

BJ-S Internal Audit Function

The following memo was the answer from BJ-S to the Controller's telefax requests in the same order of numbers used by him.

"All transactions and classifications mentioned in your points item 1 to 7 of the first page are checked by a "Department of Internal Control", directly subordinated to the top management. Then, the "Internal Audit" inspects the transaction in the bank and files a report with the Board of Directors, made up of the partners.

Thirdly, the federal law on banking prescribes the use of external auditors who file a report:

a) with the Swiss Banking Commission.
b) with the Board of Directors of the bank.

This procedure is also applicable to the following points.

1. and 2. *Purchase and sale of securities are executed by the Stock Exchange Department and checked by the Securities Department.*

3. *Commissions related to trading in securities are fixed in the Agreement of the Association of Swiss Stock Exchanges and programed into our Electronic Data Processing (EDP) system.*

4. *All instructions to withdraw or transfer funds are first checked by the portfolio manager who will control, amongst others, the authenticity of the signature. Afterwards, the Internal Audit will check again.*

5. *Administrative charges are based on the rate fixed by the bank and introduced in the EDP system. The safe-keeping charges are fixed in the Agreement of the Swiss Bankers Association which allows rebates under certain conditions.*

7. *Realized gains directly depend on a sale and as such, the answer to points 1 and 2 are also applicable.*

8. *The EDP system calculates accrued interest on bonds every day and controls the total amount on the payment day of the coupons.*

9. *Dividends and coupons are checked by the EDP system, following a daily schedule and then controlled by the Securities Department.*

11. *All commitments, liabilities and credits are investigated by the Credit Department. The decision to grant a credit must be approved by the Board of Directors.*

The next points are dealt with in the following manner:

6. *Unrealized gains are not precise accounting amounts as they depend on a valuation which can change at any minute. The valuation is based on prices supplied every morning by a well-known international service called Investdata. For certain unusual or private placements, they do not give any price and we appraise the price ourself.*

10. *The valuation of assets has already been defined under point 6.*

12. *Every morning, the Foreign Exchange Department takes note of the exchange rates fixed at the opening of the market and introduces them in the EDP systems. These rates are used for the valuation and the comments*

under point 6 also apply here.

13. *We are not sure to understand what you mean by cut-off procedures in trading securities. If this is related to mechanisms to automatically stop the sale of securities when the market drops too fast, we do not use them.*

14. *We do not use the "average invested capital", as it can be quite misleading. To calculate the rate of return, we use an "amount of reference" which is the grand total of the valuation of assets at the beginning of the year (initial valuation) indexed by all transfer, remittances or withdrawals (cash and securities). After each transfer, a new "amount of reference" is calculated, using the formula:*

$$\text{New amount of reference} = \text{former amount of reference (or initial valuation if applicable)} \times \frac{\text{actual valuation including transfer}}{\text{valuation before transfer}}$$

The difference between the "new amount of reference" and the "actual valuation" measures the rate of return.

If the transfer is an addition three times larger, or more than the amount of reference, or withdrawal representing three quarters, or more, of that amount, the rate of return is calculated as if the amount had been opened.

15. *The decisions taken by the portfolio manager will affect the valuation , at least over a certain period of time. Each account has at least two portfolio managers: one who is responsible to follow the account daily, and a substitute to replace him or to build up a team with him. In some cases, there is also an assistant portfolio manager.*

The committee for Investment Policy, headed by the partner in charge of the Research Department, is responsible for the bank's investment policy. The partner in charge of the department of portfolio management is responsible to check the application of this policy.

1. *and 2. Purchases and sales when authorized are processed through a dealing desk and contract note is produced, which is checked.*

3. *All commissions or charges wherever applicable are shown on the advice.*

4. *Withdrawals or transfers are only made when duly authorized and checked thereafter.*

5. *All charges are shown on the advice, no direct charges other than credits and debits.*

6. *Unrealized gains can be calculated from the valuation, no separate postings.*

7. *Realized gains are shown by the contract note and by entries across current account.*

8. *Accrued interest is shown on valuation with specific details.*

9. *Credit advises are produced.*

10. *Telekurs, an outside source provides daily market price for valuation.*

11. *Specific transaction note produced to show all commitments.*

12. *Foreign exchange rates are put into the system on daily basis, and they are provided by the Foreign Exchange and Treasury Department of the Bank.*

13. *All bargains are processed on the day of the transaction, late bargains are processed for the next day.*

BJ-S System for Controlling the Portfolio Transactions

1. *All transactions are subject to checks and controls: initiations, accounting, movements and reconciliations are done on daily basis. Computer processes entries automatically.*

2. *Only duly authorized transactions are put through the system and checked against third party confirmation.*

3. *An outside independent source is used, such as Telekurs who provide daily prices.*

4. *Transaction note on execution is stamped by time-machine.*

5. *Valuation shows the classification of assets.*

6. *Valuation shows the summary.*

7. *Valid computer input result in automatic accounting entries and checked daily".*

The Controller's View on BJ-S Internal Control System

The Controller was not quite satisfied that BJ-S enjoyed a reliable internal control system. The reporting package demonstrated by BJ-S was not satisfactory. It was difficult to see at a glance the realized and the unrealized gains. Also BJ-S was not clear about how to segregate and report interest as part of the portfolio income. But at least, the representative showed a high appreciation and cooperation to amend the system for processing interest income separately.

BJ-S did not show its detailed methods for security analysis and for managing risk.However, the representative assured the Controller that BJ-S intended to remain conservative and slightly exposed to shares. Accordingly, the Controller set his own specific control measures to cope with the specific and different aspects of BJ-S's control system. The detailed monitoring procedures to suit the situation of BJ-S are presented in the post investment case studies in the next chapter.

The Proposed Form of the Fiduciary Relationship

Very rarely Money Managers and Mosnic have recoursed to the stipulations of the Investment Management agreement to have their differences settled. The agreement was a precautionary document and just routine (for Mosnic) in investment management through agents. The contents of the discretionary investment management agreements were always carefully written and addressed, in a very formal style,

fundamental issues related to authority and responsibility in the complicated process of discretionary portfolio management.

For a successful and good business relation to be built, mutual respect and trust has been the corner-stone to the relations between the Asset Managers and Mosnic. However, an agreement has to be formalized.

BJ-S Bank proposed the following major aspects to be covered by the proposed agreement.

1. Responsibilities of the BJ-S as a discretionary asset manager.
2. Responsibilities of BJ-S Bank as a custodian.
3. Responsibilities of Mosnic as a client of BJ-S bank.
4. Fees and remuneration chargeable to Mosnic by BJ-S bank for services to be rendered.
5. Termination formalities.
6. General.

It is important to give the reader a view of how the fiduciary relationship appeared in its purely formal stipulation.

Indeed, BJ-S proposed to Mosnic the following:

Responsibilities of the Bank as Investment Manager

To manage the assets of the Client that are subject to this agreement "Assets" on a discretionary basis within the investment policy guidelines agreed with the client.

In making investment decisions the Bank will exercise its discretion to the best of its ability. However, the Bank will not use information received in a capacity

which obliges it not to use or disclose it for any other purpose. The Bank shall not be responsible for any loss in value or for profit not taken whether resulting from changes in market conditions or in consequence of the Bank's management of the Assets.

The Bank shall execute the purchase or sale of the Assets, the exercise of all rights, and debit and credit the Client's Accounts as appropriate.

Notification of all changes in the Assets will be sent as soon as possible after transactions have been confirmed.

All transactions will be carried out on terms as favourable as those on which the Client could deal direct.

The Bank will provide to the client or the client's nominated representative.

i) valuations of the Assets based upon middle market prices as at 31st March (or 5th April if elected by the Client), 30th June, 30th September and 31st December, and these will be despatched to the Client no later than 5 weeks from the valuation date.

ii) statements of the Capital and Income Accounts.

ii) appropriate tax vouchers.

The Bank's Investment Management Fee Scale forms part of Discretionary Investment Management Terms and Conditions.

Responsibilities of the Bank as Custodian

All Assets shall be held at the Client risk in the name or custody of the Bank and/or its nominee and/or its agent for the Client's beneficial ownership.

The registration of any securities by the Banks nominee or agents may be as part of larger holding of securities of other clients of the Bank which will not separately identify or allocate the holding of any particular client. By signing this Agreement Mosnic acknowledges that the Client's entitlement to any such larger holding shall be the proportion which the securities owned by the Client bears to the securities owned by all other co-owners for the time being of the particular securities concerned. The client further acknowledges that the client will have no greater or lesser rights either as against the Bank's nominee or agents or any of the Bank's clients other than those

which the client would have as some beneficial owner or, in the case of joint signatories to this agreement, joint beneficial owners.

The Bank shall open Capital and Income accounts for and on behalf of Mosnic.

The Bank shall collect dividends and interest due after deducting tax where applicable on the Assets and credit the Client's income account when received.

Responsibilities of the Client

Mosnic warrants that the Assets are owned beneficially free from all encumbrances.

Mosnic undertakes not to deal with any of the Assets or to authorize anyone else so to deal.

Any request or instructions relating to the Assets, the accounts or this agreement shall be made in writing to the Bank.

Mosnic shall indemnify the Bank against all costs, expenses, demands and losses which may be incurred in the lawful exercise of its duties and recognizes that any advice given by the Bank under this Agreement shall not entail any responsibility on its part.

This agreement shall be binding on Mosnic's estate and personal representatives. In the event of more than one investor jointly signing this Agreement, and unless the Bank is notified in writing to the contract, on the decease of any of the Clients, the Bank shall hold any balances on any accounts in their joint names and all securities and other property of theirs to the order of either:

Fees and Remuneration

Investment Management Fees will be charged quarterly in arrears as per the Bank's Current Investment Management Fee Scale (para 1.7) on the basis of the Asset valuation to be provided under paragraph 1.6.

The Investment Management Fees are inclusive of the Bank's safe custody charges but do not include correspondents charges which will be debited in addition when incurred by the Bank.

Normal commissions and transaction charges will be debited by the Bank in accordance with its current terms and conditions.

The Bank's fees will be charged and directly debited to the Client's Capital account even though as a result the account may become overdrawn. For this reason and also to cover any temporary mis-overdraft together with associated interest and cost, and hereby charges as security for such overdraft all Assets, to be applied by the Bank at its sole discretion in repayment. The Bank undertakes that the overdraft facility will not be used to purchase additional investments.

Purchases and sales of investments by the Bank for the Client may form part of larger transactions in which other clients or parties are interested. In such cases, the Client authorizes the Bank to retain any additional benefit that my be earned by the sale of such transactions.

Interest payable on Mosnic's Capital Accounts in accordance with the Bank's current terms and conditions.

Termination

This Agreement may be ended without penalty by the Client at any time. However, the Bank shall give at least 30 days written notice of termination.

On termination the Bank will not execute any further transactions except at the Client's request and will arrange for delivery of the Assets to the Client, as soon as practicable, after deductions of management fees and other sums due.

Criteria for the Appraisal of BJ-S Means and Methods

The Controller learnt that it would be difficult to quantify why a portfolio manager should be selected. Rational measurement of agent qualities may not be easy. One had to go through a complicated process which involved a lot of qualitative judgement. However, the Controller tried to evaluate the result of appraising BJ-S. There had to be some criteria. Thus, the Controller evaluated (a) the means, and (b) the methods in BJ-S as follows:

(a) **Means**

(i) Global Portfolio Management Capability:

The Controller became convinced that BJ-S would be qualified to manage a domestic and global portfolio (internationally) in the major financial markets with its portfolio managers officiating from Western Europe, Japan and North America.

(ii) Staff:

BJ-S staff were found to be adequately experienced (i.e. with a long period in service and satisfied (motivated) to implement the investment strategy). The Controller found adequate number of strategists (economic analysts), traders, marketing experts, administrative and support staff.

(iii) Support:

In all the major aspects of security investing, BJ-S had been found adequately supported by security analysis and economic research facilities. BJ-S also was adopting an acceptable global investment strategy produced by a fairly organized system. The world research resources used by BJ-S was adequate.

(b) **Methods (Philosophy)**

(i) Strategy formulation:

BJ-S portfolio management was tailored with room for flexibility to meet the specific investment objectives of Mosnic's stakeholders. BJ-S agreed to try to invest in relatively under-valued securities within Mosnic's risk

tolerance which might shift. Indeed, BJ-S showed maximum flexibility to meet the changing requirements of Mosnic.

(ii) Fixed Income Philosophy:
BJ-S view on bonds maturity, quality etc. were compatible with Mosnic's current income and liquidity requirement plans. Regarding the problem of interest, BJ-S showed the utmost cooperation to preserve the restrictions set by Mosnic.

(iii) Criterion for Equity Selection:
Generally, Mosnic did not see a problem with BJ-S with regard to the above.

(iv) Personalization of Service:
BJ-S ensured to the Controller that their client communication system supported the maximum possible frequent contacts with Mosnic and could be a guarantee for individualization of the discretionary account management. The BJ-S style of portfolio management would cater for personalization of investors' services. These personalized services could provide for amending BJ-S models to different investors objectives, expectations and concepts on risk. BJ-S portfolio management service programme was found satisfactory in terms of: (1) daily supervision of the portfolio decision processes; (2) monthly investment policy commentary; (3) quarterly review of the portfolio; (4) quarterly appraisal of the portfolio; (5) continuous personal consultation; and (6) looking ahead to the bottom line performance.

Other Factors:

(i) Different investors had assigned management of more than 20 Billion U.S. Dollars to BJ-S. Thus BJ-S size was found satisfactory.

(ii) BJ-S had been operating for a long time.

(iii) The performance track record of BJ-S was satisfactory.

Based on these positive results of evaluating BJ-S means and methods, BJ-S was then chosen as a discretionary agent for Mosnic. The Controller had now to think about how to treat an external agent as an accountable unit.

Conclusion to the Selection of BJ-S

The case of BJ-S bank selection as a discretionary agent has disclosed the complicated processes followed by Mosnic for formulating the investment decision. Neither Mosnic nor BJ-S had to impose on each other a standard investment model/strategy. Investment strategy formulation would depend on: (1) BJ-S using its means and methods in conducting sophisticated analysis of the securities to be selected; and (2) the Controller continuously reflecting the shift in the stakeholders' objectives. This process was different from the process by which strategy emerged with MIP. The impact of this difference on the principal's (Mosnic) control system is discussed in chapter (7).

The additional control requirements of BJ-S designed by the Controller were numerous and significant to compensate for BJ-S weaknesses in reporting and in the

other internal control aspects. The pattern of the Controller's involvement in formulating the portfolio strategy and in interpreting the objectives of the stakeholders' requirements to BJ-S was an important aspect of BJ-S selection processes.

SECTION 5-C
DE-SELECTION OF AN AGENT
THE CASE OF VONTOV BANK

OBJECTIVES AND OUTLINE

This case study attempts to describe part of the problem involved in maintaining a portfolio of agents. It tells the story of an agent selection and de-selection (termination of the fiduciary relationship) due to: (1) unsatisfactory performance resulting from the agents violation of Mosnic's investment strategy and the set of guidelines given to the agent, and (2) change of agent strategy, structure, and processes. The case study shows that the agent de-selection decision cannot be easily based on sophisticated rational measurement of the portfolio performance. It also establishes the fact the risk-adjusted return approach to the appraisal of discretionary portfolio becomes trivial if not coupled with a number of other processes.

The case study concludes by giving an overview of some of the problems confronting investment houses in the process of maintaining an appropriate portfolio of agents.

1. VONTOV SELECTION PROCESSES

The Stock Market Rally Attraction and the Need for Vontov.

On his return from a trip to the United States, the Director of Mosnic said to the Controller:

"So many professional portfolio managers I have met with believe that 3000 on the Dow Jones before Christmas is possible. None of those professionals think that we would see the Dow as low as 2300. Stocks are selling at 20

times earnings. I think as a result of our conservative approach, great opportunities are lost.

Tell me, how can we take the advantage of the rally in the stock markets while ensuring that the principal to be invested will not be put into jeopardy? Can you think of controlling aggressive agents, tell me how?"

The Controller replied:

"Unfortunately we are taught a scaring rule. That is return is the function of risk. However, I think we can go a bit aggressive without exposing capital to loss."

The Director:

"Not a bad idea. Let us search for an asset manager to play that game. Mind your controls. We must not change the corporate asset allocation policy. Shares in the corporate portfolio must not exceed 20%. So we can be aggressive only within the 20% limit allowed exposure to shares".

So the Controller went back to the market for agents to look for an agent specialized in investment only in global equity portfolios.

Vontov Investment Strategy, Structure and Processes

The Corporate Controller proposed three agents to the Director for the special task. The Controller knew about Vontov from another agent. Moreover, Vontov had once sent its literature to Mosnic. This was kept in a file. The Director agreed to consider Vontov as a potential agent. Thus, the Controller went back to his old files to revitalize the contacts with Vontov.

The Controller started the analysis of Vontov in coordination with the Director and the other members of

the IPC. As usual, the Corporate Controller used the ASSPQ (Appendix 5.1) as a guide to ensure that all the aspects pertaining to Vontov strategy, structure and processes were covered. Notwithstanding the use of the ASSPQ, the study of Vontov was not conducted in the same chronological order of the ASSPQ (appendix 5.1).

Using different means of communication (e.g., the telephone, telefax, meetings and literature provided by Vontov) the Controller conveyed to Vontov that Mosnic wanted to be clear about the following aspects of the bank strategy, structure and processes (i.e., the means and the methods):

(1) Size of Vontov business.
(2) Investment Approach.
(3) Information access.
(4) Experience.
(5) Branches.
(6) Custody Services.
(7) General Investment Philosophy and Style.
(8) Portfolio Structure.
(9) Risk Management.
(10) Investment Decision Making Structure.
(11) Powers Required by Vontov.
(12) Approach to portfolio performance
(13) Fees
(14) Readiness for Informal Cooperation and Communication.
(i.e., personnalization of services)
(15) Size of Global Equity Portfolio.
(16) Management of Currency Risk.
(17) Technological Support.
(18) Reporting and Internal Accounting Control.

The Controller asked Vontov to explain how (despite the financial market's volatility) one can select the least cyclical shares to construct a conservative portfolio. In response to the Controller's request, Vontov showed a high level of cooperation. In fact, the appraisal process was long and it required a lot of effort

and time from the Controller. To make it simple, the following is a summary of the feedback by Vontov in response to the Controller's inquiry about its methods and means.

Vontov as a Global Equity Portfolio Manager

Vontov representative said:

"If an investor wishes to appoint outside managers to advise on equity investments in international markets, an early decision has to be taken on whether to appoint a global manager to advise on equity markets worldwide or a regional equity specialist in one or a number of markets. We believe that there is merit in considering a `global' approach at the outset because most value added is gained from a manager switching between markets, rather than from a manager seeking to outperform an index in one specific market".

Size of Vontov Business

The Vontov Group had over US $16.7 billion of assets under management and had been advising its clients on the allocation of assets internationally.

Market Coverage and Scanning Abilities

Vontov representative said:

"Vontov develops its existing presence and information base in the world's major markets (the United States and Japan) and maintains its comprehensive coverage of the U.K., continental European markets and Hongkong. In each of these Vontov has an investment management operation. In addition a representative office has recently been set up in South Korea. Another office was scheduled to be established in Australia in early 1987".

Staff Stability

"The company maintains a working environment which ensures continuity of staff. Vontov group has an exceptional record in this respect and this has been critical in building the excellent relationships Vontov enjoys with their professional clients. The group is also committed to developing further its international staff base,with a diverse pool of talent from different nationalities contributing to investment policy".

Information Access

"Vontov Maintained a full macro-economic and portfolio research capability based upon:

a) input from the overseas operations mentioned above;
b) competent full time in-house economists;
c) a quantitative research unit developing and proving new techniques for investment opportunity identification, analyzing risk and protecting portfolios.

The combination of the above ensured a diverse and consistent input of macro-economic research, together with sector and company analysis, to contribute to effective performance".

Experience

"Vontov had a long experience of investing worldwide. Vontov Investment Management Limited (VIM), which assumed all the investment management activities of Vontov & Co., Ltd. in early 1976, is responsible for the management of international equity portfolios and for coordinating the specialist expertise in the group in various markets".

Branches

"The full investment process i.e.dealing, administrating and reporting of a global portfolio is conducted out of London. In the management of the Far East segment of portfolio, VIM would want to involve as closely as possible the London office of the company's Far Eastern specialist fund managers, Vontov international Investment Management Limited (VIIM). VIIM would be responsible to VIM for the performance for that segment of the portfolio and would be remunerated by VIM".

Custody Services

"The registration, nominee and safe custody services of Vontov Brothers & Co., Limited (the banking arm of the Vontov group) are available if this is permitted and desired".

General Investment Philosophy

"VIM's investment aim is to achieve consistent above average performance in the expectation that this will translate to top quartile performance over the medium to long-term without incurring excessive risk in

attaining short-term performance. The virtue of this approach has been demonstrated in the performance of existing clients.

This philosophy applied to VIM's Global Investment Management requires a decision making process which combines macro-economic 'top down' assessment of markets together with a micro-economic assessment of sector and company potential. It requires an active approach to determining and comparing value (and assessment of the time horizon within which value will be recognized), and decisive moves to secure perceived benefits.

VIM's style is therefore to take positive decisions in terms of asset allocation geographically and by sector. Vontov believes strategy applied to markets affects turnover. Investment managers who seek to outperform increasingly rotational markets by anticipating short term sector and company preferences have a relatively high turnover; those managers who by temperament and philosophy are disinclined to follow the rotational aspects of markets and who invest on the basis of fundamental analysis, will have a lower turnover.

Vontov's basic philosophy places them in the second category but rotational characteristics have in recent years made acceptance of a high level of turnover essential to performance in some markets such as Japan where interest - and performance - tend to be concentrated. The greater part of our overall turnover has, however, continued to result from changes of investment strategy -i.e., between rather than within markets.

A feature of Vontov investment management, which has led to superior performance in the past, is the lower emphasis placed on investment in the U.S. This remains our current stance, although there has recently been some increase of the U.S.A. at the expense of Japan. Vontov have been consistent in giving higher emphasis than many competing managers to Europe over the past three years".

Investment Style

"Vontov approach to risk can perhaps be illustrated by the long-term minimum/maximum ranges they would consider appropriate for an international portfolio. In terms of sector and stock selection, they would be driven by stock selection, with consequent sector weighting, which would nevertheless be monitored, a secondary consideration".

Portfolio Structure

"The structure of the portfolio in terms of weighting and number of stocks held will vary from market to market and portfolio manager to manager. The overall number of stocks in the portfolio is unlikely to exceed 80 stocks in normal circumstances".

Use of Quantitative Techniques in Assessing Risk

"Periodically, the position of international portfolios is reviewed and adopted by the use of optimization techniques. In these exercises, an efficient frontier is drawn up for portfolios on the basis of six monthly forecasts of returns and volatility of returns. Five geographical allocations for portfolios are arrived at, varying from a risk averse allocation up to maximum return allocation, with risk being defined in absolute terms. If necessary, the position of the portfolio is changed to reflect the appropriate risk profile".

Decision Making Structure

"A Director of VIM is responsible for global portfolios. He sits on the International Investment Management Committee, which meets monthly, and, in addition to contributing to strategy, is responsible for

i) coordinating the equity specialists within VIM with those elsewhere in the Vontov investment group;

ii) monitoring the implementation of asset allocation decisions.

iii) monitoring liquidity levels.

He is to be assisted in the management of a portfolio by a group of equity specialists, who also sit on the Committee and include a representative from their office".

Investment Decision Making Powers Required by Vontov

"Vontov is comfortable with wide investment powers, in that they have found that their best performance has been achieved when they have been given wide discretion. This of course requires confidence that VIM will not abuse <u>this discretion</u> and, in <u>pursuit of short-term performance, accepts levels of risk, which are not consistent</u> with the philosophical approach outlined to Mosnic".

As part of their discretion, managers would welcome a facility to cover or hedge:

i) Currency exposure;
ii) Stocks;

by use of futures and options as available.

It might however, be unacceptable, and unwise, to permit the `gearing' of a portfolio by taking out uncovered open positions without the client's specific prior consent".

Measurement of Performance

"In Vontov, they believe comparison with domestic benchmarks of performance measurement although of critical interest to investors, is insignificant to measure global performance achievement. Investment performance statistics to demonstrate their competence in the U.S., U.K., and Europe and Far Eastern markets are available to clients if required".

Fees

"The inclusive investment management fee which they would charge for the management of a US $30 million global portfolio would be 0.7% on the first US $10 million, 0.5% on the next $15 million, and 0.375% thereafter. VIM would earn no further remuneration from the management of the portfolio. The above fee scale would include all incidental expenses, and travel and accommodation expenses in connection with reporting visit and a less formal interim visits as required by Mosnic".

Readiness for Cooperation

"Vontov belief is that a successful ongoing relationship with any client can only be fostered by a full understanding of the client's requirements by them and of their philosophy and strategy by the client.In addition to full quarterly reviews, two meetings per annum is normally desirable. In addition Vontov would welcome the opportunity of receiving the Controller in London or in Geneva, in order that investment philosophy and process can be more readily appreciated and the control and capability of their organization demonstrated".

Size of Individual Global Equity Portfolios

"Global equity portfolios managed by VIM are divided into two categories:

	No. of Funds	Funds Under Mgt $M	Largest Size of Global Portfolio $M	Average of Global Portfolio $M
i) International Equity Element Funds.	*46*	*860*	*114*	*18.6*
ii) Global Equity Portfolio Managed for Institutional Customers.	*5*	*105*	*40*	*21*

International customers include Middle Eastern high value investors."

The Management of Currency Risk

"Vontov managers aim to avoid currency risks. Currency positions are always hedged, by one of two methods. The foreign exchange hedge or swap is less frequently used. This method involves the purchase of a particular currency by selling dollars. At the same time a commensurate sale of that currency position is fixed at an agreed exchange rate on some predetermined date in the future".

Technological, Computer and reporting support system

"Vontov portfolio managers have two important technical aids. The Computer Management Support System enhances investment decisions. The Computer Reporting System allows the availability of a continually updated, accurate picture of each client's positions. By means of this system comprehensive month end reports are produced for clients detailing not only the value of current holdings but also a summary of all transactions carried out for their account during the period".

The system had been developed and continually enhanced by Vontov since the late 1987. The system incorporated an evaluation system for the whole gambit of instruments. The system also tracks, on a daily basis, 3,000 equity related instruments and the underlying stocks, representing the largest markets.

At the beginning of each month, Vontov promised Mosnic to prepare a detailed valuation of the portfolio. The valuation would have a number of features, which would enable Mosnic to have a clear picture of the current position of its portfolio. The valuation package would also contain an extensive breakdown of the portfolio. All current holdings would be detailed, including the size of the holdings, the cost price and the market value. Each holding would also be valued as a percentage of the overall portfolio. The cash balance as well as the cash statement would give the full cash element of the portfolio.

The valuation also would include details of all holdings which would be bought or sold within the period which might not yet be settled. A list of all the transactions performed during the period would be part of the reporting product.

Finally the portfolio's performance record would be laid out for Mosnic so that it could appraise the current state of the portfolio.

2. THE RESULT OF EVALUATING VONTOV AS A POTENTIAL AGENT

Having gone through the process of studying Vontov's strategy, structure and processes, the Controller became more convinced that there could hardly be a universal truth about agents' means and methods. The satisfaction of the principals with the agent means and methods specifically depended on what the agent would be used for.

The Controller was satisfied with the means and methods of Vontov which were different from those of MIP and BJ-S. The analysis of the case studies in the next chapter will disclose these differences.

THE METHODS

(i) THE GLOBAL EQUITY PORTFOLIO MANAGEMENT CAPABILITIES:

Vontov was found unique in its belief that there could be merit in considering a `global' approach to equity portfolio management at the outset because most value added would be gained from a manager switching between markets rather than from a manager seeking to out-perform an index in one specific market. For globalization of equity investment, Vontov demonstrated superb infrastructure.

(ii) INVESTMENT APPROACH

Vontov's philosophy of achieving consistent average performance in the expectation that this would translate to top performance over the medium to long-term without incurring excessive risk in attaining short-term performance, was a good sign to Mosnic.

(iii) RISK ASSESSMENT TECHNIQUE

The study of Vontov's strategy, structure and processes indicated that it (Vontov) could apply sophisticated security analysis techniques to select the stocks. In addition, Vontov promised to be flexible in understanding the objectives of the stakeholders to assess

risk as might be necessary and required by the principals. In fact, Vontov demonstrated high concern about personalization of its services.

THE MEANS

STAFF:

Vontov succeeded to maintain a working environment which ensured the continuity of its professional personnel. The number was adequate. The staff specialism and experience was satisfactory.

DECISION MAKING STRUCTURE

The team formed of the director and the equity specialist was found qualified. The team structure was made in a way that the quality of the decision would be cross-checked.

TECHNICAL, COMPUTER MANAGEMENT SUPPORT, AND THE REPORTING SYSTEM

The following were provided to Mosnic by Vontov bank's technological, computer and reporting support system:

(i) Month end reporting with details of the current holding's value and also a summary of all transactions carried out for Mosnic's account during the month.

(ii) Vontov system tracked on a daily basis, 3000 equity related instruments and the underlying stocks, representing the largest markets.

(iii) The month end portfolio valuation report demonstrated by Vontov was comprehensive. It reported interest separately.

The Controller was then authorized to agree with Vontov on managing a purely equity global portfolio. However, the following conditions were suggested by the Director to be observed by the Controller. First, Vontov would take profit on any equity which might appreciate to the level of 10% above its cost. Vontov objected to the practicability of such a policy, but promised to try it. Second, the Controller would closely monitor Vontov to ensure the application of the above policy. Vontov's reservation about the policy was that if a sale was made at 10% profit or more, there would be no option but to buy over-valued shares or to keep the realized proceeds in interest-bearing account which would mean violation of the Islamic precepts. Vontov also argued that if one had to sell in a rallying market, opportunities might be lost if profit taking time was earlier than it should be. Moreover, if one had to wait for market decline to buy again, one would never know how much would be the loss in the time value of the funds. In addition, Vontov argued that, whatever would be earned as interest income,would be a lost income for Mosnic because of the Islamic belief of the stakeholders and their guidelines to Vontov. Indeed, these points made by Vontov were very valid. The reader may wonder: So why did Mosnic persist with the 'sell at 10% up strategy'? In fact, the Controller and the Director

thought this strategy would increase the turnover (the number of times shares were to be bought and sold). So Mosnic would realize little gains in a number of transactions without setting a conservative standard ROI to be produced and consequently losing opportunities. The argument of Vontov was that the velocity of turnover of shares was not as fast as Mosnic imagined and the transaction cost was under estimated.

(3) THE POST-INVESTMENT RELATIONSHIP WITH VONTOV

The invasion of Kuwait left the global investors in panic. The markets were volatile and were extremely panicky. On 5/8/90 the Mosnic stakeholders decided to quit the stock markets completely and to remain 100% liquid. Just before the Gulf crisis, all shares in Mosnic portfolio managed by Vontov were appreciating by more than 10% as a semi-annual ROI.

Vontov was not active in taking the profits. Vontov seemed to favour a bottom line performance evaluation approach. Its representative has always pointed out that Mosnic should not panic at the decline of the investment value during crises. The representative repeatedly made arguments that profit-taking policy could release Vontov from claiming its full responsibility for performance. He also argued that such a policy might not be practical. Indeed, Vontov was reluctant and unsatisfied with this guideline. It thought the market would rally further.

When Kuwait was invaded, the Controller contacted Vontov to examine the situation in the portfolio following the unpleasant news about the stock markets. He received the following information on performance from Vontov.

PERFORMANCE:

- o For the third quarter of 1990, the Mosnic account declined by 18.2% in dollar terms. This was in line with the World Index.
- o For the year to date, the account portfolio has fallen by 16.5% versus a 24.3% decline in the World Index.

The Controller and the director expressed their worry about this poor performance and asked Vontov to explain the reasons and what should be done to rectify the critical situation. Vontov responded asserting the following points:

MARKET MOVEMENTS:

- o All equity markets registered a decline in the third quarter.
- o Japan, Germany, Spain and Sweden all fell by greater than 25% in local currency terms.
- o The dollar was generally weak against all currencies.

ASSET ALLOCATION:

- o The third quarter equity profile favoured markets with generally higher earnings growth. A fully liquid position will be adopted.

COUNTRY IMPACT:

- o Over the third quarter most emphasis was placed on the larger European markets with the exception of Germany.
- o Japan remained underweight.

The Controller then asked Vontov to disclose more information about market movements. Vontov replied as follows:

INVESTMENT COMMENTARY:

- There could be near-term uncertainties stemming from weakening economies and events in the Middle East.
- The longer term fundamental outlook could be favourable.
- During the third quarter of 1990, Mosnic account declined by 18.2% in dollar terms which matched the Index over the period.
- For the year to date, the portfolio had fallen by 16.5% versus a 24.3% decline in the World Index.

MARKET MOVEMENTS:

- The EAFE index fell by 21% during the third quarter, with most of its constituents declining by 15-25%.
- The U.K., Netherlands and Australia were relatively good performers, falling by 10% or less (U.S. was down 14%) as their energy resources apparently afforded some downside protection against the unsettled backdrop in the Persian Gulf.
- Most currencies strengthened by 3-5% versus the U.S. Dollar partially cushioning even larger index declines measured in local currencies.
- The widely publicized plunge in Japanese share prices in the quarter is notable principally because it follows the large declines seen earlier in the year, and not because of any uniqueness over the last three months when half a dozen other markets like Germany, Switzerland, and France suffered similar drops.

ASSET ALLOCATION

The Controller asked Vontov to advise him what it would be doing to overcome the declining situation of the portfolio.

Vontov said:

CASH POSITION:

- The near term aim is to generate full liquidity in the account in order to protect against current uncertainties and equity markets' volatility.
- Longer term, it is clear that, on a valuation basis, significant opportunities will be presented in many equity markets.

Vontov Commented on country impact by stating:

OVERWEIGHT POSITIONS:

- The largest overweight position was in France with an impact of 8% versus the Index. Singapore, Norway, Denmark, and the U.K. were also overweight.

UNDERWEIGHT POSITIONS:

- Japan continued as the largest negative bet throughout the period.

IMPACT CHANGES:

- The major changes in emphasis reflected a greater exposure to France. The sharp reduction in exposure to the U.S. was as a result of the decision to enhance liquidity.

The Controller asked for more reflection on the future outlook. The following was part of Vontov's commentary in response to the Controller's request:-

Vontov continue to believe that the world financial markets will produce very good returns over the intermediate to longer term.In fact, the recent pronounced weakness in securities prices undoubtedly provides a window of opportunity for investors with two year time horizon.

These investors can think of a rewarding bottom line ROI.

The Iraqi invasion of Kuwait came as a major surprise and did much damage to asset values (especially equity values which were very fully priced at the beginning of the third quarter). This "problem" will subside in importance as time passes, and market attention will focus once again on the enduring economic factors which ultimately determine asset values. The precise manner in which the "problem" is resolved is impossible to predict, so we have chosen not to repeat the various possible scenarios in this report. For what it is worth, we hope and expect soon to see quick action sufficient to push this issue off the front pages of newspapers worldwide.

The most significant economic effect of the Iraqi surprise has been to increase the price of oil to a newly sustainable level of perhaps $25 per barrel.It also pushed up interest rates, the price of gold, and military spending expectations, and these developments collectively should serve to push the impending peak in OECD inflation upward by perhaps one half of one percent versus our previous forecast and to push the valley in economic growth downward by a somewhat smaller amount. In other words, it should on balance produce a rather unimportant negative slip in economic terms.

Therefore, we have only marginally adjusted our OECD economic outlook to call for a somewhat "firm" rather than a soft landing. In most of the "Iraqi blip" already has been seen, the inflationary threat already appears to be receding and economic policies have begun to east in Australia, the UK and the U.S. where they had been tightened earliest, beginning two years ago.

We remain fully invested in accounts with somewhat longer time horizons, and in those with clearly-defined and fully invested benchmarks. While share prices could move lower on further bad news, the declines seen in the third quarter largely corrected the overly full valuations widely seen at the end of June.

Economic Outlook:

The OECD economic outlook continues to be relatively healthy and well-controlled. Growth is slowing as desired especially in the Anglo-Saxon economies, and inflationary pressures and fears are receding (with the notable exception of the uncertain prospect for oil). Earlier fears of strong consumption pressure from East Germany or Eastern Europe in general, and speculation about possible re-acceleration in demand growth in the U.S., U.K. and other countries have proven to be very wide of the mark. Monetary policies already have begun to ease in some countries and are likely to be relaxed in most others over the next two to three quarters.

We continue to expect slowing economic growth in the main economies and for the OECD as a whole. Most of these forecasts have been revised downward somewhat since June, especially for the U.S. and the U.K.

Market Outlook:

Share prices today represent much better value than they did three months ago. The large impact of the Iraq Shock on share prices worldwide has more than discounted the rather modest impact this development will have on inflation, economic growth, and interest rate levels.

In the very short-term, prices continue to be vulnerable to news from the Gulf and interest rate declines still appear to be a prerequisite to further advances in equity values, but we are inclined to look beyond any short-term "valley" in the expectation of rewarding gains just beyond.

As for currencies, Vontov now clearly favors the Yen which has begun to recover from a low level following a long period of under-performance versus its European counterparts. We are concerned about the U.S. dollar and currencies linked to it, is relatively low levels of U.S. interest rates, the short-term adverse effect on the U.S. trade deficit from higher oil prices, and continuing severe structural problems could push it significantly lower. With Sterling now a formal participant the EMS represents neutral ground between the Yen and the Dollar for the time being.

Opportunities among the main equity markets are less clear cut than they were three to six months ago, however, we continue to favour Continental European and Southern Asian shares. As a result of its dramatic fall this year, Japan now provides some interesting sectors and may be nearing a point where it would compare favourably overall. The U.S. and the U.K. are difficult to assess as they still face relatively severe economic conditions (with the related large, but unpredictable impact on corporate profits) and structural challenges (though the U.K. may have found new discipline within the EMS), while, on the other hand, they will take the lead in reducing interest rates. On balance we are prepared to increase U.K. holdings but still are reluctant on the U.S.

The Controller asked if there were any developments in the investment strategy.

Vontov replied as follows:

"For the first time in almost one year, Vontov is making some notable changes in their strategy.

- *Vontov continues to be fully invested in equities in the long-run.*
- *The Yen now is their currency of choice for holding cash and they may hedge into Yen from time to time. They are underweighting the Dollar.*
- *They maintain their European emphasis (in EAFE or Global Accounts with active asset allocation mandates), increasing the U.K.. somewhat. The timing of a further increase in Japanese holdings is an active discussion.*
- *They are less inclined than three months ago to increase the U.S. holdings, and would only do so while hedging out of the Dollar.*
- *They continue to heavily emphasize value, both relative and absolute, in selecting individual issues."*

The Vontov performance was not satisfactory. The loss was huge. The Investment Policies Committee met to discuss the situation of Vontov. Some argued that we should take the loss and move out from Vontov. Others called for waiting for a second rally in the markets to make-up the loss. Another opinion was to move the securities as they were to another agent to handle them. But underlying all this was a change in the investment approach followed by Vontov which the Controller was asked to investigate.

4. AGENT DE-SELECTION: A COMPLICATED PROCESS

The drastic decline in the portfolio performance following the Gulf crisis was not the only problem with Vontov. Indeed those losses were symptomatic of other concerns arising in Mosnic. Compared to the other portfolio managers serving Mosnic, the post-investment

relationships with Vontov were different for the following reasons. First, Vontov as a firm ended its joint venture with its American Partner. This change was significant to the ownership structure and to a number of processes in Vontov. Second, Vontov considered a merger with another firm. This meant to the Controller a change in investment approach. Indeed, Vontov effected a fundamental change in its investment approach (philosophy) which had been a major attribute for Vontov's selection to be an agent for Mosnic. Third, the split in Vontov led to basic shifting in the key professional personnel attached to Mosnic portfolio managed by Vontov.

CHANGE OF VONTOV STRUCTURE

During the Gulf Crisis, and while Mosnic management was working hard to manage this new upheaval, Vontov sent the following notice to the Controller.

"Vontov plans to purchase the 49% of its stake currently owned by ML-Bank. The closing of the purchase is scheduled for August 30, 1990. Under the act and in accordance with the terms of your asset management contract with Vontov, the purchase of this interest is deemed to constitute an assignment of your contract with the New Von which assignment require your consent. This letter seeks your consent."

Actually this information about the change of Vontov ownership structure led the Controller to raise a number of inquiries which were addressed by the Controller to the Director of Mosnic (the head of investment policy committee). These were:

1. How would the split in Vontov lead to changes in its organization for investment decision making ?

2. How would the split in Vontov impact its investment approach ? i.e., the style, the type of assets to be selected, risk taking attitude ?

3. Would this new situation lead to shift in the key portfolio management personnel ? If so, how long time will it take from the Controller to get familiarized with the new key strategists, economists, portfolio managers etc, who might have access to Mosnic's portfolio with Vontov ?

4. If the new key portfolio managers looking after Mosnic account have new views of shifting the current structure of the portfolio, is such shift in Vontov's general investment model affecting Mosnic's portfolio ? and at what cost ?

5. Given the new change in Vontov's ownership structure, how different would it be from the other agents in terms of performance measurement system ? and would this difference, if any, need from the Controller designing new monitoring system ?

6. Considering the structural changes in Vontov, if any, how would that impact its methods, processes and investment strategy ?

7. To Mosnic's Controller, what should be the further measures to cope with the subsequent shifting in

the strategy, structure and the processes of the accountable unit?

The director fully agreed with the Controller that there were fundamental changes in Vontov's means and methods and the Controller had to move quickly to gather information to decide whether Vontov could still satisfy the criteria set by Mosnic for agents selection or not.

Thus, the Controller started the process of working with the New Von (the new institution emerging from the merger) to clear all the above inquiries. In response to his oral inquiries, Von sent the following short message in a attempt to justify the new move.

"After more than ten years of co-operation, the Vontov global investment operations have matured to the point where the joint ownership no longer is necessary to achieve the objectives of both companies. Thus, Von has purchased Tov's shareholding in the joint venture.

The staff and products of Von will be positively reviewed, and as far as clients are concerned, it is "business as usual" but with an even greater ability to match resources to client needs. New products will be offered."

This short message from Von increased the worries of the Controller about what Von meant by "staff and products will be positively reviewed ..... New products will be offered".

The worry of the Controller arose from what could be the implications of these new changes to the investment strategy and the processes of Von.Moreover,the Controller needed to know about the impact of Von structural changes on its risk management style.

VONTOV CONSIDERING A NEW MERGER

While still striving to know more about the split of Vontov joint venture, the Controller received news that the New Von was contemplating entering into a merger with another firm. Naturally, the Controller became keen to know about the impact of the new merger on Von strategy, structure and processes. The focal point in the search of the Controller was to find out how the new changes of structure would impact the strategy and the risk management processes of the New Von. Knowing about these differences was fundamental to the Controller to determine what type of changes in the corporate management control system could be necessary to match with the new situation.

CHANGE OF THE INVESTMENT APPROACH

Indeed, the structural changes in Vontov which followed the split resulted in a fundamental shift in its investment style, type of asset selection, strategy etc. These changes even made Vontov different in a lot of attributes from MIP, BJ-S (and from other portfolios managers used by Mosnic but not studied in this research). Compared to the other agents, the above-mentioned differences could be clearly seen in the following presentation made by the new Von to convince the Controller and the Director of Mosnic to resume the fiduciary relationship.

CURRENT INVESTMENT STRATEGY

"The new Von continues to maintain its balanced strategy for investors, emphasizing the importance of quality during this difficult period. As a result of the uncertainties in the Gulf we have retained levels of liquidity higher than normal but as can happen in turbulent markets, unusual opportunities have surfaced in selective investments. We expect a firmer market trend for equities overall. Our recommended global asset distribution for a balanced investment account for the current quarter is as follows:

ASSETS ALLOCATION		R E A S O N
Asset	Current %	
EQUITIES	50	A redeployment of high cash positions by investors will sustain both equity markets.
CASH	30	Rates of return, adjusted for volatility, will be better for
TREASURY BILLS	20	equity investors than cash returns as equity markets rally
	---	in anticipation of monetary
	100	monetary easing. A firmer bond
	===	market will add to a better market trend.

	NEW VON CURRENT %	NEW VON PREVIOUS %	MORGAN CAPITAL INT'L. (WORLD INDEX) %	REASON
NORTH AMERICA	42	40	38.5	The net liquidation of U.S.stocks by foreign investors in excess of $10 billion during 1990 should be reversed as the U.S. dollar stabilizes.
JAPAN	25	20	29.8	An oversold market will benefit from gradual lowering of long term interest rates.

PACIFIC BASIC #	4	4	3.5	
WEST GERMANY	6	6	4.1	Continued high interest rates and ongoing budget pressures due to last year's reunification may retard further market advances.
FRANCE	5	5	3.6	
HOLLAND	3	4	1.8	The outlook of profit growth is deteriorating due to a high interest rate policy.
ITALY	-	2	1.7	
SPAIN	-	2	1.1	
SWITZERLAND	4	4	2.1	
SCANDINAVIA	1	1	1.5	
U.K.	5	6	10.5	The recession could be longer and deeper than previously anticipated.
OTHER	5	6	1.8	
	100%	100%	100 %	

PERSPECTIVES

Event Risk

The outbreak of war in the Gulf really represents the widening of a conflict that began with the Iraqi invasion of Kuwait. The initial reaction of the markets to the intervention of the United Nations forces has been positive; a powerful rally in stocks and bonds suggests that markets expect a short war and a short recession. While we sincerely hope that the market's optimism is justified, the balance of risk has clearly altered, such that disappointment either as a result of longer cyclical downturn or a wider and more protracted war may well reverse some of the market's recent gains. Such an investment environ-

ment is one which favors our philosophical preference for selective concentration of investment in quality stocks and the safety of government treasury bills.

Growth

The defining feature of the present economic situation has been the increasing divergence between the economic prospects of the U.S. and other Anglo Saxon countries and Germany and Japan. In the U.S. the slowdown is marked by the efforts of all sectors-consumers, corporations, and public-sector-to rebuild balance sheets in the wake of the credit binge of the 1980's. While the first signs of a slowdown are emerging in Germany and Japan, the central banks of both countries remain sufficiently concerned about latent inflationary pressures to remain quite

Inflation

restrictive relative to the U.S. Thus putting increasing pressure on the economies of other European countries tied to German policy through the Exchange Rate Mechanism.

Interest Rates

The last time the U.S. experienced a similar credit deflation, the Federal Reserve and Treasury responded by abandoning any target for the U.S. Dollar and lowered interest rates dramatically. We think that the Federal Reserve will respond to the present situation with a rapid reduction in the Federal Funds rate over the next two quarters. This should have a significant positive effect on financial assets in general, and on bond markets in particular, not only in the U.S., but also in Europe and Japan.

Currencies

These moves will also impact the currency markets, with the initial response being a further decline in the U.S. Dollar. The chances are very good, however, that the U.S.currency will turn sometime this year, as the perception grows that interest rates elsewhere, especially in Japan and Germany, will also decline.

INVESTMENT PHILOSOPHY

" Von believes in producing long-term returns that are in excess of the rate of inflation and of the rates available from holding cash through investment in global equity and fixed income markets.

The selection of an appropriate asset mix is of prime importance in achieving this objective, and regular asset allocation meetings are held to review the performance of, and outlook for, the major equity and fixed income markets of the world, as well as for the major currencies.

Both in equity and fixed income investment, quality is the prime consideration. For equities, this means investment in companies with above average internal growth rates and good dividend growth prospects. Emphasis is placed on companies with a proven management record and which are likely to remain competitive because of the excellence of their product profiles whether they are engaged in manufacturing or service industries. In fixed income markets, investment is restricted to high quality government paper where there is no risk of default.

Because Von believes in the long-term outperformance of equities, portfolios are to be 50% fully invested in equities. Although on occasions an amount of cash may be held for tactical reasons determined by Von."

It became obvious to the Controller that the strategy and the structure of Von had started to make differences in the investment processes of Vontov as will be explained later in this chapter. Indeed, the Controller could not be provided with adequate information to evaluate the impact of the new structure on the internal control system operated by the New Von to safeguard Mosnic assets.

Having gathered information about the new investment strategy and approach of Von, the Principals became unhappy with the way Von planned to manage the portfolio by investing in some funds created by Von. Moreover, the Controller expressed to Von the principals' reservations on having 50% of the portfolio in equities and 30% in interest bearing cash deposits which meant both aggressiveness and usury. He also explained to Von other problems which Mosnic started to have with the new fiduciary relationship.

The Controller discovered another problem. The New Von mentioned that it was in the process of developing new products and that it would have the discretion to invest part of Mosnic funds in these new products.

The Controller consulted the principals who expressed their concerns about these new changes. The Director reiterated that if the new Von did not meet the general criteria set by Mosnic and if the new structural changes were going to expose the portfolio to any risk, the Controller would have to advise urgently what measures he would take to protect the interest of the principals.

The Controller expressed to the representative of the New Von his reservations about the new products which were not part of the investment approach initially negotiated with Vontov. The Controller also asked the representative of the New Von to explain a number of aspects about the new products. These were:

1. What is the investment objective of each fund, and does each objective differ from the principals' objectives assigned to Vontov?
2. Which kind of asset mix was in each fund ?
3. Who of the portfolio managers known to Mosnic would be involved in these funds management ?
4. What would be the redemption period for each fund?
5. How much of Mosnic portfolio would be allocated to the new Von funds ?

6. How would the investment in these funds impact Mosnic's frequency of access to its assets ?

7. How much would be the fee Mosnic would be charged?

8. What were Von's forecast for each fund ROI?

The representative of the New Von gave the following brief replies.

MUTUAL FUNDS MANAGED BY THE NEW VON

FUNDING INVESTMENT OBJECTIVE	ASSET MIX
1.To achieve capital growth by investing primarily in equities, bonds and money market instruments offered in the international financial markets.	International Equities; 60% maximum. International Bond and money market instruments 40%. A maximum of 60% of assets may be invested in non-U.S. currencies.
2.To achieve capital growth by investing in equities in the USA, Europe, Japan and the Pacific Basin.	International Equities; 100% A maximum of 60% of total assets may be invested in non-U.S. denominated securities.
3.To provide long-term capital growth through investment in international bonds.	International Bonds; 100%. A maximum of 40% of the assets may be invested in non-USA currencies.
4.To achieve long-term capital growth through investments in cash and money market instruments.	Money Market Instruments: 100%. Approximately 50% of the assets may be invested in non-U.S. currencies.
5.To achieve capital growth by investing primarily in money market instruments, fixed income bonds and equities in the USA, Europe, Japan and the Pacific Basin.	Money Market Instruments: 100%. Approximately 50% of the total portfolio. International Bonds: a maximum of 35% of assets may be invested in non-U.S. currencies.
6.To achieve capital growth by investing primarily in shares of companies in the USA, Europe, Japan and the Pacific Basin. A minimum of 50% of the total portfolio will be invested in Islamic Trade Finance.	Islamic Trade Finance: a minimum of 50%. Equities: a maximum of 50% of total portfolio. Commodities: a maximum of 10% in precious metals. A maximum of 30% of assets may be invested in non-U.S. currencies.

VONTOV'S DIFFERENCES FROM MIP AND BJ-S

In a number of aspects Vontov was different from MIP and BJ-S. For example, the ownership structure in Vontov was different. Most of the portfolio managers in Vontov were specialized in equities. The investment approach in Vontov was different from the approach of the other agents. After the split, the difference in the investment approach became wider. Moreover, the shift in the investment approach led to major differences between Mosnic's objectives and those spelled out by the approach of the New Von. Indeed, the New Von became different from the other agents in aspect such as, assets allocation, choice of stocks and the products to be managed. Vontov had been different from the other agents even in the way it selected the equities based on income, growth,companies etc. Vontov wanted to remain fully invested in growth stocks of small companies. The number of stocks in the portfolio was also an aspect of difference between Vontov and the other portfolio managers.

In terms of investment input (i.e., sources of information), the New Von became more different from the other agents. In asset allocation policy the views of Von were different from the other agents in: (1) monetary economic analysis, and (2) interest rate forecasts. In terms of security selection, Von had different views about the industry factors and the fundamentals of security.

After the split in Vontov, the Controller observed that the investment decision making in Vontov had changed.

For example, the new portfolio managers were given more powers than before to select the securities with a general policy guideline. This was found to be different from the system followed in MIP and BJ-S where the investment policy committee used to approve comprehensive lists of securities.

On one occasion, the Controller tried to discuss with the new portfolio manager assigned by Von to Mosnic account the cost impact of shifting the portfolio structure corresponding to the proposed change in Von strategy. The portfolio manager argued that in the long-run the new strategy would out-perform ROI expected for the current one.

The Controller discussed the question of parking 30% of Mosnic resources in interest generating cash accounts and stressed the concern of the principals with interest. The representative of the New Von mentioned that to the opinion of his institution and to his view the new model being proposed would achieve diversification of the portfolio in a way suitable for the prevailing market situation. In this respect, Von was different from MIP and BJ-S. Also these opinions of Von indicated differences from Mosnic objectives.

In measuring their investment performance, Vontov and the New Von had similarities and differences from the other agents. They were in agreement in the following: (1) measurement of performance based on asset allocation

at market value including the realized and the unrealized gains; and (2) accounting for the return on time weighted basis.

The major difference between the New Von and the rest of the agents was that the latter had more readiness to take into consideration the way the principals perceived risk in measuring risk and return. The new Von wanted to stick to its model irrespective of the views of the principals about:

(1) Von funds investment.

(2) Interest bearing investments.

(3) Over-exposure to equities.

The differences in strategy and processes were serious enough for the Controller and the Director of Mosnic to quit doing business with the New Von.

The views of Von about comparing investment performance were different also. In this respect, the representative of the New Von made the following statements.

"It is our view that the investors must not compare the portfolio we manage with other portfolios managed by others. We have our own philosophy of assets allocation and assets classification. By the assets classification we mean, for example, the convertible bonds are not to be included with equities."

He further added that, *"from what we have learned by going through your account background, your investment objectives, and your views about investment risk that in some times your objectives were fundamentally different from the objectives aimed at by the models set by Vontov. There have been a great deal of compromise going on between your objectives. We suggest you give us more freedom and to agree with us to judge on our performance after a longer period. We are comfortable with say 3-4 years. We know you care very much for timely surveillance of what Vontov achieves compared to the*

other managers you may be dealing with. In doing this, some investors like comparing their portfolio to market indices. It is our view that: (1) you can not use one index for all purposes. (2) Each index is made up of specific list of securities. These securities may be weighted in a specific way, and (3) The prevailing indices have problems and shortfalls."

In this particular aspect the Controller asked for more explanation. Von representative replied:

" Standard and Poor's 500 policy is to measure the pattern of common stock movements; for this purpose 500 large companies are used; the list is timely revised for change by a body in S & P's. Standard and Poor's 400 deals with the measurement of industrial stocks; in all other respects it is similar to S & P 500. Dow Jones industrials deals with measuring movements of industrial companies. This includes 30 large industrials.It does not change so frequently. In cases of merger or acquisitions for example changes are made."

THE DECISION OF TERMINATING THE RELATIONSHIP WITH VONTOV

Mosnic arrived at the conclusion that the strategy, structure and processes of Vontov had changed to levels which were inconsistent with Mosnic investment objectives. Moreover, compared to the performance of equities assigned to the other portfolio managers, the results reported by Vontov during the Gulf Crisis indicated imprudence in the selection of securities. Moreover, the risk management style of the New Von showed fundamental differences from the investment risk perceived by the principals. Thus, it was decided to terminate the formal fiduciary relationship with Vontov. The formulation of the de-selection processes was not easy to take and required a close analysis of Vontov's change in investment style and policy. It involved the application of complicated systems before the final judgement was made.

SECTION 5-D

CONCLUSION TO CHAPTER-5

EMERGING ISSUES FROM AGENTS SELECTION CASE STUDIES

The selection of the three agents is an integral part of the corporate investment decision. The three agents were selected to operate as part of the portfolio of agents maintained by Mosnic. The three case studies also showed the maintenance of the portfolio of agents could be a cornerstone for allocating the resources of Mosnic.

Indeed, the pre-selection processes conducted by Mosnic revealed other processes which were significant for the formulation and later on the implementation of the strategic investment decision. These were complicated processes and the Controller found it difficult to follow a totally objective planning perspective to carry out these processes. Some of the important processes were: (1) evaluation of the three agents' strategy, structure and processes; (2) introducing the principals' investment objectives, such as assets mix, currency allocation, income and growth mix, the investment period etc. to the intended discretionary agents; (3) amending the investment models and the proposed investment strategies of the discretionary agents to make them compatible with risk taking attitude and hence the objectives of the stakeholders; and (4) determining the control needs of the specific agents to compensate for the manageable problems found in the intended agents' methods and means.

In fact, these processes clearly projected the different functions and roles of the three agents in the principal's strategy formulation process. It was evident that each one of the three agents would participate in negotiating and forming the investment strategy which would be satisfactory for them to implement and which would accommodate the specific requirements of Mosnic's stakeholders. The Controller played a key role in orchestrating the interaction between the three agents and the principals.

The Controller had problems in determining the control procedures which would keep each agent under control. Indeed, the Controller found these problems a lot more difficult than what he had expected after studying the general control problems of the company [see chapter (3) the case of Mosnic]. The Controller found the three agents different in methods and means. These differences were clearly impacting the manner by which each agent would analyze securities. This meant that the Controller would end-up with three agents managing three portfolios different in aspects like the geographical mix of the assets, the currencies mix, income/growth mix, industry mix, etc. In other words, at deeper levels of the investment decision, the three agents were expected to be extremely different. This actually made the Controller feel that, as he went deeper to understand the control processes for monitoring the discretionary portfolios, life was very complicated. Thus, the Controller thought it

could be quite inappropriate to assume that there could be a universal truth for the three agents control requirements.

Another problem which beset the Controller in the three agents selection processes was that he could not arrive at rational (measure-based) criteria acceptable to the three agents to set an ROI standard for portfolio performance appraisal. Indeed, the stakeholders would not even rely on a measure of ROI relative to the best (or average) achieved in the market. They thought their perception of the markets' uncertainty was not well reflected by the rational economic and financial or security analysis carried out by the agents. Their capital preservation objective, their religious percepts, risks they assumed in their investment other than the marketable securities, their own experience with the financial markets, their own calculation of the transaction costs (including extensive tests required of new agents), their conception of realizing gains, their forecast of their future cash requirements in different currencies, were all factors about which agents would need additional information in order to analyze the characteristics of risk and uncertainty taken by the stakeholders. The Controller discovered that quantitative risk measurement techniques of return were considered simplistic and too theoretical by the stakeholders. The absolute measures which include standard deviation, variance,and mean absolute deviation which the agents used

to measure portfolio rates of return in order to measure the volatility or risk of the portfolios were viewed as techniques perhaps useful to the agents, but not so useful for Mosnic's principals and the satisfaction of their own objectives. For that, these statistical devices seemed of marginal significance.

In fact, using the standard deviation, the portfolio's variability of returns was being measured by the intended agents in relation to the average return. In the beta analysis conducted by the agents, the portfolio's covariance was measured in relation to the market place, but the principals considered Beta, which is a calculation that results from making an historic regression analysis, as inadequate for their purpose. In fact, relating two variables such as:

(1) rate of return on a stock or a portfolio; and

(2) the rate of return of the market,

was considered hardly applicable to the principals. They believed the markett portfolio risk classification into diversifiable or non-diversifiable risk was different from their conception of the risk involved in the fixed income instruments. This was also complicated by their beliefs whereby fixed income (interest) also involved religious risks. Moreover, they wanted a portfolio which would reflect the shift in their perception of future market place specific conditions which were regularly reviewed and revised. Therefore, they thought measurement of ROI and assessment of historic, long-term covariances could

lead to rigid and simplistic decision-making besides being time and effort consuming. Rightly or wrongly the Mosnic stakeholders' conception of risk was fundamentally different from that implied by simply adjusting the expected returns to reflect the portfolio beta. Risk was therefore to be continually re-assessed and managed and, if necessary, avoided - not calculated passively and merely 'compensated' for by expected return which might not materialize anyway.

The Controller also went through a complicated process to make the three agents understand that the principals would often intervene with the agents to explain the process by which the investment objectives would shift in order to avoid currently perceived risks. At the same time, the Controller explained to the agents the process of holding them accountable for their performance despite the intervention of the principals because, after discussion and interaction, the agents were supposed to formulate portfolios to reflect the principals' current desires. Of course, this fluid process of objective shifting and interaction made it more difficult to assess whether agents were at fault, but, in principle, they were still responsible for portfolio construction and revision.

ISSUES EMERGING FROM AGENT DE-SELECTION CASE STUDY

The de-selection of Vontov bank indicated that maintaining a balanced portfolio of agents prepared to

interact with Mosnic was a key factor for appropriately allocating the resources of Mosnic. In other words, Mosnic de-selected Vontov to remain diversified over the least risky discretionary managers. However, Vontov could not be de-selected based on a risk-return performance measurement criterion alone. The Controller discovered that the process by which Mosnic terminated its relationship with Vontov was complicated and needed the consideration of a number of inter-connected factors before a final judgement was passed. The incompatibility of Vontov's decision processes with the shifting expectations of the principals was proved to be too complicated to be measured simply by applying rational ROI criteria. Although there had been a large loss at the time of the Gulf crisis, deeper inquiries were needed to see whether in Mosnic's view, Vontov's investment strategy had been imprudent and inconsistent with Mosnic's desires.

The cases also projected the fact that Mosnic had to depend on a mix of performance appraisal approaches to arrive at the conclusion that the fiduciary relationship with Vontov had become unmanageable. Hence, the Controller learned that the agents pre-selection processes had to involve designing a suitable mix of the procedures to evaluate the performance of the intended discretionary portfolio managers.

Furthermore, the emerging lessons from the pre-investment case studies clearly show that life is also

complicated in the post-investment stage (i.e. after agreeing to work with specific agents). Therefore, it seemed necessary to conduct more detailed post-investment case studies to understand further the post-investment strategic control processes involved in monitoring the discretionary agents. These are presented in the next Chapter.

CHAPTER - 6

AGENTS MONITORING AND PORTFOLIO PERFORMANCE EVALUATION CASE STUDIES

Objectives and Outline of the Chapter

Performance evaluation of the discretionary portfolio managers was a major control issue in Mosnic. The effectiveness of Mosnic's control system depended to a great extent on evaluating the performance of the discretionary agents in the post-investment stage.

This chapter is concerned with post-investment case studies for two agents. Section 6-A deals with the post-investment processes carried out by Mosnic to monitor MIP bank. While Section 6-B deals with BJ-S bank. The comparison between the two cases aims to project the differences in the decision and the control processes between the discretionary agents serving in the same portfolio of asset managers.

This chapter also describes Mosnic's processes of interaction with the two discretionary agents in the post-investment stage. The description unfolds strategic control aspects and throws light on the responsibility accounting problems caused by the difficulty faced in setting standard financial elements for the agents (the accountable units). The post-investment case studies also describe strategy implementation, operation, and the tactical investment decisions.

Section 5-C summarizes the major issues emerging from the post-investment case studies. In this section the Controller reflected (by comparatively looking into the two cases) on how the differences in the agent's means and methods led to differences in the principals' control processes.

SECTION 6-A

THE CASE OF MONITORING MIP BANK

I. Post-Investment Control Process Overview.

It is impossible to describe in few pages all the iterative process which took place between MIP and Mosnic in the post-investment stage. Therefore, it seems logical once again to simplify the description by depicting such an iterative process in a diagrammatic framework. Fig. 6.1 represents a framework developed by the Controller to project the independent variables which influenced the post-investment control processes and actions which took place for monitoring the performance of any agent. Both time and the state of financial markets were the key influencing variables as shown in Fig. 6.1 which also explains the shifting process of the key variables in the general conceptual framework of the research (Fig.4.1 in chapter 4).

The following is a brief description of Fig. 6.1.

THE KEY VARIABLES SHIFTING OVER TIME (Fig. 6.1)

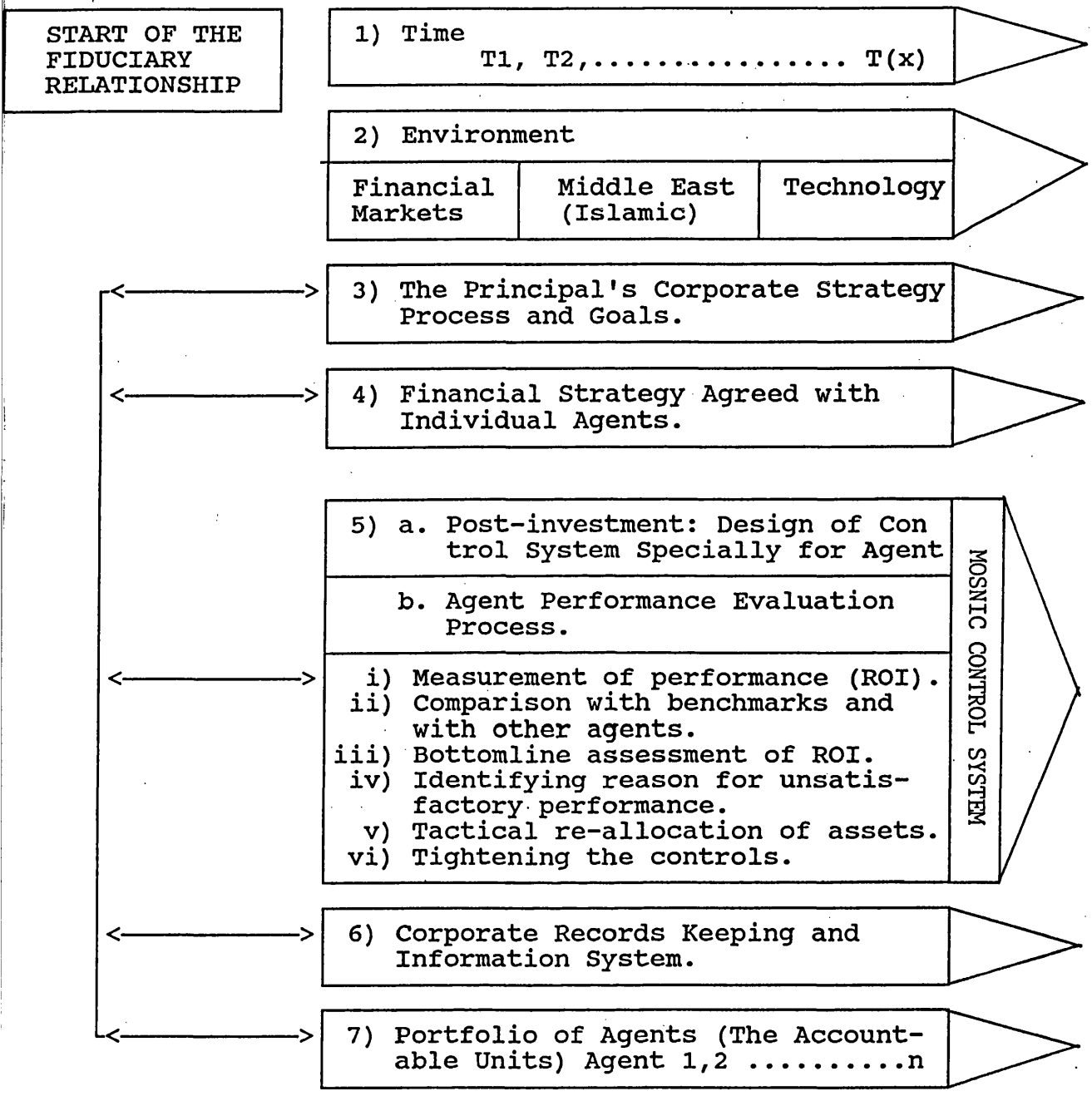
(1) Time Factor.

The upper top block (1) in Fig. 6.1. represents the time factor subsequent to investing through MIP.

(2) Environment.

Block (2) represents the environment. Environment refers to the global financial markets, the Middle East

Fig. 6.1
THE KEY VARIABLES FOR AGENT
POST-INVESMENT MONITORING PROCESS



Islamic environment, and technology. As time passes, the financial markets change depending on a lot of external factors beyond the control of the investors and their agents. Over the history of Mosnic, information and communication technology has advanced. MIP as a new agent had an application of technology which could be different from the rest of the discretionary agents.

DEPENDENT VARIABLES
(Fig. 6.1)

(3) Corporate Investment Strategy and Goal.

The financial strategy negotiated with MIP during the selection process was part of the corporate investment strategy pursued by Mosnic. The agreement on the financial strategy was not the end of the problem. As time passed, MIP and Mosnic negotiated a number of strategic matters. The selection of MIP as a discretionary agent involved formulating an important segment of the corporate strategy in complete coordination with MIP. The addition of MIP's investment strategy to Mosnic's portfolio of strategies made the Controller think about the necessary amendments of the strategic control system.

As time passed, the corporate investment strategy changed in response to two factors: (1) change of the stakeholders' desires and, (2) change of agents' strategies.

One of the major controllership tasks in Mosnic was to monitor the strategy, structure and processes of MIP which were found in the selection (appraisal) stage. This

process (described in Chapter (5))ended up with evaluating the methods and the means of MIP. Any major change in MIP strategy, structure or process, was communicated by the Controller to the Stakeholders. Mosnic management would then consider with MIP the amendment of any unsatisfactory aspects in MIP's tasks, methods, and means to eliminate agents' weaknesses.

(4) Financial Strategy Agreed with MIP.

As time passed, the stakeholders, MIP, and the Controller showed high response to the volatile financial markets. The strategy initially negotiated with MIP did not remain static. Re-formulation of strategy was a key process to adjust the corporate strategy parallel to the change in the financial markets. The need for the re-formulation was triggered by both the stakeholders' interaction with the markets and by the interim appraisal of the portfolio performance. The re-formulation of the strategy also reflected the shift (over time) in the Principal's objectives.

(5) Mosnic Control System/Controllership.

The control system factor shown represents the post-investment control processes carried out by Mosnic to evaluate the performance of MIP and to monitor the investment decision processes related to its strategy implementation. As time passed, the strategic control system changed to keep track of the impact left by change in the environment on MIP's strategy and processes.

(6) The Principal's (Mosnic) Record Keeping and Information System.

Also, as time passed the environmental impact on the corporate goal setting led to a change of MIP's financial strategy which had to be met in terms of achieved objectives. Such a process led to changes in the corporate information system necessary for the strategic control procedures designed to monitor MIP's investment decision processes.

(7) Corporate Structure (Portfolio of Agents).

Once the asset management agreement was signed, MIP was considered a responsibility centre (a new accountable unit) within the structure of Mosnic. Moreover, as time passed, the control processes (Block 5), and strategy and goal setting (Block 3) were interacting and changing while taking on board the strategy agreed with the new agent. An addition of a new discretionary agent and the formalization organizational relationship with the selected discretionary agent, meant a change in Mosnic's structure. Change of structure led to shift in the control processes.

II. Description of the Post-Investment Control Processes

Summary

The post-investment interaction with MIP was extremely frequent and a continuously circulating iterative process.

Signing the asset management agreement was the start of the formal and the informal fiduciary relationship between Mosnic and MIP. The process started by the Contro-

ller trying to ensure that stakeholders' goals and guidelines already negotiated were maintained by MIP. The Controller started contacting MIP expressing the stakeholders' readiness to discuss more realistic goals. He found a positive response from MIP.

Before any action was negotiated, MIP had to report on its recent performance as well as to comment on its future outlook, alternative strategy and any proposed investment objectives. On receipt of the reports, Mosnic expressed its worry about any declining performance. Indeed, the Controller was always approaching MIP to disclose any problems related to the portfolio performance. It was then argued by MIP that the negative performance could be good as it outperformed the market indices. Although Mosnic was concerned about the poor performance reported by MIP, it did not terminate the fiduciary relationship for two considerations. First, markets in general were not doing well. Second, it looked forward for improvement in MIP's performance in the long-run run. Mosnic expressed its worry about the low ROI and requested MIP to propose how the latter thought a corrective financial strategy could be formulated.

MIP proposed a re-structured portfolio which showed more conservative allocation of assets. Short-term positions with fixed income were also suggested. From a religious stance, Mosnic did not feel comfortable with the fixed income short-term positions. Thus, MIP was requested

to consider that special requirement of the stakeholders. MIP appreciated the request, but emphasized the technical difficulty of preserving it because of the domination of interest system in all the Western financial and economic systems. MIP promised to overcome this difficulty without guaranteeing the result of truly eliminating interest.

Amended objectives, revised strategy, new guidelines and adjusted asset mix policy were negotiated and approved. Thus, Mosnic started a new round of the fiduciary management process. Needless to say that the negotiated financial strategy was not the last one. The market volatility continued. Mosnic and MIP negotiated new strategies, new objectives and alternative composition of the assets in the portfolio. The circle continued in an iterative process. Every time the following process was not typical to the one which preceded it, the Controller started to become less confident on the risk-return analysis models presented by the agents.

Detailed Description of MIP Monitoring Processes
Amendment of the Financial Strategy

Soon after the inception of business, MIP reported an exceptional decline in the value of the portfolio. The financial markets were nervous and this led to instability in the investments performance. The principals found it necessary to take new measures to cope with the new market situation. The Controller, who was told to seek the opinion of MIP, sent the following advice:

" *We are unable to foresee how the market will behave. We feel we need to change the strategy by taking more defensive posture. Will you please reflect on:*

a] Macro economic factors we have to account for in planning. i.e., your outlook.
b] How does MIP judge the markets?
c] How does MIP see the future of the U.S. equities?"

MIP replied:-

"A] Macro Factors.

On a global basis there seems to be little reason for, or desirability of, a slow-down or recession in 1988, perhaps not even in 1989.

Globally, inflation is not a problem, unemployment is excessive, and capacity remains ample. There are, however, several serious problems reflecting the uneven and unbalanced nature of the growth pattern to date.

The expansion imbalances appear to have reached a critical point. The U.S. consumer now must restore his savings at the expense of consumption (especially when compared with his Japanese or German counterpart).

We know that a critical point has been reached because the world's financial markets are telling us so. Dollar weakness threatens to put severe upward pressure on U.S. interest rates and perhaps U.S. inflation as well. Stock markets are still extremely nervous.

It seems that the world economic and financial system is in a period of maximum strain and high uncertainty. At best global economic expansion in aggregate seems likely to slow over the next several quarters, particularly in the U.S., Germany and other European economies. At worst, we may be about to enter a recessionary period or one of the very flat output.

B] Market Judgements.

Overall, it seems to us that 1988 (or most of it) may be a difficult year in which to generate attractive returns. There is an uncomfortably high possibility that security values could fall further in the atmosphere of uncertainty generated by volatile exchange rates, conflicting policy statements, and a U.S. presidential election campaign.

As a result we feel it is only prudent to take some defensive steps. Though we seldom hold cash as a matter of policy, there seems to be little opportunity cost to holding cash over the next few months. Bonds seem attractive, especially since we would be willing to

hold through short periods of higher interest rates. Equities almost certainly will remain volatile and selectivity by market and sector never has been more important.

C] Equity Strategy.

Our basic strategy is to use the next few months to re-access the developing economy and to retain flexibility. In the first instance this involves holding some cash (and in the short-term, bonds) in order to be able to take advantage of possible market declines, a rare stance for MIP to adopt. In addition we are avoiding the US dollar, companies with great exposure to the US consumer, many European markets where growth is likely to be sluggish, and shares which rose to excessive valuations in the long bull market since 1982.

In the near term, the trend of US figures will be viewed by both investors and policy makers as a key test of whether the 're-balancing' process is already underway, or whether further moves in interest and exchange rates are necessary. Clarification of this issue is the major determinant of our strategy.

On a longer view, it seems clear that the case for international investment remains strong. There are distinct differences in country performances over the last twelve months and we are sure that there will be a similar range of opportunity over the next twelve months, reflecting the differing abilities or political, economic and corporate management around the world to react to the changing environment."

Problems in Change of Financial Strategy

The Controller conveyed to the IPC the feedback from MIP. It was evident that the financial strategy previously agreed with MIP was superseded by the markets volatilities. Again the Controller had to consider re-formulating the strategy in consultation with MIP. Because it took a defensive strategic posture, it seemed that MIP had no choice but to park the funds in interest bearing money market instruments. This meant to the Controller further losses for Mosnic and violation of the Islamic restrictions of the stakeholders.

On the other hand, despite the depressed performance, Mosnic could not decide on the de-selection of MIP for the following reasons: (1) MIP performance was not worse than the market indicators; (2) MIP did not promise to achieve a standard ROI target; (3) Mosnic hoped MIP would achieve a bottom line satisfactory performance in future; (4) Mosnic was reluctant to take the cost associated with de-selecting MIP; (5) Mosnic did not have in mind a better replacement for MIP; and (6) MIP did not violate the stakeholders investment guidelines. In fact,its investment processes were appropriate and reflected high understanding of the principals' shifting objectives.

Unfortunately, the misfortune continued with MIP. During the first year of its relationship with Mosnic, the stock market crash occurred. In fact, MIP was a great loser during the stock markets break of October 1987. The dramatic decline in the value of the portfolio by nearly 25 %, aroused the attention of all the stakeholders, but no one recommended to terminate the fiduciary relationship with MIP. They tried to deal with the situation without panic. However, MIP had to explain the problem and why it happened.

In spite of MIP's argument that *'crashes do not come everyday'*, the Mosnic investment committee met and requested from the Controller to work out with MIP steps to be taken in the post-crash era and to make sure that new strategies had been formulated. In response to the request of Mosnic Management, MIP reflected on the situa-

tion and highlighted the macro and the micro factors impacting the formulation of the investment strategy for the post-crash era. MIP said:

" *At MIP, we recently have become more optimistic regarding expected returns on equities, and as a result we are in the process of significantly restructuring your holdings. It is premature to be too cautious.*

We had taken defensive action, raising cash and hedging back into the dollar, your base currency. In retrospect, these two steps followed and reinforced a third major move, the earlier decision to shift away from the "overvalued" Japanese equity market.

The recessionary environment we feared has not yet developed, and now seems unlikely to do so for sometime. Therefore, we see good opportunities to make money once again."

The Controller reiterated the stakeholders' high concern about the poor performance reflected by the negative ROI. MIP was asked to give more details and to be more specific as well as to propose new structure of the portfolio, the market outlook,and the strategy for equity. MIP mentioned to the Controller that it took a lot of strategic measures after the crash. It was clear that MIP had started becoming more conservative. The conservative strategy proposed by MIP involved fixed deposit investment which was considered by Mosnic as non-Islamic.

The feedback by MIP was detailed. The report emphasized the changes made in the previous strategy. It was clear that MIP aimed at convincing the Controller of the appropriateness of its investment decision processes irrespective of the depressed performance. MIP started by comparing the performance of Mosnic U.S. Dollar portfolio

(time-weighted for cash flow) with the World Index and the S & P 500. The report mentioned that during the first quarter of 1988, Mosnic portfolio declined by 11.85% compared with an 11.5% decrease in the World Index. MIP mentioned that their underweight position in Japan continued to be the major factor negatively impacting the portfolio's relative performance. It remained MIP's perception that the Tokyo market as a whole was distinctly overvalued.

MIP also mentioned that they added to the level of liquidity (meaning more interest) over the quarter, primarily by reducing equity exposure. MIP also transferred Sterling exposure into the U.S. Dollar via the forward exchange markets. The report mentioned that their overweight positions in Hongkong and Spain benefitted from the strong performance of those markets.

STRUCTURE OF THE CHANGED PORTFOLIO

MIP outlined the changes made in and the structure of the portfolio at the end of the quarter. It commented on the outlook and policy over the next period. It pointed to the movement of the Morgan Stanley Capital International indices during the quarter divided between the large and smaller markets. The distribution of the portfolio assets by market or region was also shown. MIP mentioned in the report that the cash and bonds position increased over the quarter as a result of equity sales. The bond position accounts stood for 17.8% of the portfolio and was held

mainly in U.S. Dollar bonds. This represented a switch from U.K. and DM bonds. Cash account formed 20.4% of the portfolio and was largely held in U.S. Dollars. The higher exposure to Japan at the end of the period largely reflected the superior relative performance of that market. In Europe, MIP reduced the U.K. and France whilst maintaining a significant exposure to Spain. The positions in Switzerland and the Netherlands were increased. Canada and New Zealand were eliminated completely, whilst Australia was reduced.The exposure to Hongkong remained significant.

MIP explained the percentage points difference in country weightings between the equity part of Mosnic portfolio and MSCI World Index. This helped to identify the areas in which MIP was making significant asset allocation 'bets' versus the passive index. The position at the end of December 1987 and June 1988 was compared. MIP commented that Japan continued to be a major negative bet, although as stated earlier, the market's had increased. Germany remained a negative bet. Canada was also a negative bet. The U.K., Hongkong, and Spain represented the major positive bets.

MIP displayed the significance of the major holdings in the portfolio at the end of the quarter. The following were emphasized: (1) Outside the U.S., the portfolio remained highly concentrated in individual holdings. (2) MIP's main Japanese holdings were in companies experiencing strong earnings growth -Tanabe in pharmaceuticals, Kyocera in semi-conductor materials,and Deichin in retail-

ing. (3) In other Far Eastern markets, MIP had retained exposure to Hong Kong. (4) In the USA, MIP had adopted a quantitative approach to stock selection and portfolio construction which MIP believed had proven historical track record of superior performance.The result was that in this market, the portfolio was significantly more diversified than in prior periods. MIP believed this approach would be justified by greater value added over time.

The report was satisfactory to the Controller. Regardless of the low ROI (negative), the Controller and the Director arrived to the conclusion that MIP's investment processes were appropriate for those market circumstances. Hence, they decided to give further support to MIP for improving the future returns on the portfolio. Thus, MIP was asked to provide the market outlook. In fact, the Controller wanted to check if the market outlook by MIP needed further input from the other portfolio managers view fed to the Controller.

MIP's Market Outlook

MIP mentioned that its 6-18 month outlook for markets changed though its longer-term view remained intact. Essentially, it believed that the longer term change in underlying trends could be several quarters in the future. MIP advised that for the immediate future the major market characteristics seemed likely to be as follows: (1) Interest rates, though volatile, were likely to remain

firm against the backdrop of continued growth and rising prices. This was particularly assumed by MIP to be true in the United States. (2) The Dollar might be stable for a time, but the risk of a further 10% or so drop later that year had increased. (3) Bonds might not be able to generate returns above the current Dollar coupon rates of approximately 9%. (4) The upward trend in equity prices could continue for somewhat longer, as good corporate profit growth outweigh the negative interest rate environment.

For the longer-term, MIP believed that the significant changes, which would be seen in the underlying economic environment in and after 1989, were likely to produce even more significant changes in major trends in the financial markets. It added that their impact would be all the greater if they could catch markets by surprise.

The Controller informed MIP that the decision of the stakeholders regarding the currencies allocation remained unchanged with regard to maintaining the level of 70% to 80% of the portfolio currency in the U.S. dollar. Taking this into count, MIP began repositioning the portfolio in the light of the market outlook just discussed. It seemed that MIP saw there was enough time left in the current cycle to return to a tactically bullish stance moving back to a fully invested position and committing both cash and bonds to the equity markets. MIP showed tendency to move away from the pro-dollar stance, believing it to be tactically premature even if strategically correct. The

Controller confirmed to MIP that the principals did not accept 100% exposure to equities. MIP resumed stock selection search for rapidly growing, late cycle issues where value still could be found. It argued that a significant number of those opportunities could be found in the one-quarter of the Japanese market which MIP believed still could be considered on fundamental grounds. Therefore, the Japanese exposure would increase.

MIP agreed with Mosnic that the longer-term strategic backdrop might call a significant shift to the dollar. However, MIP reiterated on the stakeholders' negative views about shares. It tried to convince them that even with high exposure to equities the portfolio can be structured conservatively. It mentioned that the new direction probably would be characterized by emphasis on defensive shares and/or liquidity, pro-dollar stock selection and currency investments, and strict control of Japanese exposure. However, at that moment the evidence was strong that there was a significant opportunity to generate further good equity returns before the cycle was exhausted and before a defensive posture was called for.

The Controller conveyed to MIP that the stakeholders were still looking unfavourably to total exposure to equities.

The Profit-taking Policy Problem

MIP's investment decision processes made the Controller and the Director feel comfortable. However the stake-

holders' remained worried about the nervous stock markets. The stakeholders pressed the Director to negotiate with MIP early profit taking strategy. Nothing could be done before considering the matter with MIP. The following advice request was sent to MIP. Indeed, the Controller did the interpretation of what the principals wanted.The final wording of the specific requests of the stakeholders were:

1) *"Sale of Securities and Portfolio Breakdown by Instruments:-*

The crash losses are becoming a turning point to the long time back corporate strategy.
Our Board of Directors have decided to set securities sale criteria to avoid loss of unrealized gains if any market unexpected break occurs. You are kindly requested to advise on:

(1) Reasonable level of gains whenever attained you recommend liquidation of securities.

(2) Optimal diversification of investment portfolio broken down into different instruments to suit market expectations for 1988.

You will appreciate that the Board of Directors does not like imposition of rigid guidelines, however, the objectives have been set at:-

- *Realization of a reasonable [gain + income] not less than the money market rates.*
- *100% capital preservation.*

Therefore, it is imperative to have your opinion before consideration of 1988 investment guidelines and strategy.

2) *Request of Advice on U.S. Equity Exposure:-*

We are being advised by other professionals that there is an uncomfortably high possibility that securities values could fall sharply in the atmosphere of uncertainty generated by a U.S. presidential campaign. U.S. newly elected administration economical policies may conflict with the Reagan administration measures.

As a result, we feel it is only prudent to take some defensive steps. If you agree with us that equities in general, and U.S. portion of it, in particular, will sharply decline pursuant to the U.S. presidential

elections will you please look into the following proposals.

1) Consider reduction of equity exposure.
2) Suggest a point and a period of time for implementation that we can adopt your plan as a formal guideline.

Otherwise, if you have any counter-opinion please feel free to convey it to us. Our ultimate objectives are:

1. Realization of equities gains.
2. Avoidance of presidential elections mal-effects on Dow Jones.

3) Reasonable gain Realization & Investment Portfolio Optimal Breakdown by Instruments.

As discussed in our meetings we believe investment strategy guideline set-up has to stem-out from what asset managers believe practical and client objective attaining. With that view, your professional opinion will be highly appreciated. We no longer believe in indefinite stay on the unrealized gains. A reasonable gain - considering the market circumstances - has to be realized and capital has to be fully preserved.

Please give specific recommendations such as sell equities at 12% gain.

Corrective Strategy

MIP responded by asserting its previous stance that profit-take approach might contradict with the long-term portfolio management spirit. It also might trigger the question of what to do next with the cash position to be created. The markets might remain over-valued to re-buy securities. This would lead to the accumulation of interest income.

MIP suggested the following alternative strategy:

"We also are nervous about the outlook for equity returns. The world-wide economic recovery which began in 1982 now is well-advanced and has begun to show serious imbalances (trade) and excesses (U.S. consumer borrowing, Japanese P/E multiple, takeover activity) indicative of the late

stages of the cycle. Coincident with these signals, the U.S. Presidential election cycle at least adds uncertainty, and could lead to policy changes bringing on a recession in the U.S., spreading elsewhere.

Our best guess is that the world is in fact heading for a very slow growth or recessionary environment sometime between now and mid - 1989. If the market decline last October had not been so large we would be selling now as our strategy is to become increasingly defensive.

The October crash, however, did occur, and price declines were so great they seemed to discount a certain and immediate onset of recession. Since the timing,likelihood, and severity of the slow-down is by no means certain, our tactical position has been to look for a rally as an opportunity to reduce equities further.

As you can see in the table below, (using Mosnic as an illustration), we already have made some significant changes since last September by:

* *Raising cash and bonds to 34% of the total.*
* *Reducing U.S. and Canadian equities to 22% from 55% of the total.*
* *Switching into more "defensive" equities in some markets.*

	September 31, 1987		Current	
	Value	% of Total	Value	% of Total
	(Millions)		(Millions)	
Cash	$ 0.0	0.0%	$ 6.0	16.6%
Bonds	0.6	1.2	6.4	17.6
Equities:				
U.S.	25.4	51.4	8.1	22.3
Canada	2.4	4.8	0.0	0.0
Japan	4.1	8.3	6.1	16.8
Far East	6.1	12.3	2.7	7.4
U.K.	6.9	14.1	4.0	10.8
Europe	3.9	7.9	3.1	8.5
Total	$ 49.4	100.0%	$ 36.4	100.0%

Recent developments have supported our tactical decision to wait for a rally.

* *The U.S. consumer seems to have slowed his spending but rising net exports and industrial demand seem to be holding the U.S. economy steady.*

* *Recent US. Trade figures have seen the deficit decline somewhat.*

* *The Japanese domestic economy is growing,*

* *Recent German indicators suggest better-than-expected growth there also.*

* *George Bush, the candidate least likely to " rock the boat" has emerged as the front-runner for the presidency, while Richard Gephardt, a protectionist, has faded.*

A rally is in progress in many markets and we are selling. While we have not set a specific target date nor a target amount for this selling program, we plan to be well over 50% liquid within a month or two, given the appropriate opportunities.

As to your interest in setting specific guidelines and targets, we suggest that you give careful consideration to your basic objectives and the role you expect MIP to perform, before setting binding parameters.

The most useful guidelines from our point of view would set parameters for broad classes of assets, intended to be valid for many years and within which we, as manager, could exercise our professional discretion. For example, you might choose maximum and minimum ranges as follows, although you must make the final decision as to percentages.

Asset Class	Range Permitted
Cash & Short-term	0% - 50%
Fixed Income	40% - 80%
Equities	30% - 60%
(U.S.)	(0 - 25)
(Europe)	(0 - 10)
(Asia)	(0 - 15)
Total	100%

Having done this, you can easily instruct us to move toward the upper or lower limit for each category as the cycle progresses and as you develop strong feelings of your own.

Presently, for example, you might ask us to move in due course to a very low U.S. equity level (near 0) and to a high cash holding. With clear guidelines in place the implications of such instructions would be clear to both sides and easy to implement.

MIP's Alternative Approach to the Profit-Taking Standard

MIP's reply clearly stated that it had never found it useful to attempt to set precise capital gains targets for markets nor for specific securities. That was clear in MIP's statement which said:

"We always monitor the price movements of holdings and pay careful attention to relative price movements and relative valuation levels. Thus, we are stimulated to sell a stock when its price has moved up further than seems to be justified versus alternative holdings. We may also be prompted to sell in order to buy another share whose price has fallen to very good value. Also, at times we sell when the outlook for the company deteriorates, whatever the share price changes or not. We believe this is more effective than setting gain realization target."

MIP added:-

"I should say that in general we are looking to liquidate many existing U.S. and other equity holdings when they have risen 20% or so from last October's lows. However, the specific target and timing varies by stock".

MIP Amends Its Approach to Match with Mosnic Objective

"Finally, it is clear that you and we are on a very similar wavelength at this point in time. We are looking for a somewhat more opportune moment to increase the capital preservation characteristics of your holdings by reducing U.S. and other equities and switching into bonds or liquid holdings".

MIP's Role in The Tactical Re-Allocation of the Assets

Having discussed the unsatisfactory performance situation, the IPC moved to reconsidering the allocation

of the assets. The Controller asked MIP how it planned to diversify the assets?

MIP replied:

"*Our decision to sell is based on the price appreciation to some extent, but also on the earnings outlook for the company. So, we do not have intentions to re-allocate your assets immediately. However, I would also like to mention that the strong diversification of the equity portfolio should limit the risk of a decline in its total value. Based on your objectives and on our in-house policy, WE NOW RECOMMEND THE FOLLOWING BREAKDOWNS OF ASSET MIX*

Cash & Fix Income Securities	*50 %*
Convertible Bonds	*5 %*
Equities	*40 %*
Gold	*5 %*
	100%
US $	*2/3*
Strong Currencies	*1/3*

Amongst strong currencies, we put heavy emphasis on the Swiss Franc, as it is not linked to the European monetary system, and could, therefore, rise more than others in case of panic. As for the time frame, I think that this objective could be realized in the very short-term, this is a few weeks, as it reflects our current investment philosophy. A new assessment should be made in three months, when we will know more about the possible outcome of the presidential elections.

To conclude, we feel that these decisions should reasonably well protect the portfolios in case of disappointments engendered by the U.S. presidential campaign.

Mosnic Amends its Objectives

The Director did not like 40% exposure to equities as he received cautious views about the stock markets. Thus, the Controller told MIP:-

"*Our consultations indicate that: A recession or a slowdown in the U.S. economy cannot be avoided. Therefore, you are kindly requested to reduce exposure to equities in account to 15-20%. This is not a green light to liquidate shares which have good potential price appreciation nor*

those which have good earnings outlook. This memo should not be viewed as rigid package of guidelines. Should you feel you have strong reasons to maintain equities at 40% of the portfolio, please firmly confirm to us."

MIP replied as follows:-

" We did not see an urgency in reducing the equity proportion to 10/15% since the majority of the finance world was expecting another improvement of the U.S. trade figures. Good trade figures would have boosted stock markets considerably, since at the same time confidence into the $ was slowly coming back.

With respect to the economical outlook for 1988/early 1989, our economists do not believe in a recession. The world economies are in much better shape than many investors had thought after the crash. In our view, we cannot exclude even an overheating of the US economy in 1989.

For most of the companies where we have shares (with the exception of Germany), we expect a healthier growth of their earnings (two digit figures) for 1988 and even so it is too early to make serious forecasts for 1989, we see no reason for a significant slowdown.

Election years in the US are usually good years for the stock market; 7 out of 10 election year saw the stock market rise.

Where as we are moderately optimistic for the world economies, we are still concerned about a new financial crisis due to the huge US budget deficit and the difficulties of financing it. In view of your fax, we have reduced the equity by approx. 10% and we shall continue to do until we reach the level of 10-15% desired by you"

Mosnic Tightens the Strategic Control Processes

With a view to the poor performance of the portfolios after reducing equity exposure, Mosnic requested MIP to:

"(1) Give specific reasons for the bad results.
(2) Provide investment strategy for 1989, very specifically giving the recommended allocations of the discretionary assets in terms of:

i. <u>Instruments</u>: Such as equities (%), bonds (%),short-term (%), precious metals (%), etc. Explaining why such asset allocation, and your view on the bond and equity markets for 1989.

ii. <u>Currencies:</u> US$ (%), C$ (%), P.Stg. (%), etc. explaining how you view the money markets during 1989."

Mosnic tried to set fixed investment objective by giving the following instruction:-

"Our minimum required return on investments in terms of performance should be at least 8.5% other discretionary managers have achieved this performance. Please recommend how you will allocate assets to achieve that goal, at least.

We are waiting for your prompt telefax response to give our new guidelines and specific requirements for 1989."

MIP's Second Refusal of Setting ROI Standard

MIP justified the poor performance as follows:-

"Let me be clear, that we also are disappointed regarding the performances of your accounts with us in 1988, and have been giving the accounts our best efforts to try to recover some of the lost potential gains. So far our management of your accounts has resulted in an increase in the region of 4-5%.

Additionally, the accounts all did well in the 4th quarter with, for example,Mosnic advancing at 5.3%. This means that since the end of September, the accounts have been appreciating at an annualized rate in excess of 20%, well ahead of available deposit or fixed interest returns. The real problem, and drag upon the portfolios occurred earlier in the year 1988, and it is this problem that I wish to address.

Following the crash in October 1987, MIP moved to try to provide some form of insurance or protection for the portfolios against a further market decline. If we try to remember the market environment in the first quarter of last year, it was one of extreme nervousness with many prominent market commentators predicting a further sharp decline. We did not expect a second crash, or depression environment, and therefore took the bold step of keeping the overwhelming portion of your portfolio in equities. (For the purpose of this discussion, I am using Mosnic numbers but similar analysis applies to your other accounts with the exception of the handling of fixed income).

This protection insurance in the end was not needed and, therefore, cost the portfolio nearly 2% of performance in the first quarter, due to bond declines. For the year as a whole, bonds exhibited a TWRR (time weighted rate of return) of nearly 8%."

MIP further argued that Performance in most markets (for Mosnic) was satisfactory as can be seen by the following table:

MOSNIC
TWRR 1988

Portfolio Breakdown ($ Returns)

USA	+ 11.5%
Japan	+ 7.1%
U.K.	- 5.5%
Germany	+ 26.5%
Switzerland	+ 0.3%
Netherlands	+ 0.2%
France	+ 39.4%
Italy	+ 20.8%
Spain	+ 11.1%
Australia	+ 27.7%
Honk Kong	+ 18.5%
Singapore	+ 10.2%
Bonds	- 7.7%
Cash/Forwards	- 9.2%

The above table showed that most equity sub-portfolios had a TWRR greater than that obtainable on US deposits or fixed interest securities. MIP placed too large a weighting on bonds and cash in the portfolio which counterbalanced the equity gains. The quarterly figures showed that MIP put this loss period behind and generated sound positive returns.

MIP Criticizes Mosnic Approach to Investment Decision

The Controller succeeded to build a trustful relationship with MIP. Within this relationship, he requested from MIP to be frank in telling its problems with Mosnic's approach to the investment decision. MIP replied:

"First, in our opinion, it is ill-advised to try to become a market timer and to pull your money out of the

financial markets and back into the financial markets every time you expect the market to move. Due to the high cost of the transactions and the probability of incorrect projections from time to time we think the ability to add value to your investment results is suspect. Furthermore this technique would substantially add risk to your portfolios and works against your stated objective of conservative, preservation of capital.

We recommend, as a conservative long term strategy a mixture of bonds and common stocks. We further recommend the decision of when to execute this policy be decided by your professional money manager. We think the stock market will likely be under short-term pressure and we would be looking for an appropriate timing before we initiate our purchase program. We expect this opportunity would arise by the autumn."

Performance Appraisal by Comparison to Other agents Objection by MIP

MIP added:

"*A further reservation is concerned with your approach to the appraisal of our performance by comparison to the other discretionary asset managers. We do not believe in the appropriateness of this approach. We have experience dealing with Mosnic. We know you shift your investment objective in a direct response to the particular situation of the portfolio under consideration. We do appreciate that approach of dealing with the specific problems of the portfolio under evaluation. On the other hand, the portfolios' performance problems differ from one manger to the other depending on how different managers make the selection of the individual securities. Consequently, Mosnic's pattern of interaction and the shift in its investment objectives can be different. Hence, you can not compare managers assigned different objectives.*"

The Controller expressed his appreciation of the sincere advice given by MIP and promised to moderate the shift in the stakeholders' objectives by trying to encourage them to pursue longer-term results. Furthermore, the Controller accepted the argument of MIP regarding the comparison approach of appraising portfolio performance.

Strategy 1989

MIP proposed to structure the portfolio as:

1/3 U.S. equities
1/3 Far East equities
1/3 European equities

MIP Adjusts its Approach to the Principal's Objective

MIP accepted to take into count Mosnic proposal by confirming on the following:

"I have carefully considered your comments regarding capital preservation and desire to improve upon the return obtainable from US dollar deposits. To fully meet that goal I suggest we slightly restructure as follows:

1. *Increase the number of individual security names by 30% .*

2. *Spread the geographic risk to be 1/3 US, 1/3 Far East, 1/3 Europe.*

3. *Use bonds/cash only in exceptional circumstances, and have no bonds at present.*

4. *Hedge 1/2 of the currency exposure associated with non-dollar equities into the U.S. dollar using the forward markets to remove much of the foreign currency risk.*

Let me assure you that we at MIP have worked hard to produce a portfolio for you that balances risk and return. We were not happy with the results for the early part of 1988 as we placed too much emphasis on risk minimization through bonds/cash. We have produced an annualized rate of return of 20% since October 1988 to date, and believe the above four point restructuring will improve the risk/reward ratio for the remainder of 1989."

The Controller responded to MIP as follows:

"We still hope you can reverse the unpleasant performance and come up with a break through. Nevertheless, I will monitor the portfolio more closely than before. The Director requests, MIP to cooperate in making my monitoring task successful."

Thus, MIP proposed the following:

"If Mosnic requires more detailed monthly performance numbers of individual markets, asset types, stocks or currencies please let me know and I will extract the relevant figures. Also, if you desire a more detailed analysis regarding market weights or individual equity

choices I can prepare a special report. Feel free to contact me either in the office on(international) or you can reach me at home outside of office hours on (international)."

Islamization of the Investment Process Through MIP

In an attempt to avoid interest income, the Director sent the following request to MIP:-

"As it may be clear to you our belief does not advise keeping permanent fixed deposit accounts within the portfolio for generation of interest income viewed as usury. It is our intention to study with you the possibility of replacing any fixed deposit investments by other money market instruments with secured income such as, US Government treasury bills.

You are kindly requested to advise us on the negative impact such step might have on the ROI.

If you have any comment on possible portfolio management complications which might be triggered by exclusion of the fixed deposit investments, please let us know.

As a matter of principle, we do not see a problem in transitional fiduciary placements until that time funds are re-invested."

MIP replied as follows:

"We do not consider fixed deposit investment as a permanent investment in uncertain times such as the first five months in 1990 when interest rates rose and equities fell. They represent a cheap flexible way of parking the funds earmarked for investments in tradeable securities.

However, certain markets offer interesting alternative with tax-free discount papers such as Treasury bills in the US and UK. Transactions in such papers with maturities up to 3 months are subject to brokerage fees of only 0.1% and Federal and local taxes of 0.115% of the amount which compares with 0.125% annually for a fixed deposit. Redemption is free of fees and taxes. The following is a comparison for you to see the difference.

Other markets such as Switzerland and Germany do not offer such a choice of short term money market investments for tax reasons.

In Switzerland however, one can buy "Money market claims on the Swiss Confederation". Brokerage is 0.25% for purchase only; no taxes. Provided the claims are sold before maturity, no with-holding tax is levied. Sales are

free of costs whatsoever.

Hope this covers what you required.

	YIELD	ANNUAL	COST
REDEMPTION		**IN %**	
US Treasury Bills 3 months	*8.02*	*0.86 (1)*	*No cost*
US$ Fixed deposit 3 months	*8 1/4*	*0.125%*	*No cost*
UK Treasury Bills 3 months	*13 1/2*	*0.86 (1)*	*No cost*
UK Fixed deposit 3 months	*15*	*0.1255%*	*No cost*
Swiss Money market claims	*8*	*1.00 (2)*	*No cost*
SFR. Fixed deposit 3 months	*8 5/8*	*0.125*	*No cost*

(1) 0.215% X 4 quarters
(2) 0.25% X 4 quarters

The difference between Money market instruments and deposit lie in the fact that fees on deposits are calculated on an annual basis whereas fees on Money market instruments are calculated on the amount (purchased for 3 months) and therefore have to be multiplied by four for a yearly period."

Reporting of Interest Income Separately Considered Costly and Difficult by MIP

As a result of close interaction with the Controller, MIP was aware of the stakeholders views on interest. Therefore, MIP commented on interest reporting problem as follows:-

"Our problem with you will remain the fixed income holdings in the portfolio. You will agree with us that the whole west is built on interest system.To be honest, we do not know how we can assist in interest reporting. It will require a new system researching cost and then demonstration and implementation. Definitely both of us are not prepared to bear that cost. Our cash managements (CMS) is designed for the wider base of our western clients.

We regret to inform you that, in terms of interest separate reporting, we suggest that you rely on your in-house system of data processing. We will definitely cooperate within certain limits."

CONCLUSION TO CASE OF MIP

(MIP Accountability Problems)

The process described in this case study indicates that it was not an easy job to set specific financial targets for the discretionary agents to be the base for a strict responsibility accounting. The financial markets were difficult to predict.

The case study shows that for evaluation of performance, Mosnic system depended on information provided by MIP. It was only through an interactive inquiry process that the Controller managed to get information.

The process by which Mosnic appraised the performance of MIP depended on the nature of the current problem being faced in the portfolio. The portfolio performance appraisal system seemed to be a mix between (1) benchmark approach; (2) continuous principal-agent liaison process; and perhaps (3) a bottom line approach. Comparison of MIP performance with the other agents did not work. The process by which Mosnic shifted its objectives was complicated and it caused problems to the securities analysis models adapted by MIP. Perhaps other post-investment cases may be needed to shed more lights on this complicated multi-methods system.

The yardstick used by Mosnic for the measurement of MIP performance seemed inconsistent. The Controller observed the following: (a) if the markets were rallying,

MIP performance was compared with the other agents; (b) the market benchmarks was used by MIP to justify the weak performance in the portfolio; and (c) when the markets were troubled, MIP performance was compared with the Dollar Money Market Rates.

Timely liaison of MIP with Mosnic in a number of strategic matters led to ambiguity of discretionary power for MIP accountability in a formal manner. The Controller had to overcome this problem by seeking the view of MIP on Mosnic's approach to the investment decision. The whole process was found continuous and complicated. The complication was increased by the difficulty of separating strategy, tactical decisions (either Level I or Level II), and the operative management of the portfolio. To moderate these complexities and to make the shifting objectives manageable, the role of the Controller was important.

SECTION 6-B

THE CASE OF MONITORING BJ-S BANK

Objectives and Outline

This case also aims at advancing our understanding of how agents were controlled after selection. The purpose behind studying one more agent's performance evaluation processes in addition to the previous case of MIP, was to understand how differences in agents' means and methods led to different processes of evaluating the portfolio performance.

The study starts by emphasizing the major features of the control system set by the Controller to suit the situation of BJ-S. The case study also advances our understanding of the investment strategy operation through the agent and throws lights on the deeper level investment decision processes in the post-investment phase.

The case also emphasizes the day-to-day interaction (in an iterative process) between the principal and the agent and highlights the great overlap between strategy, operation, tactical decisions and the strategic control processes.

1. Special Control System Designed to Compensate for BJ-S Weaknesses

BJ-S bank's means and methods for portfolio management were quite satisfactory. However, the Controller was not satisfied with the internal control system of BJ-S bank. Mosnic view was to select BJ-S as a discretionary agent

but to compensate for its control system weaknesses. Thus, in the post-investment phase this became the first priority for the Controller to handle. As such, he had to find ways to cover up this loophole.

By the time the selection of BJ-S was completed, the Controller was aware of the control procedures necessary for monitoring BJ-S. Such knowledge about the control needs of BJ-S was acquired while studying its strategy, structure and processes in the selection stage. In particular, the Controller was not happy with the performance information package which BJ-S promised to provide. It was obvious that the Controller would need to monitor BJ-S system closely to cover this weaknesses.

Nevertheless, BJ-S was good in other portfolio management aspects. This conclusion was based on the result of evaluating BJ-S methods and means as shown in BJ-S selection case study. Moreover, BJ-S promised to report interest income separately from the realized and the unrealized returns of the portfolio. Another problem was that the Controller had to account for the influence of the individual portfolio manager (i.e. not the team) on the investment decision taken by BJ-S. The representative of BJ-S believed that the individual portfolio manager could have the authority to amend the investment policy to provide for the need of the client without the need for consulting the portfolio analysts on every situation. This was a good sign. However, the Controller had to be careful about the limitations of the individuals in

formulating the investment decision.

By the nature of its investment policy, BJ-S was not an aggressive manager. Therefore, the control system designed by the Controller to monitor BJ-S investment policies governing the selection of securities were not as tight as in the case of MIP Bank which had a higher tendency to invest aggressively in shares. The procedures designed for monitoring the dominant role of the individual managers were more tight in the case of BJ-S and looser in the situation of MIP which had the team approach to portfolio management.

After the investment process started with BJ-S, the Controller discovered that the internal accounting control system (as one attribute to select BJ-S) was not operating as efficient as described by the representatives of BJ-S. For example, the initial value of assets transferred to BJ-S from another agent were not in reconciliation with Mosnic records. Portfolio performance measurement reported by BJ-S did not account accurately for fund withdrawals and remittances by Mosnic. In these processes the Controller observed some errors.

The reporting system applied by BJ-S failed to provide the adequate data on: (1) the realized and the unrealized losses and gains of the portfolio; (2) details of bonds liquidated before maturity to avoid interest; and (3) details of securities sale and purchase transactions. Later on, specific reservations made by the Controller

about BJ-S system will be described.

In the first year of the post-investment relationship, the Controller observed that the response of BJ-S to the shift in the objectives of the stakeholders was a bit slow, particularly when it came to implementation. It seemed as if the portfolio manager was over-loaded. This will also be described after explaining the specific system designed for monitoring BJ-S.

The Corporate Controller decided to design a detailed monitoring system to overcome BJ-S internal accounting control weaknesses. To accomplish his task, the Controller depended on his past experience with the large accounting firms' (Arthur Young, Price Waterhouse) management consultancy departments to tailor the appropriate control procedures. Indeed, the Controller decided to formalize these procedures to control the quality of the work to be performed by his staff. This also aimed at raising specific remarks to BJ-S for improving the portfolio management system. Conveying the remarks and the exceptions orally to BJ-S was not enough. Without formalized procedures and the build-up of due work paper system, the Controller was not able to ensure the implementation of the designed procedures. The Controller also aimed at training his staff on the job. These procedures gave more comfort and trust to the stakeholders to maintain their fiduciary relationship with BJ-S. The Controller was open and frank with BJ-S and told them that these procedures were essential and they might be time

consuming. BJ-S promised to be cooperative and to spare time for the Controller and his crew to understand the principals' objectives further. BJ-S also made a commitment to make the monitoring mission of the Controller successful.

BJ-S Bank Monitoring Detailed Procedures

- Ensure that objectives discussed with BJ-S are well preserved and report any deficiency.
- Compare the portfolio account balances with those of prior periods and investigate with BJ-S any unexpected changes (or the absence of expected changes).
- Perform an over-all test of the reasonableness of interest income by multiplying the average interest rates by the average amounts invested.
- Review the marketable securities reports and related accounts (e.g. interest and divided income) for unusual items.
- Verify the existence and ownership of reported/ recorded securities through confirmation/ examination of evidence of ownership (e.g. stock certificates).
- Determine the bases of which additions and disposals are entered.
- Inspect brokers advices and other support to verify that additions and disposals have been entered into the manager's reports properly.
- Inspect with BJ-S market quotations or other evidence of the current value of marketable securities.
- Contact BJ-S to provide a report determining that marketable securities are carried at the appropriate amounts. Generally, at the lower of cost or market value.
- Verify interest and dividend income by calculating interest earned and referring to published records of dividends paid.
- Verify computations of gains and losses from sales of securities.

Permanent Impairment of Value of Investment.

- o Ascertain with BJ-S that investments are carried and reported at the appropriate amounts (i.e. at cost, amortized cost, equity market value, or estimated net realizable value). Determine whether any decline in market value below cost represents "a permanent impairment" of value, and, if so, whether such impairment is properly reflected in reports provided by the portfolio managers.

- o Verify interest and dividend income and equity in earnings (Losses) of investees by calculating interest earned or by referring to published records of dividends paid or to the financial statements of investees.

- o Verify calculations of amortization of bond premium or accumulation of bond discount.

- o Verify computations of gains and losses from sales of securities.

Verification of Existence.

When inspecting investment check:-

a. The exact names of the issuers.
b. The descriptions of the securities.
c. The name of the indicated owner of the securities.
d. Any evidence of pledging or restrictions on disposal shown on the certificates.
e. The certificate number of the documents.

Carrying Amount of Investment.

Review marketable equity securities reported by BJ-S separately from other securities and determine:

a. The portfolio of marketable equity securities has been properly aggregated.

b. Any valuation allowance has been properly computed.

c. Changes in the valuation allowance have been properly approximately included. So as to consider permanent impairment in value and the corresponding effect on equities.

Decline in Market Value other Than Temporary.

- Ensure that BJ-S evaluates all securities which show a market value less than cost, say quarterly - to determine whether the decline in market values is other than temporary i.e. permanent impairment of value.

- To determine whether or not a decline in market value below cost is temporary in nature or is reflective of conditions that are more persistent contact BJ-S to gather information.

- To ensure the ability of the portfolio to ultimately recover the carrying amount of the investment discuss with BJ-S whether;

  a. The decline in market value is attributable to specific adverse conditions for a particular security.

- Check the market price with the proper sources i.e. The price which refers to each single share or unit of a marketable equity security, on a test basis for each portfolio report submitted by BJ-S.

- Perform spot checks on market value which refers to the aggregate of the market price times the number of the shares or units of each marketable equity security in the portfolio.

- Consider with each BJ-S valuation allowance which quantities the net unrealized loss in that portfolio.

- Ascertain that realized gain or loss represents the difference between the net proceeds from the sale of a marketable equity security and its cost and ensure that such gain or loss is reported only upon sale of a security.

- Perform spot checks to ascertain that net unrealized gain or loss on a marketable securities as reported by the BJ-S represents at report date the difference between the aggregate market value and aggregate cost.

- Be sure that unrealized gain is not used as a factor in the computation of taxable income.

- Discuss with BJ-S and obtain ascertainment of the location of the investment securities.

- Inquire about the internal controls of the BJ-S if there is any change.

- o Ensure that securities held with the BJ-S are satisfactorily safeguarded.

- o Consider possibility of physical inspection of securities with each BJ-S three times during each fiscal year.

- o Suggest to BJ-S that the dates for at least two of these inspections shall be chosen at random by us.

- o Inquire about any securities in transfer or undelivered by brokers or others at the date of the examination and check the authenticity of the transactions usually by inspecting subsequent liquidation.

- o Test portfolio transactions by representative purchase, sale and exchange transactions, brokers advices or other documents should be examined to ascertain that they agree with the entries made by the BJ-S.

  The test should cover:

  - Extensions
  - Commission rates
  - Taxes
  - Trade dates
  - Price reasonableness by reference to published sources

  The test should again be made to ascertain that sales have been properly reported during the period.

- o On a test basis for each period review securities cost of acquisition and conclude on cost components.

- o Review at a 100% scope all costs and fees charged by BJ-S Brokers Custodian and document your comments.

- o Review management agreement fee clauses and ascertain that BJ-S charges are reasonable and in compliance with the agreed rates.

- o Ascertain that management fee debit notes/advices are charged to the correct holder account.

- o Agree individual withdrawals and contributions to the respective debit advices and credit notes.

- o Ascertain that debit notes and credit notes in support of withdrawals and contributions are backed-up by signatories authorization documents.

- Ascertain that significant dividend and interest receivables as of the prior period are correctly accounted for and reported by BJ-S.

- Review the investment schedules at the date of the portfolio report and note securities which are "Non-income producing" in order to disclose such data on the schedule of portfolio securities.

- On an overall basis, perform analytical review procedure (ARPS) by comparison of the total income in relation to prior periods income and obtain explanation for any significant variance from the concerned portfolio manager.

- Obtain schedule of tax deductions and review their validity with the right tax expert in the region.

- Ascertain that the valuation methods utilized for determining the market value of portfolios coincides with stated policies and rules of regulatory authorities.

- Document policies and methods noted in 42 and report on any over-statement of portfolio value which may lead to unjustifiable uprise in management fee.

- To review methods of valuation refer to quotations published by a reliable quotation service or a financial publication in order to substantiate the valuations used for the related securities.

- In case of the over the counter securities for which quotations were not available from publicized sources, consider obtaining quotations as of the valuation date from more than one independent source.

- Use a form letter showing the security description and a space where the broker, bank or other source may place the requested "Bid" and "Asked" prices for return to us.

- If you are not satisfied with valuation date results, you may wish to obtain further quotations at a subsequent date or dates.

- For all securities valued in good faith review the BJ-S procedures for its continuing appraisal of such securities and ascertain that the methods established for valuation are followed and that they have been reviewed and approved currently by the board of directors of BJ-S.

- In case of values assigned by the portfolio managers themselves consider any investment limitations or conditions or the acquisition or holding of such securities which may be imposed.
- If such restrictions are met by a narrow margin, give extra care in satisfying yourself that the evidence indicates that the security valuation determinations were biased to meet those restrictions.

BJ-S was kept informed that Mosnic was unhappy with their errors in performance reporting. BJ-S was also told that Mosnic had decided to carry out intensive monitoring processes which would require a high level of interaction with BJ-S. The latter did not object. However, some methods and means of BJ-S obstructed the implementation of the special system in the way and time the Controller targeted for.

The following is a brief example of most of the reservations raised by the Controller to BJ-S about its system. In response to these reservations, BJ-S kept Mosnic more informed about the detailed analysis of the fundamentals influencing the investment decisions.

"You will note from the enclosed statement which had been prepared based on data availed by you, that an additional $ 4.1 million will be at our disposal, upon executing the changes in the portfolio as authorized by us.

Despite our satisfaction with the means and the methods of BJ-S as a portfolio manager and with your personal special attendance to our business, we regret to tell you frankly we had acute and critical difficulties with the deficiency noted in your reporting system. Our files and records are full of errors and contradicting information provided by BJ-S. We have managed to overcome these weaknesses of BJ-S by performing intensive extra-ordinary monitoring procedures. We have also observed that BJ-S response to the remarks raised by Mosnic concerning the allocation of the assets in the portfolio is slow. May be BJ-S is not convinced to change. We just need to know your justification.

We hope you will manage with your organization to overcome this difficulty."

2. Description of the Post - Investment Processes

Beside the previous procedures, Mosnic needed to interact with BJ-S to discuss specific performance issues, re-evaluate the financial strategy and to get BJ-S opinion on the future strategy matters. The first priority of the Controller was to convey, in a timely manner, the shift in the objectives of the stakeholders to BJ-S.

The Controller was not keen to spend more time to examine the risk analysis techniques BJ-S followed to manage the portfolio. First, the analysis of individual securities and their selection was a task to be almost fully undertaken by the concerned discretionary agent. Second, the Controller was sure that the risk analysis models, irrespective of their level of sophistication, would require from BJ-S to go through the complicated process of understanding the shift in the investment objectives of the principals.

The general view about risk assessment, as a means of performance monitoring and agent appraisal, was that the assumptions of risk measurement could not be appropriate because the financial markets might move fast in unpredictable directions. Hence, close interaction with BJ-S and the day-by-day management of the investing process were preferred as a means for evaluating the performance of the discretionary portfolio. In most of the

cases, corrective actions for straightening investment portfolio's performance deviations were executed through dynamic re-allocation of the assets in the account. Asset allocation proposals to improve the portfolio's rate of return were prepared by BJ-S and then negotiated with Mosnic. The asset allocation projections submitted by BJ-S were built on analysis of different factors such as (1) Western economies; (2) capital markets; (3) stock markets; and (4) social and political factors. This process was continuous and hardly had an end. The rest of this chapter is devoted to describe the post-investment interaction between BJ-S and Mosnic, namely:

(1) performance monitoring;
(2) controlling agent misjudgment and imprudent investment management;
(3) enforcement of corrective action by Mosnic on BJ-S; and
(4) dynamic strategy and assets re-allocation.

However, the processes to be described were only selected to give an idea about the processes involved in the post-investment stage to manage the discretionary portfolio.

(i) Performance Appraisal based on information provided by BJ-S

Taking the opportunity of a good performance achieved by BJ-S, the following debate took place between BJ-S and Mosnic investment committee. The Controller and the Director aimed at encouraging BJ-S to keep momentum.

The Director:

" *9 % for six month is not bad. Hopefully your annualized performance will out-perform the money market rates. It looks as if you will end-up this year by 18 %.*"

BJ-S Representative:

" *We hope so. But, you never know the markets. The currencies risk is growing beyond all the portfolio managers expectations. What ever you make on the investment side can easily be distorted by the sky high dollar and the sliding other currencies.*"

The Director:

" *Paradoxically you provide data and we use it to evaluate your performance. Our problem now is the errors and inadequate information you provide.*"

BJ-S Representative:

" *No, This is one of the business conventions. We are responsible legally and ethically for every bit of information we give. No prudent portfolio manager will risk his business future by giving deceptive information. You have the possession of the figures reported. Definitely you have your relationship with a number of our competitors. Feel free to obtain any number of independent opinions on our figures. I would not mind rendering my free professional views on their figures submitted to you.*"

The Controller:

" *How do you measure performance in investment portfolio?*"

BJ-S Representative:

" *This is a lengthy process. In brief we try to stick to a number of principles in the process:*

1. *To weight the returns time-wise is essential.*

2. *Totaling of the returns is necessary i.e., the returns must include both income and changes in market value (realized and unrealized capital appreciation)*

3. *Assets value measured at market must be the base for measurement of performances and not at any type of cost.*

4. In the measurement of performance we try to include cost as well as return."

BJ-S Representative:

" *The dollar weighted return [DWR] is the measurement technique BJ-S follows. It considers:*

- *The ending value of the portfolio.*
- *The beginning amount of the portfolio plus the cash remittances to the portfolio."*

He added that BJ-S system, at a point of time, before Mosnic relationships started, was using the [TWR] measurement of performance. In BJ-S quest for more meaningful information to the funds sponsors, the TWR i.e, the *'Time Weighted Return'* system was brought to a halt. The major reason for refraining from the TWR was that it was viewed as disregarding the fact that money was remitted to the portfolio or it was removed from the fund.

(ii) Comparison with the other Agents For the Appraisal of Performance

The Director:

" *Based on consolidated information on Mosnic portfolios, BJ-S is ranked as of 06/30/1989 number 2 out of 8 portfolio managers. There is a manager who made 10 % for the last six months. How do you view that ?"*

BJ-S Portfolio Manager:

" *In BJ-S we used to tell our business associates that such comparison may not be useful to them. In your case I advise strongly to measure the portfolio in either of the ways:-*

1. *In comparison with Mosnic goals and objectives.*
2. *In comparison with Portfolios managed under the same guidelines.*
3. *In comparison of our performance with international markets benchmarks."*

(iii) Responsibility for Misjudgment and Imprudent Investment Decision

The Director:

" *For the sake of argument, if a manager under performs other portfolio manager or under-performs the International Financial Markets, does that mean imprudent management."*

BJ-S Representative:

To my view that is difficult to prove. My personal advise is to terminate the investor-manager Fiduciary relationship if the mistrust reaches the level of taking the matter to the court. In BJ-S we believe the manager is a member of the investor organizational set up. In cases of misjudgment how do you act with-say-your Corporate Financial Controller ?

My only advise is: build-up your organization internally, manage your portfolio managers efficiently and closely. Discover any misjudgment as it occurs. If investment is being handled imprudently, terminate the Fiduciary relationship. You do not have any other option. Time is value of the portfolio."

(iv) Enforcement of Corrective Actions

The Controller:

"*The imprudence of judgement by discretionary managers is a problem. It may be difficult to prove it. It also relates to the organizational philosophy and the investment policy followed by that particular institution managing the assets. The question is: How is it possible to change the discretionary agents' organizational policies?"*

(v) Checking the Safe Custody of the Assets

The Controller:

" *We have not yet succeeded to obtain an evidence that Mosnic assets under the Fiduciary responsibility of BJ-S are under safe custody and free of liens, charges and encumbrances.*

BJ-S Representatives:

What you mentioned seems to me unconventional. You are absolutely right in worrying about your asset safety and ownership. I do not know how can a manager ensure that other than issuing periodic confirmations that assets under BJ-S Fiduciary management are free from all types

of liens and charges. The discretionary portfolio managers, as we confirmed to you in the pre-agreement stage select the custodians according to criterion securing the interest of both the investor and the Fiduciary manager [BJ-S].

The fundamental qualities we search for in an organization to be vouched as able for dependable custodial services are:-

1. *The discipline found in the organizational's security procedures.*
2. *The reliability of its information system and the record keeping.*
3. *Cost competitiveness .*
4. *The financial stand, strength and ability of the organization.*
5. *The organizations understanding of the Fiduciary Relationship."*

(vi) Change of the Financial Strategy through the Tactical Re-Allocation of Assets

The Director addressed the following statement to BJ-S:-

" *The fact that we expressed to BJ-S our concern about capital preservation, led the ROI to unprecedented low levels. That ROI cannot be tolerated, as we get news that other agents are performing better."*

BJ-S defended as follows:-

" *Keeping in view the conservative investment approach which we have pursued in accordance with principals wishes, in this instance our present stances for the management of funds has been:*

- *Positive on the US $ exchange rate. 100 % invested in US $.*

- *Investing in the short end of the fixed interest markets with the main emphasis on 3 month euro-commercial paper, where today we are investing the bulk of the funds at 10 -15 % p.a.*

A synopsis of the four major economies of the world is attached.

Against this background, for U.S Dollar based clients, we as a Group currently advocate the following investment strategy:

Currency - 60 % minimum U.S. $

Asset Structure :

Equities	*45 %*
Bonds (including convertibles)	*35 %*
Cash	*20 %*
	100 % "

The Director commented, *"you will be over-exposed to equities."*

BJ-S requested its evaluation to be over long periods i.e. more use of the bottom line approach to the portfolio performance appraisal.

In January 1988, the Controller requested BJ-S to promote post-crash investment strategy, beside further explanation of why 45% of the holdings were in shares.

The representative of BJ-S bank responded as follows:

" *It is now imperative for any portfolio managers investment strategies to be re-tailored to cope with the outcomes of October market turmoil. The market break is over, but the troubled days are following. What to look out for under the new circumstances cannot be separated from the variables affecting the investment strategies of the forthcoming periods. Our views which we look forward to be discussed with your specific requirements and guidelines are reflected in the newly developed BJ-S investment strategy Please walk through and furnish us with your specific guidelines.*"

The following are some of the quotations from BJ-S response to Mosnic inquiry on post-crash investment strategy. The purpose of these quotations is to give the reader an idea about the detailed decision analysis predominantly carried out by the agents. The opinions given at the end of each factor analysis were presented by BJ-S to be negotiated with Mosnic to end up amending the investment strategy. This process made the principals

feed to BJ-S the maximum input relating to their objectives. It also made BJ-S satisfied with the amended strategy to be pursued. The role of the Controller was recognizable in the interaction process.

INVESTMENT STRATEGY

Economy.

BJ-S commented that the crash in the international equity markets had focused attention firmly on Americas twin deficits [trade and budget] since they were universally viewed as the real culprit of the present global financial crises.Given the good trend of economic activity worldwide prior to the stock market crash, BJ-S did not expect a recession to emerge. BJ-S added that since the necessary policy action was taken [in particular liquidity provision and initial moves to reduce the U.S. budget deficit], however, imperative as it had become, would not be achieved without further strains on the financial markets.

Capital Markets.

BJ-S drew attention to that whereas, since mid-summer, greater currency stability had been achieved at the price of increased volatility in interest rates. However, since Black Monday the situation had changed completely.

BJ-S Opinion: *"We expect sentiment in the bond markets to remain positive, at least until an improvement in the economic outlook permits monetary authorities to become more restrictive again".*

BJ-S RECOMMENDS TOP QUALITY NON-CYCLICAL STOCKS

BJ-S argued that the October 19, 1987 marked the beginning of a new chapter in the history of the stock markets. The Dow Jones industrial index plunged 508 points or 22.6% in one day taking the rest of the world stock markets with it. BJ-S believed that the situation would stabilize shortly.

BJ-S Opinion: *"Until then we recommend a defensive strategy, with the emphasis on top-quality non-cyclical stocks".*

CURRENCIES/GOLD

According to BJ-S, the turmoil in the stock markets also could not fail to impact the dollar. It was, after all, a statement by U.S. Treasury Secretary, James Baker on the dollar exchange rate that precipitated the rout in the financial markets.

BJ-S Opinion: *"We estimate the downside risk to the dollar versus the Swiss Franc at around SF 1.30 and versus the Dutch Mark at DM 1.60."*

U.S.A.

BJ-S asserted that: "Economy will Grow at 1.5 for the Year". It also added that the US-economy was still enjoying growing prosperity. The shift in the focus of economic momentum away from consumer spending toward business investment was in full swing. BJ-S expected real growth to average around 1.5 % for the year.

BJ-S Opinion: *"We would therefore give preference to short to medium term investments at the present time."*

Stock Market

BJ-S advised that for the moment, as long as uncertainty about the future direction of the economy prevailed, the market would remain vulnerable.

BJ-S Opinion: *"Should therefore focus on top-quality holdings with long-term earnings visibility".*

JAPAN

Economy

The analysis of BJ-S indicated that the Japanese economy has once again demonstrated its flexibility and strength that year. It added that the overall real growth on GNP would be only slightly lower in 1988, at just under 3 %, than in the current year. Japan's trade surplus, which had shrunk substantially over the last six months from last year's level should continue to narrow in the year ahead.

Capital Market

BJ-S believed that fears that the Bank of Japan might raise the discount rate to curb the strong expansion in the money supply [over 10%] had now evaporated.

Opinion: *"This makes the Japanese bond market one of the most attractive in the world in our view."*

Stock Market

BJ-S commented that shortly before the crash on Wall Street, the Tokyo stock market reached an all-time high of just under 27000. To the view of BJ-S, the Japanese market was thus still the most expensive in the world by a wide margin.

BJ-S Opinion: *"We view the downside risk of the Kabuto-Cho as considerable."*

GERMANY

Economy

BJ-S said that the dollar's renewed free fall and the collapse of share prices worldwide would inevitably have consequences for the German Economy. The future trend of the economy, however, would largely depend on the monetary course the Bundesbank would follow.

Capital Markets

BJ-S advised that: (1) The average yield on government bonds, which had fallen from its annual high of 7% in mid-October to currently 6%, would continue to decline steadily towards the annual low of 5.25 % it reached in spring that year. (2) Medium-term maturities were still worth buying.

Stock Market

BJ-S described the German stock market as one of the hardest hit by the October crash. Average price declined by 40%. This could provide the basis for the markets next countermove, which would be of a purely technical nature as long as there was no lasting recovery in the dollar exchange rate.

UNITED KINGDOM

Economy

About the U.K. economy, BJ-S said that the current account would probably deteriorate, ending the year with a deficit

of P. Stg. 2bn. About the U.K capital market, BJ-S added that the relatively high level of nominal interest rates coupled with a currency which was virtually tied to the Dutch Mark made the UK gilts look extremely interesting, especially for dollars investors.

Stock Market

BJ-S, therefore, believed that the UK equity market would outperform the international markets as a whole in the coming weeks. The most likely candidates in their view would be the recently privatized monopolies such as British Telecom and British Gas together with defensive consumer stocks.

SWITZERLAND

Economy.

Regarding the Swiss economy, BJ-S projected 0.8% real GDP growth in 1988 [previously 1.8 %] versus 2.0 % this year.

Capital Market

BJ-S hinted that with the danger of the Swiss Franc taking off on its own, the Swiss National Bank was in a monetary bind. The generous supply of liquidity to the money market would bring short-term interest rates down further over the next few months. In line with the downward trend in inflation expectations, bond yields would also ease further in the months ahead.

Stock Market

About the Swiss stock market BJ-S said that in the light

of the risks underlying the current macro-economic scenario, the emphasis in investment selection should be on stocks of the highest quality. To improve portfolio structure BJ-S recommended at the current low levels shares of companies with sound balance sheet ratios, high earnings quality and clear growth prospects for the 90s. The following companies in particular met these criteria. Sandoz Nestle, Zurich Insurance, UBS, BBC, Reuter, Suizer, Holder-bank, Holzsoff and Ascom.

CURRENCIES

The view of BJ-S on the currencies were:

U.S. Dollar

Estimate of the downside risk to the dollar versus the Swiss Francs would be around SF 1.30 and versus the Dutch Mark it would be DM 1.60.

Yen

For the next few months BJ-S expected the yen to fluctuate against the dollar in a range between 130 and 145 yen.

Dutch Mark

BJ-S said referring to the DM that again the background of a gloomy outlook for the economy, the rationale against an inflationary expansion of the money supply would lose its force.

BJ-S Opinion: " *We do not expect any major shifts in the Swiss Franc/ Dutch Mark parity. The similarity between monetary approaches in both countries will assure continuing stability in the relationship between these currencies [range SF 82 to SF 84.]*"

ECU

Concerning the ECU, the view of BJ-S was that as long as the dollar did not come under renewed pressure, BJ-S did not expect a realignment of key currencies in the next few months.

BJ-S Opinion: *"We would nevertheless be cautious about investing in high-interest currencies [French and Belgian Francs] at the present time."*

Pound Sterling

With respect to the British Pound, the stance of BJ-S was that given these good fundamentals and an exchange rate policy aimed at stabilizing the currency, the risk of the pound depreciating [also against the European currencies] would certainly be limited. (If the dollar continued to depreciate against the European currencies).

BJ-S Opinion: *"However, we would expect the Pound to tend weaker because the Bank of England might counter a further strengthening in the Sterling exchange rate with interest rate cuts".*

Gold

About gold BJ-S commented:

"In the weeks of enormous losses in the stock markets precious metals have proved a haven of relative price stability. We expect gold to trade in a relatively broad range between 430 and 480 $/oz. in the month ahead. On one hand, fears of recession will adversely affect the market for sometime. On the other, current US monetary policy, which is bent on preventing a recessional all costs, could have a positive influence on gold over the long-term. In the latter case, the inverse relationship between gold and dollar prices would be rapidly restored."

The Proposed Re-Allocation of the Assets

BJ-S proposed the following asset allocation for Mosnic as a dollar based investors.

Investment Category	North America	Europe Others	Europe U.K.	Pacific Area	Gold	Total
Short-term	15%					15%
Bonds	25%	5%		5%		35%
Shares	25%	3%	5%	12%		45%
Gold					5%	5%
Total by Currency	65%	8%	5%	17%	5%	100%

BJ-S added:

"The fundamental factors that determine the economy look altogether favourably. Hence, one can expect the financial markets to perform accordingly relatively well in 1988. It must be expected, however, that it can still last a while before the fundamental aspects, which were temporarily forgotten by the panic mood following the crash, again have an effect, as the situation still looks negative on the chart. Renewed serious setbacks cannot be excluded, but must put down to purely technical reasons. An engagement in U.S. shares can absolutely be recommended, but considerable volatility on the stock markets still has to be reckoned with throughout the year.

Opinion: "Stocks must therefore be chosen selectively."

(vii) Amendment of the Strategic Controls

BJ-S started conservatively with minimum exposure to shares. It achieved fairly good performance. It gained the trust of the Investment Policy Committee. As a result, BJ-S was given the green light to allocate 35% of the portfolio to shares. Pursuant to this, the Controller had to plan for more tighter monitoring procedures than before to make sure that increasing the percentage of shares in

the portfolio would not make their situation more risky. Thus, the Controller started checking BJ-S process by which it selected the new shares to be added to the portfolio. The process did not end as long as the relationship existed between the principal and the discretionary portfolio manager.

SECTION 6-C

MAJOR ISSUES EMERGING FROM THE POST-INVESTMENT CASE STUDIES

(THE CONTROLLER'S ADVANCED THOUGHTS)

Strategy Implementation, Operation and Tactical Decision

It is evident from the two case studies that the investment strategy implementation involved amending the strategy to reflect the shift in the stakeholders' requirements caused by the volatility of the financial markets. Strategy does not stand aloof as independent of events. Strategy grows from events. In the strategy amendment process, the two agents did not depend on the security analysis approach alone. Rather, the two agents were careful to understand the nature of the shift in the principal's objectives in response to financial market fluctuations.

A common tool for the amendment of each agent financial strategy was the tactical re-allocation of the assets in the portfolio. Throughout this process, the involvement of the principals through the Controller was clear in negotiating the structure of the portfolio at the first level allocation of the assets i.e. allocation to stocks, bonds, cash, and metals beside the currency allocation to the U.S. dollar. The analysis of individual securities and their selection was predominantly the task of the agent. While performing this task, the two discretionary agents were in a continuous interaction with the Controller who interpreted to them the shift in the stakeholders'

perception of the investment risk.

The two cases also showed that tactical decisions, strategy amendment, operation and portfolio performance monitoring were emerging in one inseparable process. It was difficult for the Controller to separate them. The involvement of the Controller made the complex strategy process manageable for both the two agents and the stakeholders.

Multi-systems for Measurement of Performance

The two case studies did not emphasize the rational measurement of performance (ROI) achieved by the two discretionary agents as a fundamental method of appraisal. Indeed, the portfolio performance measurement system was a mixture of: (1) reading the agent's performance (ROI) compared to the markets' benchmarks. This was a general indicator. It was not used as a final standard for performance evaluation; (2) monitoring the investment decision processes of the agent emphasizing prudence and the quality of the agent judgement; (3) trying with one of the two agents to set a conservative profit-take standard; (4) liaison with the agents to understand their problems which led to unsatisfactory performance; and (5) trying to make the agents feel that at the end of the day bottom line performance will be a major concern for Mosnic. Thus, a mixed system of portfolio performance evaluation emerged in the two post-investment case studies.

Even this multi-dimensional performance appraisal system was different from one agent to the other: it depended on the specific features of the problem confronted by each agent.

The presence of the owners and the Controller was essential for the mixed performance appraisal system to work. The Controller's easy access to the owners facilitated the day-by-day management of the extremely shifting process of amending the investment objectives.

The Paradox of Loose and Tight Control

The reader of the two cases can easily observe that a risk-return approach to the portfolio performance appraisal was used by the portfolio managers. But this did not work without the input of the Controller which depended on what the principals required. Due to the complicated changes in the principals requirements, the Controller felt that the goals to be pursued appeared as if they became ambiguous.The intervention of the principal through (the Controller) might give the feeling that the strategic control became loose. However, this was not the case. In fact, the two discretionary agents were given the full freedom to analyze securities in any sophisticated way their means could provide. However, Mosnic would not leave it loose for the agent to guess the shift in its objectives as the markets were never stable. The agents were free to select the securities, but they had to come back with their models to the Controller for understanding

the principal's specific requirements. Hence, to make the control both flexible and tight, the Controller had to be heavily involved to help the two agents understand the process by which the stakeholders amended their objectives.

To summarize, the two agents maintained the discretion to select the individual securities but within the broad shifting asset allocation policy negotiated in a complicated process with the stakeholders. Indeed, this was the thrust of the principal-agent interaction process described in the two cases.

Agents' Authority, Accountability and the Principals' Involvement

The interaction with the agents gave the principals great comfort. The question was whether this intervention released the agents from accountability or not. In fact,it did not.

The intervention of the principals through the Controller did not release the agents from accountability because the Controller carefully orchestrated the involvement process in a way that the two agents should take the full responsibility for their decisions. The Controller was careful not to leave the two agents dissatisfied with the principal's objectives. This was clear in the style of the Controllers' correspondence and negotiations with the agents. Despite the intervention of the principals to amend the agent's strategy, the latters never felt that unreasonable investment objectives were

imposed on them to pursue. Moreover, the two agents were convinced to cope with the mixed performance appraisal system adopted by Mosnic. Neither one of the two agents objected to the mixed appraisal system which involved monitoring their involvement decision processes.

Different Control Processes with Different Agents

The processes by which Mosnic monitored the strategy with the two agents were different. Each one of the two agents had different views about how to cope with the markets' volatility. The two agents differently viewed the processes which impacted the strategic investment decisions differently. Thus, the asset allocation styles of the two agents were also different. The Controller did not impose on either of the agents to follow the style of the other. This meant different ways of appraising each agent investment decision process. The process by which the principals' shifted their investment objective depended on the specific problems discovered in the concerned portfolio. Hence, these processes were different. Thus, amendment of the financial strategy (an important aspect of agents control) of each agent was different from the other. This meant that standard control processes were not appropriate for being universally applicable to both of the two agents.

Conclusion

The post-investment case studies described how Mosnic worked with two of the selected portfolio managers to manage the investment process. The case studies also shed light on the problems of portfolio performance appraisal and concluded that Mosnic followed a mixed system approach to overcome the problems involved in the discretionary portfolio management processes. The major issues emerging from the two case studies in this Chapter center around strategy implementation, operation and the tactical decision processes. Problems of authority, involvement and accountability are also projected by the two case studies.

However, this is not the end of our research problem. In fact, only a simple conceptual framework was used to study the five agents cases. The cases have added a lot of insights to the contingent variables of the conceptual framework. It is now necessary to reflect further on the simple conceptual framework of the research to develop it into a detailed one. To do this, it is necessary to further our understanding of the hypothesized relationships between the contingent variables of the simple conceptual framework of the research. This is achieved in the next Chapter where the five case studies of the specific agents are analyzed. The analysis also sheds light on strategy formulation, controllership and the control system of the investment houses.

CHAPTER-7

ANALYSIS OF THE SPECIFIC AGENTS' CASE STUDIES AND DEVELOPMENT OF THE DETAILED CONCEPTUAL FRAMEWORK

Objectives and Outline

In this chapter, the preceding case studies are analyzed with a view to shedding more light on the working hypotheses developed in Chapter 4. The relationships which emerged from the analysis have been integrated into the **general** conceptual framework developed in Chapter 4 (and depicted in Fig. 4.1) to produce a **detailed** conceptual framework (Fig. 7.6). The latter represents the grounded theory induced from the initial case study of Mosnic and the five case studies on specific agents.

The analyses are conducted at two levels. Level 1 examines further the first working hypothesis and part of the second working hypothesis (2.1.a) (which deals with the interactive relationships between the stakeholders' goals, strategy and religious beliefs, environment, technology, portfolio managers and Mosnic's control system) in the light of the insights gained from the case studies on the specific agents. The remaining parts of the second working hypothesis (2.1.b, 2.1.c, 2.1.d) are discussed in Level II of the analysis which addresses the constructs of the contingent variables to take on board the additional relationships developed form the agents' case studies.

Section 7.1 expands our understanding of the first working hypothesis which deals with how the interaction

between the stakeholders' strategy and goals and the environment affected the features of the control system of Mosnic. It also examines further the impact of the information technology and the stakeholders' religious beliefs on the corporate control system and controllership function. In addition, the role of strategic controllership in Mosnic is examined.

Section 7.2, which addresses the issues hypothesized in working hypothesis 2.1.a, highlights the relationship between the environment and the portfolio managers' strategy, structure and processes (agents' means and methods). It also expands the arguments that technological resources expended by the portfolio managers impacted their related strategy, structure and processes. Furthermore, the section investigates how the religious values of the principals interacted with the agents means and methods and how such an interaction impacted the role of controllership and the control system in Mosnic.

In Level II, section 7.3 deals with the relationship in working hypothesis 3. At this level, the analysis traces the relationship between the attributes of agents' strategy, structure and processes with the control system of maintaining the portfolio of agents.

Sections 7.4 and 7.5, which investigate the working hypotheses 4 and 5, use the two case studies in Chapter 6 to examine the effect of agents' performance evaluation processes on Mosnic's control system. In section 7.6 the detailed conceptual framework is developed.

In order to refresh the memory of the reader, a summary of the working hypotheses generated in Chapter 4 is reproduced below together with the general conceptual framework.

Summary of the Research Working Hypotheses

1.1. The turbulence of the financial markets in which investment houses operate tend to influence the way stakeholders formulate investment strategy and goals. This, in turn, is likely to affect the control system and the controllership function in investment houses.

1.2. The religious beliefs of the stakeholders impact the management control system of investment houses and influence the function of the controller.

1.3. The implementation of modern information technology by investment houses operating in international financial markets through portfolio managers influences the design and efficiency of the organization's control system.

2.1. a. The way intended agents interact with financial markets influences <u>their</u> strategy, structure and processes (i.e. their methods and means).

b. Consequently, investment houses operating through a portfolio of agents tend to formulate their corporate strategies by utilizing a number of heterogeneous sub-strategies.

c. Thus, the corporate control system emerges from a number of different strategic control sub-systems.

d. These systems could be more effective by using an "involved controller".

2.2. a. The level of information and communication technology used by intended portfolio managers influences their strategy, structure and processes.

b. Hence, operating through a portfolio of agents leads to the emergence of a number of control sub-systems tailored to meet the specific control needs with regard to each agent.

2.3. a. The religious beliefs of the stakeholders of investment houses influence agents' strategy, structure and processes. This in turn influences the control sub-systems to be designed for controlling a portfolio of different agents.

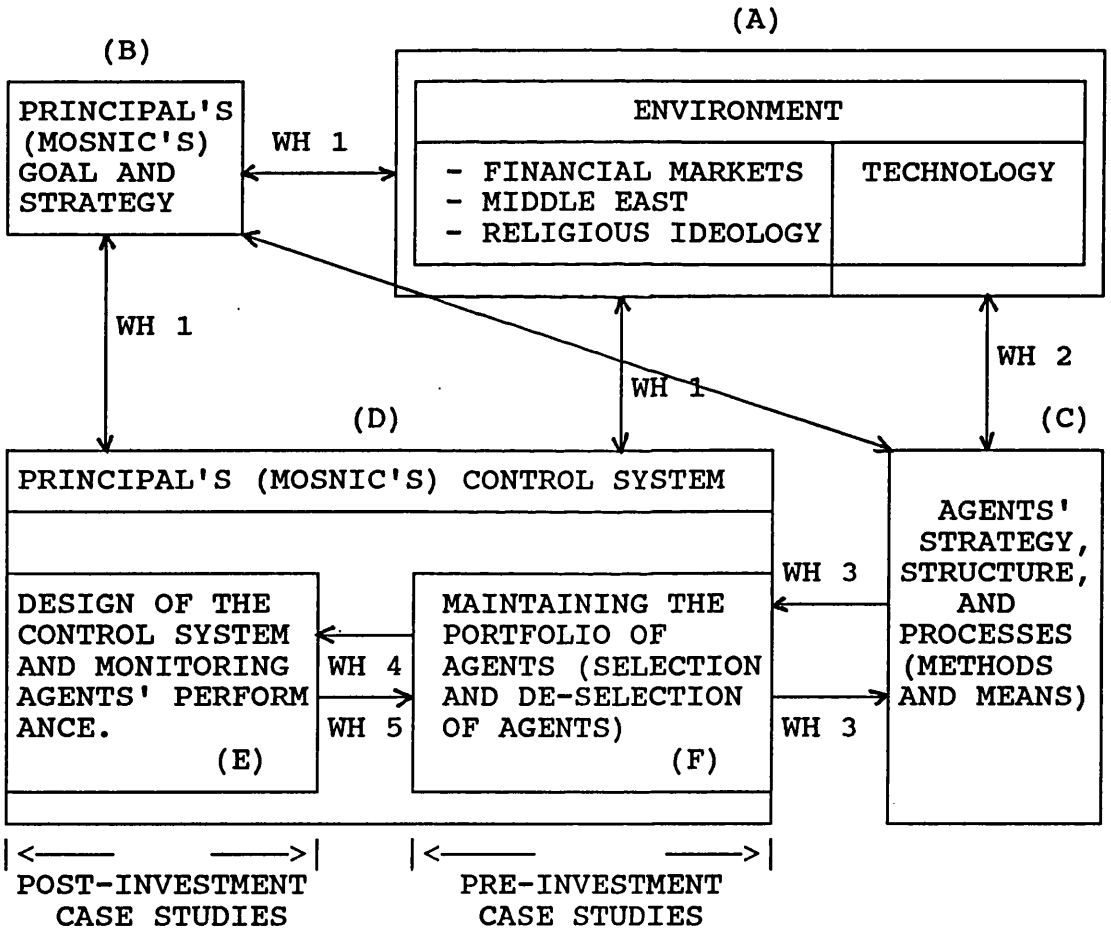
b. The role of the corporate controller in investment houses in interpreting stakeholders' religious precepts to their agents is important.

3. Agents' strategy, structure and processes influence the pre-investment processes carried out in investment houses to maintain an appropriate portfolio of agents.

4. The processes of maintaining the portfolio of agents in an investment house influences the design of the corporate control system to monitor the agents.

5. The process of appraising agents' performance has a feedback effect on the process of maintaining the portfolio of agents maintained by an investment house.

Fig. 4.1
The General Conceptual Framework of the Research

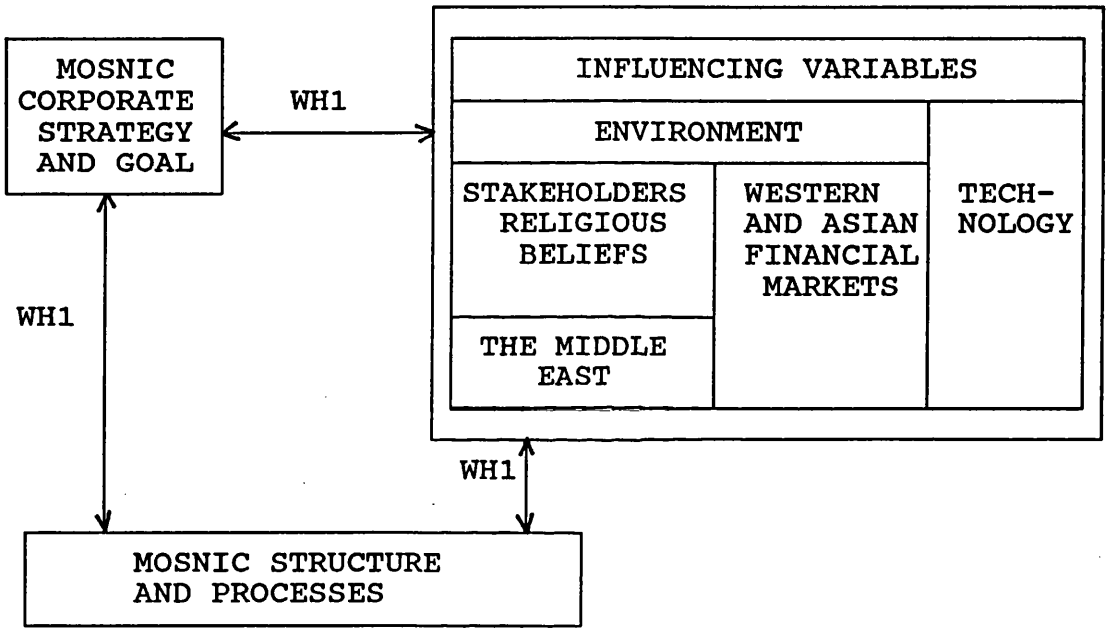


ANALYSIS LEVEL I

7.1. The Impact of Financial Markets, Religion, Strategy, and Technology on Mosnic's Control System (Working Hypothesis # 1)

In this section, I investigate the specific features of control in Mosnic emerging from the influencing variables in Fig. 7.1. The latter is part of the general conceptual framework developed in Fig. 4.1.

Fig. 7.1
Relationship # 1 (WH 1)



The Impact of the Financial Markets on Mosnic's Strategy, Goals and Control System (Working Hypothesis 1.1).

The nature of the uncertainties of the financial markets has always been a source of worry to the stakeholders. The agents' case studies show that formal long-term planning is of little value because of the volatility of the financial markets. Mosnic recruited the Controller to help in dealing with these financial market uncertainties. The five case studies do show some use of rational economic and financial rate of return analysis,

but only as a small part of the total process of making significant investment decisions (e.g. allocation of the assets, diversification over the agents and in general, assessment of risk inherent in operating discretionary portfolios in the financial markets). Rates of return were always implicit behind all the analyses used, but could not be made so unambiguously explicit that sole or almost sole reliance could be made on them.

The agents case studies, which tackled the selection of agents, substantiated the view that subsequent to recruiting the **Controller,** the principals have been significantly involved in managing both the risk they took on agents and that inherent in the uncertainties surrounding strategic investment decision. This was achieved by the **active involvement** of the Controller in the principal-agent interaction process.

The case studies also show that before the appointment of the Controller, the stakeholders did not have the opportunity to spell out their continuously shifting views which was affected by their own interaction with and perception of the investment environment. Indeed, following the involvement of the Controller, the perceptions of the stakeholders towards the situation in the financial markets were promptly translated into significant decision inputs to the agents who amended their general investment policies accordingly, while retaining responsibility also for selecting individual securities.

On the other hand, Mosnic did not have written investment strategies on which the portfolio managers could advise the financial targets to be pursued. Unlike the situation prior to the recruitment of the Controller, the case studies of MIP and BJ-S show that Mosnic formulated its corporate strategy through the following stages: (1) evaluating each agent's proposed strategy through debate and discussion; and (2) agreeing on a financial strategy with each agent separately. Hence, Mosnic did not have a pre-determined overall corporate strategy. Rather, an emergent strategy developed through interaction with independent sets of discretionary agents. On the other hand, Mosnic might amend the financial strategy agreed with a particular agent if the financial markets gave any signs of change. In the above processes the Controller played the role of gatekeeper in the sense that he explained the agents' investment models to the principals as well as the risk taking attitudes of the latter to the intended agents. This implies that the Mosnic investment strategy formation process relied to a great extent on the continued debate between agents and the Controller and not primarily on the sophisticated investment models of the portfolio managers.

The following are other important issues which emerged from the nature of strategy process (influenced by the financial markets) in Mosnic. **First,** the strategic control system in Mosnic was designed to help in monitoring a number of investment strategies acquired from a number of different portfolio managers. The Corporate

Controller observed the differences between the agents and then designed the appropriate procedures. **Second,** the corporate strategic control procedures had to be flexible and dynamic to keep pace with the amendment of the corporate strategy in line with the changes in the financial markets. This projected the importance of the role of the Corporate Controller in such processes. **Third,** the control system not only monitored the implementation of the strategy; but also contributed to the strategy formation by taking part in amending the financial strategy process of each agent. This will be explained in more detail in Level II. **Fourth,** the presence of the Controller facilitated the timely interaction of the stakeholders and the portfolio managers with the financial markets. The control system deployed by the **Controller** was designed to monitor dynamic strategies and goals which had no pre-determined ROI target. Before recruiting the **Controller,** Mosnic did not have a system of monitoring the dynamic strategies. Thus, the effectiveness of the corporate strategy process depended on the timely attendance to market information through an endless process of interaction between the Controller and the agents. The amount of information to be managed in the interaction process proved to be too much to be handled without the existence of an involved **Controller.**

Indeed, the nature of strategic decision processes show how the **Controller** needed a high degree of freedom in dealing with the agents and the stakeholders in order to

attend to information necessary for the management of complicated strategic uncertainties resulting from the turbulence of the financial markets.

The Impact of Stakeholders' Religious Beliefs on Mosnic's Control System and Controllership Function (working Hypothesis 1.2).

The agents case studies show to what extent Mosnic's Islamic investment goals were implemented by Western portfolio managers who had little or no knowledge about the Islamic financial systems. The religious influence on the control system and strategy process magnified after the recruitment of the Controller. It was also part of the latter's task to interact with the agents to make plain to them the rules of the Islamic Shari'a concerning the receipt and earning of interest. As part of this process, the Controller included a pre-condition in setting the fiduciary relationship with MIP and BJ-S which enforced the compliance with the stakeholders' requirement of reporting interest separately. Hence, the control procedures designed to monitor the work of the two agents provided the necessary mechanism of checking the extent to which these agents' performance included revenue from interest. As an attribute of judging whether the agent was good enough for portfolio management or not, the Controller looked into the potential capabilities of each agent to implement the Islamic aspects of the investment strategy of the stakeholders.

The feedback of the control system to the stakeholders and to the agents in relation to interest earned was an influencing factor that led to the amendment of the investment strategy to avoid interest. For example, the investment systems to both BJ-S and MIP included short-term cash investment (fixed deposits) as part of the standard asset allocation policy. Both agents initially proposed that an appropriately diversified portfolio ought to allocate part of the funds to fixed deposits or in general to money market instruments. In contrast to this, the Controller was decisive in telling the two agents that irrespective of their models, which presented well diversified portfolios, inclusion of interest generating investment in the portfolio was strictly prohibited. By taking a strict position from any income generated from interest, the stakeholders were actually taking the risk of holding a less diversified portfolio by eliminating many money market instruments*. This meant a further complication of portfolio risk management because Mosnic had to think of more risky investments to utilize its funds. The Controller had to manage this complicated process by examining more closely the methods of the agents concerned with the selection of the individual securities.

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* As mentioned in the initial case study in Chapter 3, the reader is reminded that if bonds are sold before maturity then the problem of usury which arises from earning fixed income would be solved.

MIP and BJ-S neither objected nor refused to do business with Mosnic in response to the stakeholders stance on interest. However, their response in making this requirement operational was different. For example, MIP was not enthusiastic about the principals' religious requirement. Its management was a bit 'too Western'. However, it had a reliable system of reporting interest separately from other revenues. On the other hand, BJ-S showed a more sympathetic response to the stakeholders' religious restrictions, but would not report interest separately. At the same time, the portfolio manager in BJ-S who was in charge of Mosnic account was careful to understand the religious requirements of the stakeholders. His knowledge about Islamic concepts of investment was even better than the portfolio manager assigned by MIP bank. Hence, the control system had to be designed to suit the specific control needs of each agent from a religious stand point. The above differences meant that MIP required more rigorous monitoring procedures than BJ-S in terms of compliance with the religious restrictions on certain investment instruments.

<u>The Impact of Information and Technology on Mosnic's Control System (Working Hypothesis 1.3)</u>

The cases of MIP, BJ-S and Vontov show that information technology applied by the agents made it possible for the management of Mosnic to learn more about the art of portfolio management. Since, as a result of utilizing the huge volume of information made available to Mosnic by the three agents, the management of the company

has improved its understanding of the investment strategic management processes. The role of the Corporate Controller also has been vital in achieving this improvement. He has succeeded in extracting strategic information from MIP and BJ-S to provide useful inputs to the corporate investment strategy negotiated with the stakeholders.

The role of the **Controller** also has been significant in the treatment of the different information systems provided by the agents. The different data processing systems of the three agents meant different information system used by each agent. For example, the style of reporting interest, the style of reporting the portfolio performance, the way each agent presents the market outlook and the investment strategy, etc. These variations led the Controller to deal differently (in terms of reliability) with each system of information to build-up the Corporate information system (as illustrated in section 5-D chapter 5, section 6-C chapter 6, and conclusion to the selection of BJ-S in page 221 chapter 5.

The agents case studies also show that the **Controller** introduced the telefax system to Mosnic and boosted the efficiency of its use. The telefaxes and the Reuter links have made the world "very small". They also have substantially reduced the cost of communication. This facility, beside that of the three agents, has enhanced the strategy process in Mosnic. Mosnic management no longer needed to be in the West or to have the Western portfolio managers physically in the Middle East to re-

formulate alternative strategy if need arises. Interaction could be carried out at a distance.

In addition, the three cases signify that the strategy monitoring process in Mosnic became more sophisticated and intensive due to the communication technology utilized by the **Controller.** By sophistication we mean further understanding of what the asset managers would do in the complicated investment decision processes and being able to interpret to the agents the stakeholders' shifting objectives to make these objectives understandable and satisfactory for the discretionary agents to pursue.

The progress in and the low cost of the international communication technology together with the presence of the **Corporate Controller** have made it possible for Mosnic to ensure that a tactical re-allocation of the corporate resources was made by the agents whenever it was seen necessary. Moreover, the advanced communication technology has made it possible for the **Controller** to build-up the corporate record keeping system by utilizing much more information provided on a timely basis by the portfolio managers. This internal build-up of information expedited both the re-structuring of the corporate portfolio and the adjustment of investment strategy as the need arose.

Concluding Remarks on Working Hypothesis # 1

The analysis of the three pre-investment cases studies, which deal with the selection of portfolio managers, have advanced our understanding of the controllership functions and the control system in Mosnic in the following aspects.

Formal quantitative analysis presented by the portfolio managers had to be adjusted in order to accommodate the changing objectives of Mosnic's owners in response to their perception of market uncertainties. Level II analysis will cast light on the quantitative investment proposals of the discretionary agents.

Further, the case studies substantiated that the corporate strategy in Mosnic emerged from a number of financial strategies which were negotiated in a continuing interactive process with a portfolio of agents.

The investment strategy became more efficient and effective by involving the Corporate Controller who played a key role in orchestrating the complicated corporate portfolio management processes while maintaining organizational effectiveness. In addition, his presence helped Mosnic to deal with the uncertainties of the financial markets in a better manner than before by securing timely attendance to the problems. Indeed, after the recruitment of the Controller, the corporate control system in Mosnic started to attempt more effectively the challenge of Islamizing the corporate investment strategy to be implemented in the West.

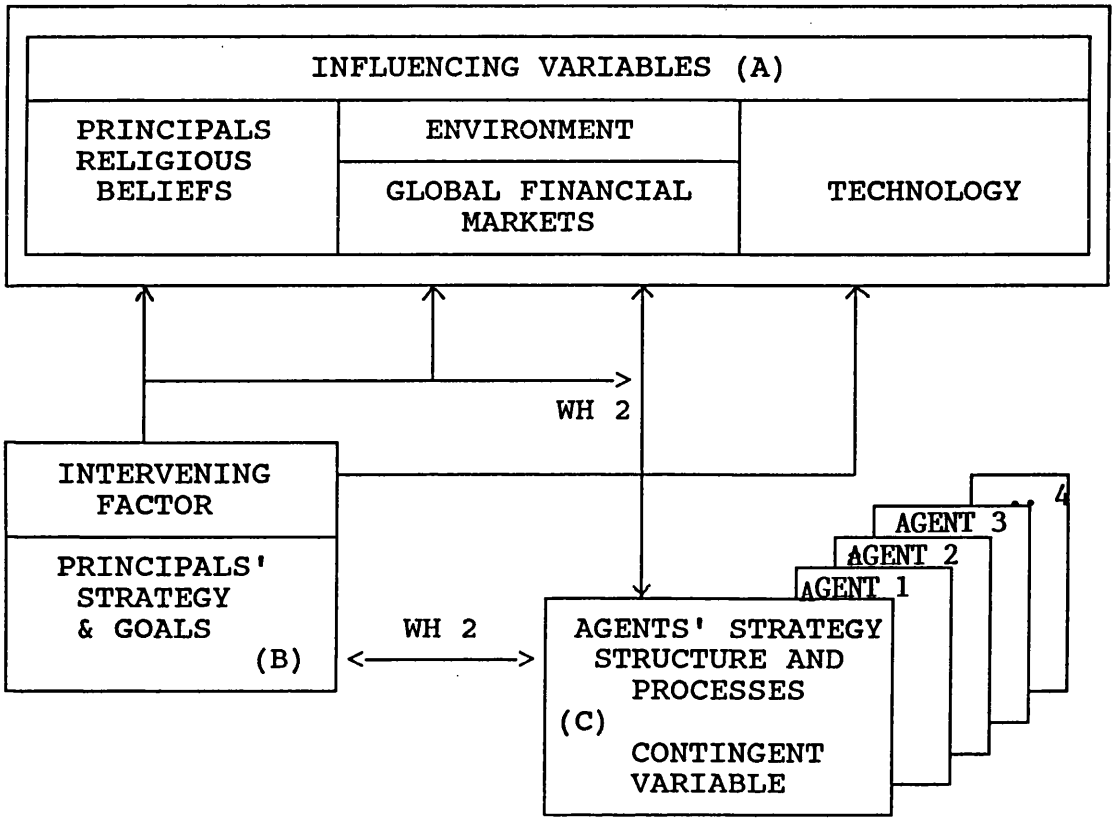
The analysis of the pre-investment case studies also show that the use of technology by the portfolio managers influenced the extent to which the Controller relied on the different agents' information systems. This in turn seemed to have affected the design of the corporate information system.

7.2. The Interaction of Environment, Principals' Religious Beliefs, and Technology With Agents' Strategy, Structure and Processes. (Working Hypothesis 2)

The working hypothesis 2 of the general conceptual framework (Fig. 4.1) indicated that environment, principals' religious beliefs, and technology influence the **portfolio managers'** strategy, structure and process. However, from the analysis of the case studies of the specific agents, it became clear that the impact of these is not necessarily a direct one. Rather, it sometimes took place through an intervening variable which was Mosnic's strategy and goals as shown in Fig. 7.2.

Level II analysis will demonstrate how the different constructs of the agents' strategy, structure and processes get inter-connected with the rest of the contingent variables and how such an inter-connection affected Mosnic's control system. Hence, it is appropriate to discuss hypotheses 2.1.b, 2.1.c and 2.1.d, which deal with the latter relationship, also in Level II of the analysis.

Fig 7.2.
The Interaction of Agents' Strategy, Structure and Processes With Stakeholders' Religious Beliefs, Environment and Technology.



The Impact of Financial Markets on Agents' Strategies, Structures and Processes (Working Hypothesis 2.1.a)

The three pre-investment case studies show how agents adjusted their standard investment strategies in response to market changes. After amending their investment models, the agents voluntarily provided the Controller with a copy of the adjusted strategy for negotiation. The case studies also highlight how the agents then adjusted their investment strategy to take into consideration the comments and guidelines of Mosnic. However, unlike the attitude of BJ-S, which showed considerable interest in understanding the pattern of the principals' interaction

with the financial markets so as to modify their investment strategy accordingly, MIP did not show that flexibility. See Chapter (5) the case of MIP where it criticized the strategy proposed by Mosnic.

Another aspect of difference between agents was found in their organizational structure. An agent's structure (e.g. the investment departments found in both MIP and BJ-S) also depended on the type of the investment markets in which it aimed to operate. For example, MIP policies and expertise were geared towards global shares portfolio management. BJ-S was oriented to bond portfolio management. Even at the level of the portfolio management staff the Controller observed that the portfolio managers were differently specialized e.g. MIP had two of its men specialized in the U.S. securities and one in Japan. On the other hand, BJ-S was the best who advised Mosnic on bonds. This also meant the type of the investment market in which the agent operated, determined the structure of the agent. This in turn would affect the agent processes. This implies that agents' structures and processes would differ according to the markets in which they operate. Hence, Mosnic needed different control systems to deal with MIP and BJ-S. Level II of the analysis will highlight how such differences from one agent to the other were critical to the corporate control system.

Agents also changed their structures (e.g. by split merger) over time to cope with new situations coming up in the financial markets (e.g. the merger of Vontov) and

possibly to gain competitive advantage. A change in the structure of an agent would mean a change in the methods of investments to cope with the new market situations (e.g. the case of Vontov).

It might be interesting to inform the reader that after this chapter was written, the Controller received news that one of Mosnic's major agents, which was not studied in this research, has merged with another investment bank to be more competitive. The Controller is currently involved in studying the implications of this merger to Mosnic's strategy, structure and control system.

The Impact of Technology on Agents' Strategy, Structure and processes (Working Hypothesis 2.2.a).

The pre-investment case studies show that communication technology intervened through the corporate information system of the principals to impact agents' strategy and processes. This was clear in the case studies where the Corporate Controller and the Director used the information and the communication facilities made available to them to negotiate with the agents and to amend the latter's strategies. In Level II, it will be argued how the use of technology by different agents led to the emergence of a number of corporate control subsystems (working hypothesis 2.2.b).

The ability of the Controller to negotiate investment proposals with the agents was dependent on his success in utilizing the communication technology to appraise critically the means and methods of the agents. The case

studies signify that it was highly unlikely that the Controller would be able to negotiate with the agents the amendment of their proposed investment strategies without the communication technological support availed by the company for his use.

The Impact of Stakeholders' Religious Beliefs on Agents' Strategy and Processes (Working Hypotheses 2.3.a and 2.3.b).

In Section 7.1. it was argued that the religious ideology of the stakeholders influenced the formulation of their investment strategy and goals. On the other hand, the agents' case studies supported the argument that the religious ideology of the principals led to an amendment of the agents' strategy, structure and processes. This suggests that the corporate strategy in Mosnic intervenes as a variable to impact the investment models of the agents. Indeed, none of the three agents really submitted investment proposals which Mosnic accepted without negotiation. In addition, the impact of the religious beliefs of the stakeholders intervened through the corporate investment goals to influence the investment strategy and approach of the agents.

The three case studies indicate that the pre-selection analysis of MIP and BJ-S gave high consideration to the religious restrictions imposed by the principals. To repeat, in the investment process, the two agents were not allowed to invest in interest bearing securities. In this process the Controller contributed to the agents' understanding of this requirement. For example, see

Chapter (6) section 6-A, the case of MIP 'Islamization of the investment process through MIP', page 284.

Concluding Remarks on Working Hypothesis # 2

The analysis of the three pre-investment case studies has enhanced our understanding of the working hypothesis 2 in the following aspects. It highlighted how **agents'** strategy, structure and processes were modified to take on board the stakeholders' perception of the nature of financial markets' uncertainties. In addition, it became clear that the agents' structure was influenced by both the type of the investment markets in which they operated and the potential changes in structure of the industry (e.g. the merger of Vontov).

Further, the recruitment of the Controller and his use of modern communication and information technology facilitated the interaction of Mosnic's owners with the agents. This threw light on how communication technology intervened through the corporate information system to influence agents' strategy and processes.

The analysis of the case studies also revealed how the religious beliefs of the stakeholders influenced the agents' strategy, structure and processes through the corporate strategy and goals.

ANALYSIS LEVEL II

In the Level II analysis, I will discuss working hypotheses 3, 4, and 5. I will also shed more light on the remaining parts of working hypothesis 2.

7.3. The Inter-Relationship Between Agents' Strategy, Structure and Processes with Mosnic's Control System of maintaining an appropriate Portfolio of Agents (Working Hypothesis # 3)

In this section, I will analyze the three pre-investment cases on specific agents to highlight the relationships between the attributes, which were developed by the Controller for the selection of agents, and the strategy formulation and pre-investment control processes. For detailed attributes to establishing a fiduciary relationship with the asset managers the reader is referred to the ASSPQ (Appendix 5.1 in Chapter (5), page 169).

The five attributes, which were described in Chapter (5) and which will be discussed in this working hypothesis, are:

1. Agents' investment approach; e.g. risk-taking attitude.
2. Agents' ability in scanning the markets, readiness to supply information to Mosnic, and agents' use of technology;
3. Agents' personnel rewarding system, turnover and portfolio management efficiency;
4. Effectiveness of agents' internal control system; and
5. Agent's structure.

1. <u>Agents' Investment Approach.</u>

The Controller felt that it was important to study the investment approach (the risk-taking attitude, the asset allocation models, etc) proposed by MIP, BJ-S and Vontov

Banks to ensure that the intended agents would successfully manage the principals' investment risk. In addition, the process of negotiating the risk-taking attitude with the intended agents and their investment approach [e.g. their rational financial economic analysis, market outlook, strategy and asset allocation, different currencies investment models' etc. for more details refer to the three pre-investment cases in Chapter (5)] was an opportunity to introduce to the agents their principals' perception of risk. This made it possible to manage the corporate portfolio within the risk parameters generally acceptable to the stakeholders. Indeed most of chapter (5) describes processes through which the financial strategies with different agents emerged from the interaction between the agents' sophisticated models and the principals' perception of the markets' uncertainties as interpreted by the Controller.

The Controller also believed that differences between MIP, Vontov, and BJ-S in terms of their investment approach and their risk-taking attitude were important for the Corporate strategy process and hence, for strategic control procedures. To understand the detailed features of the strategic control processes designed to monitor the investment decision processes of each agent, the Controller had to be clear about the details of their investment approach. Detailed aspects of differences in the investment approach of the three agents are presented in Fig. 7.3, (page 343). This figure shows the major sub-attributes used for analyzing the three agents investment approach.

For example, in evaluating the agents by the types of assets, (sub-attribute (1) in Fig. 7.3), the Controller arrived at the conclusion that Vontov and MIP had more talents in global shares portfolio management and other equity related investment while BJ-S had better abilities in bond management. The identification of these differences by the **Controller** enabled the principals to reduce their risk by assigning to the right agent the suitable type of securities. Later on the Controller came to know that MIP having realized the large size of the U.S. economy and its domination over the world financial markets, decided to employ more of the American mathematical economists to prepare them for being U.S. shares specialized portfolio managers. Knowing this, the principals requested from the Controller to bear in mind that the Americans by nature are more aggressive in risk-taking than the Swiss managers. Thus, the Controller went for more interaction with MIP.

This is not to say that there were no problems confronting the **Controller** in getting all the necessary information about agents' strengths and weaknesses in terms of who had better abilities in managing certain types of securities. Nevertheless, examining the agents' investment management style [Fig 7.3, sub-attribute (2)] revealed to Mosnic a number of important aspects for evaluating the strategy and investment processes of intended agents. For example, the outstanding experience of BJ-S in the choice of bonds convinced Mosnic's Investment Policies Committee that it would be more safe

Fig. 7.3
Attributes to Agents' Investment Approach

1. Types of Assets:

   International Securities (US & Others).

   - o short-terms
   - o equities
   - o bonds
   - o options

2. Management Style:

   a) Importance of market timing.
      (Frequency of Asset Allocation)

   b) Choice of Stocks.

      - o income
      - o growth
      - o quality
      - o large companies
      - o small companies
      - o low P/E

   c) Bond Choice.

      - o issuer type
      - o maturity
      - o quality
      - o coupon
      - o turnover

to assign bond portfolio management mainly to BJ-S. However, as shown in the control procedures designed by the **Controller** specially for BJ-S (see Chapter (6) pages 292 to 297 BJ-S post-investment case), the processes necessary for monitoring bond portfolios were different from those designed for monitoring purely shares portfolios. Thus,the difference in the types of assets and in the management styles of different agents led to different control procedures. Most important for the Controller were:(1) ensuring that certain degree of risk-taking compatibility

existed between the principals and the agents. (2) Agents had flexibility to adjust their rational (quantitative) models to the principals' perception of the financial markets' uncertainties.

2. Agents' Ability in Scanning the Markets, Readiness to Supply information to Principal, and the Agents' use of Technology.

The Corporate Controller found it necessary to formalize the process of studying the three agents' market scanning abilities, their readiness to provide market information to the principals, and their communication and information means (technology) in order to reduce the risk taken by the principals on their agents. This was also important to ensure that the intended agents' strategy and processes were based on reliable information i.e. the quality of data.

The Controller identified the differences in the above attributes between the three agents by using the following sub-attributes which emanated from the sources of investment input (information) used by the agent:

Information Sources Available for the Agent to Formulate the Investment Decision.

1. Analysis of economic factors.

(i) U.S.A., Japan, Germany, U.K., France, etc., monetary economics (interest rates outlook).

(a) Information from outside.
(b) External information.
(c) Reference/names of institutions/organizations used.

(ii) Other economics - as in (a), (b), (c) above.

2. Sources of portfolio models.

   (a) Developed internally.
   (b) Borrowed from external sources.
       (Names of institutions or individuals)

3. Stock market information.

   (a) Internally processed.
   (b) Acquired from outside sources.

4. Bond market information.

   Same as in 3 (a) & 3 (b).

5. Trends of global industry.

   Same as in 3 (a) and 3 (b).

6. Bond selection information.

   Same as in 3(a) and 3(b).

7. Common equities selection.

   Same as in 3(a) and 3(b).

MIP, BJ-S and Vontov were different in these sub-attributes as explained in Chapter 5 in the following processes:

* **asset allocation** (different emphasis in the construction of the portfolio in terms of exposure to shares, bonds, currencies, geographical allocation, and industries);

* **market outlook** (different evaluation of future trends of financial markets);

* **interest rate forecast** (different forecast for global interest rates fluctuations);

* **economic analysis** (different evaluation of the economies of the countries which affect the major financial markets);

* **security selection** (different views on the types and number of securities to be selected for the proposed portfolios).

Based on these differences, the corporate control procedures, which ensured the implementation of strategy, were differently designed for each specific agent. For example, unlike BJ-S, Vontov proposed to invest mainly in shares; however, since the stakeholders considered too much exposure in shares as a sign of aggressive investment, the Controller had to design control procedures which would ensure that shares are not cyclical, maintaining growth, and reasonably diversified. The indication of this relationship can be generalized to suggest that agent capabilities of financial markets' scanning, agent efficiency in providing timely market information to the principal, and the communication technology expended by the intended agent's strategy, structure and processes are important indicators to decide whether to select or to deselect a particular agent.

Hence, the strategic decisions taken by the agents of high market scanning abilities and by those who applied sophisticated communication technology in analyzing market information were likely to require from the Controller less strategic control procedures. For example, unlike BJ-S, MIP was considered by the Controller to be very competent in market scanning and had a reliable information system which means also the concern of the Controller about. Thus, if these attributes changed within the current agents, or as a result of hiring a new agent, the control procedures were likely to change accordingly. The concern of the Controller about the market scanning capabilities of the agent and the degree

of reliability of information provided by them also meant that the Controller wanted to be sure of the quality of the data used by the agents in their rational financial and economic analysis.

3) Agents' Personnel Rewarding Systems, Turnover and Portfolio Management Efficiency,

The Controller introduced the evaluation of agents' personnel as a further attribute to improve agents' selection. This was prompted by the case of Vontov where due to the split in the firm, the change in the investment approach exposed the interest of Mosnic to higher risk. Indeed, one of the reasons why Vontov was de-selected was because of the expensive restructuring of the portfolio (high transaction costs) by a new portfolio manager who allocated considerable part of the portfolio to a number of airlines and transportation stocks just before the Gulf crisis which led to rocketing energy cost. His approach did not properly account for market uncertainties as seen by the stakeholders. Moreover, to re-construct the portfolio for making it compatible with his approach this new portfolio manager had to sell securities. As a result, Mosnic incurred further transaction costs.

Sometimes, this attribute to the selection of agents is difficult to test. The principals may not be able to discover how in the future an agent's organization will be restructured. Hence, this type of risk cannot be known before signing the agreement, but can be monitored loosely afterwards. I have just told the recent story of agents merger in section 7.2 of this chapter. This merger was not

predictable. In any case, the Controller had no option but to deal with the risk taken on the personnel of the new agent particularly if the investment approach would change.

The takeover or merger of investment management firms by other organizations also placed a new burden on the principals who would be interested to assess whether the new ownership would provide the appropriate incentives to the key individuals in their organizations to motivate them to produce as they did before. One of the problems of mergers is that key personnel may not have the autonomy they had before. Indeed, this was another reason why the **Controller** advised the termination of the relationship with Vontov in order to eliminate any further risk the stakeholders might face due to merger or split.

The problem the **Controller** had with these attributes when examining the MIP, BJ-S and Vontov personnel situations was the inadequacy and the one-sidedness of the information available to analyze the differences in these attributes. The current compensation package of the agents' personnel, their track record, turnover, and internal mobility over time, were important attributes for deciding whether to select or not to select an agent. This was because dealing with a more stable agent meant less risk taken by the principals on their agents. However, these attributes were difficult to examine due to lack of information and the inconveniences met by the **Controller** in asking for external organizations' personnel

private matters.

It can therefore, be concluded that an agent's personnel reward system,agent's internal stability in terms of portfolio managers turnover, and the track record of agent's personnel in the efficient management of investment, and performance are all attributes of considerable value in determining whether to establish a fiduciary relationship with the intended agent or not. From a strategic control point of view,the above argument suggests that an intended agent with stable structure and with a sound track record in efficient portfolio management was likely to require less monitoring effort from the Corporate Controller (e.g. the case of Vontov). Hence, the specific control needs of such an agent would be different from an agent who had high staff turnover. After the merger of Vontov, the strategy and portfolio management personnel changed which meant that the Controller had to monitor how the new personnel would approach Mosnic's portfolio. (See chapter 5, the story of Vontov's de-selection).

Accordingly, the necessary control procedures changed as Mosnic changed the structure of its agents' portfolio. In fact, the case studies and particularly the case of Vontov showed that the portfolio of agents could be amended through the complicated processes of selecting or deselecting the agents.

(4) Effectiveness of intended Agent's Internal Control System.

An important attribute guiding whether to select or

not to select a discretionary portfolio manager is to examine the effectiveness of his internal accounting control systems. The differences between agent's internal control systems were critical to Mosnic's corporate control system. The case studies of MIP and BJ-S banks showed that in order for the Corporate Controller to determine control needs of these agents, he had to judge the extent to which he would rely on these agents' internal accounting control systems. (See chapter 5 - The internal control systems review in MIP and BJ-S case studies). However, due to significant differences which were observed, the corporate control system in Mosnic included a number of sub-systems to control the different agents. Indeed, if the sub-systems were not appropriately tailored to suit the need to each specific agent, the whole corporate control system could have been vulnerable to collapse or to be more ineffective. In fact, determining the suitable control procedures for the intended agents goes in line with evaluating the investment strategy and the structure of the agent.

Although in selecting or de-selecting an agent, it was necessary to look into the internal accounting control system of the agent, Mosnic did not necessarily drop BJ-S from its portfolio of agents because of its ineffective internal accounting control system. This is because BJ-S was found good in other aspects. Instead of de-selecting BJ-S, the **Corporate Controller** designed a more rigorous control system to overcome the specific weaknesses (as described in Chapter 6, pages 292-297). This special

monitoring system designed for BJ-S also depicts that having determined the control requirements in the pre-investment stage, the first post-investment procedure to be carried out by the Controller is to design (describe) the detailed system for monitoring the selected discretionary agent.

Thus, investment houses can deal with agents who have different levels of effectiveness in their internal control systems provided that (1) other attributes for the selection of the agents compensate for their control weaknesses; and (2) the corporate control system can be designed to accommodate the differences between agents in terms of the effectiveness of their internal control procedures.

These arguments further suggest that agents who have effective control procedures can be better positioned for vesting trust in them i.e., the level of monitoring the financial strategy assigned to them by their principals may be a bit loose. Consequently, the principal may require less tight monitoring procedures of some agents than they would for others. Hence, the principals' control processes for each agent may be different.

(5) An Agent's Structure.

The three pre-investment case studies show that an agent's structure is also an important attribute both in selecting an agent and in designing the necessary control sub-system for that agent. From the case studies it was

possible to identify the following six components of agents' structure which Mosnic had to examine in order to see how much security was found in the agents' strategy and processes;

1. organizational set-up;
2. diversified market specialism;
3. branches and associates;
4. custodians and correspondents;
5. number and type of clients; and
6. number of clients assigned to each portfolio manager.

For example, if the agent's organizational set-up for decision making was found to be satisfactory then the intended agent's proposed investment approach (process) would be worthy of more credibility (see the conclusion sections on evaluation of agents' means and methods in the three pre-investment case studies). Accordingly, Mosnic would tend to vest more trust in the agent's investment model when formulating its strategy.

Another example is that if Mosnic found that the agent's custodians were highly rated* then this would signify to it that the physical custody of its securities would be safeguarded and these assets would be free from charges and encumbrances. This would mean to the Controller that agent required loose monitoring procedures to verify the financial assets of Mosnic.

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* The reader is to be reminded that Mosnic does not depend on the approved lists provided by rating agencies. Because, for example, some central banks use the audited financial statements of a bank to rate it as a reliable institution and custodian. The Controller believes the quality of data used in financial statements requires further scanning by appraising agents' strategy, structure and processes.

The above suggests that agents' structure tend to influence their strategies and processes which in turn would affect the corporate strategy formulation and the determination of the different agent's control requirements.

Concluding Remarks on Working Hypothesis 3.

Fig 7.4. illustrates how the analysis of the three pre-investment case studies have advanced our understanding of working hypothesis 3. It shows how the attributes of the agents' strategy, structure and processes affect Mosnic's strategy formulation and the determination of the control procedures required to monitor the different agents. Further, it demonstrates the components of agents' structure and how they influence Mosnic's strategy formulation and pre-investment control procedures through the agents' processes.

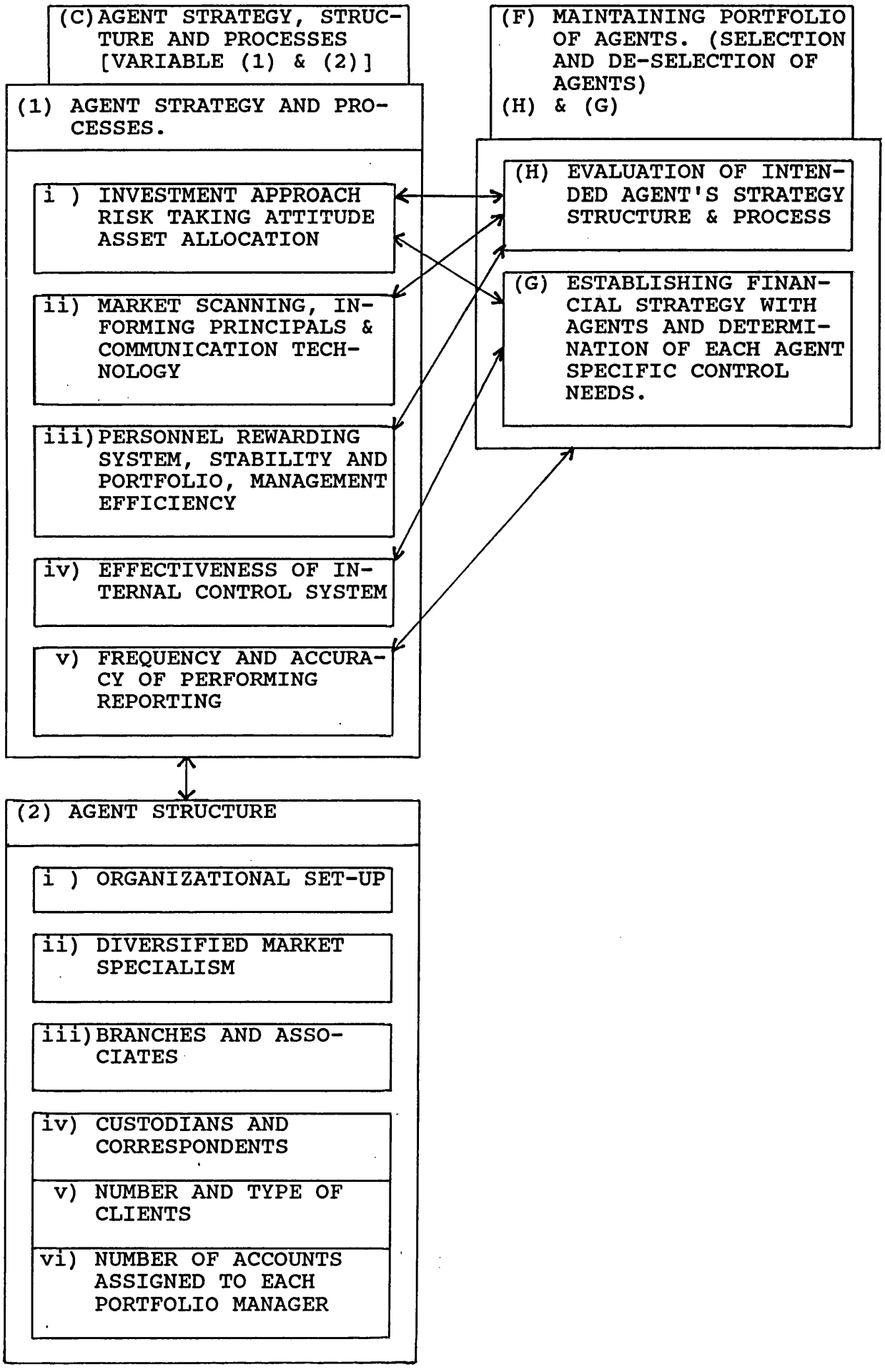
In addition, the discussion in this section has enhanced our understanding of the remaining parts of working hypothesis 2 (2.1.b, 2.1.c and 2.1.d) which deal with the impact of portfolio agents linked to Mosnic with fiduciary relationships on the corporate strategy and control processes and role of the Controller.

7.4. The Relationship Between Maintaining A Portfolio of Agents and Agents' Monitoring Processes (Working Hypothesis # 4)

The pre-investment case studies show that the agents' selection processes involved the following investment planning processes. First, the financial

FIG. 7.4

RELATIONSHIPS BETWEEN AGENTS' STRATEGY, STRUCTURE AND PROCESSES WITH MAINTAINING PORTFOLIO OF AGENTS



strategy to be pursued by each agent had to be determined. This was important aspect in the negotiations with MIP, BJ-S and Vontov about their rational economic and financial analysis. Second, the Controller set the general outlines and the features of suitable control procedure to be tailored for monitoring each specific agent. These two planning processes had a direct relationship with the post-investment strategic control processes. This is because, based on the control features developed in the pre-investment stage, the first step taken by the Controller in the post-investment stage after the selection of the agent (as mentioned in section 7.3), is to design the control procedures to be implemented in monitoring the agent.

For example, in the selection of BJ-S, the Controller had to make sure when designing the monitoring procedures in the post-investment stage that it (BJ-S) catered for some of the weaknesses in its reporting system observed in the pre-selection stage. These included the inadequacy of providing data on (1) the realized and the unrealized losses and gains of the portfolio; (2) details of bonds liquidated before maturity to avoid interest; (3) details of securities sale and purchase transactions; (4) information on different levels of asset allocation e.g.

- By sector of industry
- By country
- By currency
- By bond maturities
- Growth or income shares
- Bonds and convertible bond (warranties), etc.

Hence, given the differences observed between agents in the pre-investment stage, this meant that the control systems designed to monitor each agent would also be different. This equally applied to the strategy formulation process. While formulating the strategy, the Controller also had to design strategic control procedures of each agent to monitor the implementation of the financial strategy negotiated with the agent.

On the other hand, having designed the control procedures to cater for the specific requirements of each agent, the Controller also had to deal with the performance evaluation of the discretionary portfolios constructed by the agents. The latter process involved the following:

(1) measurement of ROI;
(2) comparison with benchmarks and with other agents;
(3) bottom line assessment of ROI;
(4) identifying reasons for unsatisfactory performance;
(5) re-allocation of assets; and
(6) tightening the controls.

In the remaining part of this section, I will discuss the most important three of components of this multi-system of portfolio evaluation, namely (1) the measurement of ROI produced by the portfolios; (2) the comparison of agents' performance with each other and with market indices' and (3) bottom line assessment of ROI.

Measurement of ROI.

The two post-investment case studies and the deselection of Vontov, indicated that some of the agents

(e.g. MIP and Vontov) used return on investment as a measure of their portfolio performance and compared it with the market indices. However, to Mosnic, that was only a general short-term indicator of how the agent strategy was proceeding. Agents were allowed a longer time horizon to adjust to the changes in the financial markets and to be able to accommodate the shifting objectives of the stakeholders in response to market uncertainties. Even Vontov (see the end of the fiduciary relationship in chapter 5) was not deselected for the unsatisfactory portfolio performance which was mainly ascribed to the panic of the financial markets caused by the Gulf turmoil. Rather, the relationship was terminated when the principals became convinced that Vontov had changed its structure, processes and strategy to the extent they were no longer compatible with Mosnic strategy and goals - although these changes in approach may themselves have contributed to the imprudent stance taken by Vontov. Hence, Mosnic used the above multi-system of evaluating agents' performance. This concept will be discussed in more depth later on in Chapter (9) where the finance literature is reviewed.

However, it is important to emphasize that most of the agents (as illustrated by the post-investment cases in chapter 6) do try to analyze performance based on risk and return. The experience of Mosnic also shows that even after using the best computing technology the asset managers have hardly been accurate in assessing the real

market uncertainties as seen by the stakeholders. Moreover, the Controller has actually observed that the portfolio mangers take risk as diversifiable and undiversifiable. They tell Mosnic that if it accepts taking the second type of risk, then markets would automatically yield an ROI equal to the money market rate less the transaction cost (1/4% on return on the fiduciary placements) and the asset management fee. Though Mosnic wanted to be very conservative, fixed interest earning (i.e. money market instruments) are not permanently allowed forms of investments due to religious restrictions. Thus, Mosnic's model for managing the religious risk (e.g. by selling before maturity and temporarily parking funds in fiduciary placement, i.e money market accounts etc.) meant that the asset managers had to re-consider their classification of risk into two main measurable types. Hence, the whole concept of ROI based on the rational portfolio models adopted by the agents needed additional information to be given by the Controller, further negotiations, and modifications in a continuous process of interaction.

Moreover, had Mosnic operated a policy of switching between agents where unsatisfactory ROI's were achieved, it could have incurred huge transaction costs. Such transaction costs would include: 1) The lead time required by the newly hired agent to reconstruct the portfolio of the old agent to make it compatible with his firm's investment strategy. 2) Brokerage fees in selling and buyinbg securities. 3) Possible loss of higher return

while money was "parked" in cash or short-term securities while the portfolio was being reconstructed (especially bearing in mind the prohibition of interest). 4) The considerable effort involved in the selection of a new agent.

Comparison of Agents' Performance for Evaluation of Results Achieved.

The comparison of the performance of MIP, BJ-S and Vontov emerged as one of the problematic issues for Mosnic because of their different structures, strategy and processes. The standards of comparison available for the **Controller** to deal with the three agents were as follows:

(1) Comparison with an absolute goal (i.e. long-term pre-determined goal).

(2) Comparison with market indices.

(3) Comparison with other portfolios.

The main problem was that, to compare one had to make accurate measurement first.

Furthermore, the agents differed in their choice of the method by which their portfolio performance should be evaluated. The **Controller** did not agree with Vontov about the idea of comparison with an absolute goal because this contradicted with the stakeholders' strategy of managing investment risk through close interaction with the markets and then with the agents.

Another problem with the absolute goal method of performance measurement was that, practically speaking,

all portfolios would fail to meet the different objectives negotiated with the agents in a troubled year and would perform better in a good time. On the other hand, Vontov, which was one of the best managers in strong bull markets, showed the poorest performance in bear markets. BJ-S, the conservative manager, showed the poorest performance in the most difficult markets. Thus, the decisions to be taken subsequent to measuring performance using absolute goals achievement system were critical and required careful considerations of the differences between agents in terms of their investment strategy, approach, and philosophy of investment before any final judgment was to be made. The case studies (e.g. MIP in Chapter (5)) showed that it could be simplistic to impose on any agent a standard ROI to be produced.

Another problem of the absolute goal system of portfolio performance measurement was that the stakeholders and the **Controller** needed to agree with the agents on the provision of additional benchmarks in order to understand the activities of the portfolio and to assess whether the manager was doing a good or a bad job in the light of the specific market environment in which the concerned agent was operating.

After the investment mechanism starts, one can hardly find typical portfolios constructed by different agents even if the guidelines are the same. Depending on each agent approach and the portfolio managers' philosophy the

selection of securities can be largely different. But each agent have his rational analysis for justifying the selection of securities. Thus, one cannot compare the agents even if the investment guidelines given to them are the same and the ROI produced by them is not the same.

Indeed, the three agents agreed to provide the benchmark information required by the principals and the Controller. The problem of dealing with different agents in terms of performance measurement by the benchmarks (market index) approach was to look beyond the problems inherent in the absolute goals. This was obvious because the pattern of each agent's interaction with the financial markets was different and dominated his investment returns. In fact, the agents case studies show that they differed in terms of guidelines issued to them. (See (1) in chapter 5 section 5-A (The case of MIP selection) asset allocation discussion, and (2) in section 5-B (BJ-S selection) see 'specific requirements' page 184). Hence, the benchmark system (which depends on standard ROI) alone was not enough.

In practical terms, the **Controller** had to look into the objectives negotiated with each agent to appraise the way in which that particular agent coped with the financial markets. These objectives were not absolutely financial. Sometimes they were even religious. Some agents were told to invest purely in shares, e.g. Vontov. Others were holding portfolios composed of bonds, treasury bills and shares. Hence, each agent required a specific

measurement system and special consideration for the emerging structure of each portfolio. Insisting on comparison of agents who are not alike, means setting one standard for the structure of all the discretionary portfolios. This would actually contradict with the policy of diversification over agents to benefit from their different types of specialism. This policy is one of Mosnic's models to cope with investment uncertainties but without necessarily using sophisticated measurement techniques.

Comparison of Different Agents' Performance with Market Portfolios (Benchmark comparison)

This is an important process because its indications draw attention to the problems of the financial strategy adopted by each agent.

The fact that agents used to compare their performance with market indices led to problems of a different nature. For example, the representative of MIP failed to explain to the **Controller** why in evaluating its performance MIP compared Mosnic portfolio with the market portfolio. The MIP representative's reply was that the system was set by the bank and applied as it was. MIP representative also could not explain to the **Controller** whether the market indices had the same transaction costs incurred by Mosnic. These costs differed from one agent to the other. The problem of Mosnic was more complex because the three agents serving Mosnic had different portfolio transaction

costs. Hence, the comparison of different agents performance with market indices would usually lead to different results. Above all that, as argued earlier, the stakeholders' could hardly believe that beta can measure accurately the relative risk of stocks.

Bottom line Assessment of ROI.

The case studies also indicated that the principal's post-investment pattern of dealing with the three agents differed from one agent to the other. This meant that Mosnic applied different bottom line judgements on the different performance of agents taking into consideration the different market situation in which each agent operated and the investment strategy negotiated with each agent. Indeed, the asset allocation style which Mosnic negotiated with MIP, BJ-S and Vontov was not the same. Because once the investment process started and the performance was reported, attention moved to the current specific problem of the portfolio rather than arguing about what had been agreed. Even if the same objective was agreed with each agent when the investment process started, the three agents came upon dissimilar problems. Hence, the tactical re-allocation of the portfolio securities (a process in the bottom line approach) with each of the three agents turned to be the most significant post-investment control procedure. It was different from agent to the other depending on the nature of the found post-investment situation.

This also indicates that debating the re-allocation of assets by investment houses (as appropriate in each portfolio) in reaction to the financial markets is at the core of the control procedures stakeholders use to manage their risk while hoping in a more general way for a bottom line satisfactory performance. Indeed, to avoid the risks involved in over-reacting to the short-term depression of the performance, and shifting from one agent to the other, Mosnic tried to make sure that the agents were appropriately re-constructing their portfolio. This meant improving the decision processes of each agent as appropriate while satisfying the requirements of the stakeholders.

Hence, it can be argued that the bottom line approach is a process by which the principals rectify the agent strategy and processes to improve the portfolio performance. However, the bottom line approach does not replace the rational measurement of the ROI. Rather, it treats ROI as one of the factors which is considered together with other processes. Moreover, the bottom line appraisal processes are complicated, unpredictable, depend on the specific nature of the portfolio problem and they fundamentally differ from one agent situation to the other. This is because the different agents organizational processes lead to different types of portfolio management problems. The Controller had to understand each problem specifically. There is no hard target for ROI in either absolute or relative terms. The ROI calculations serve as

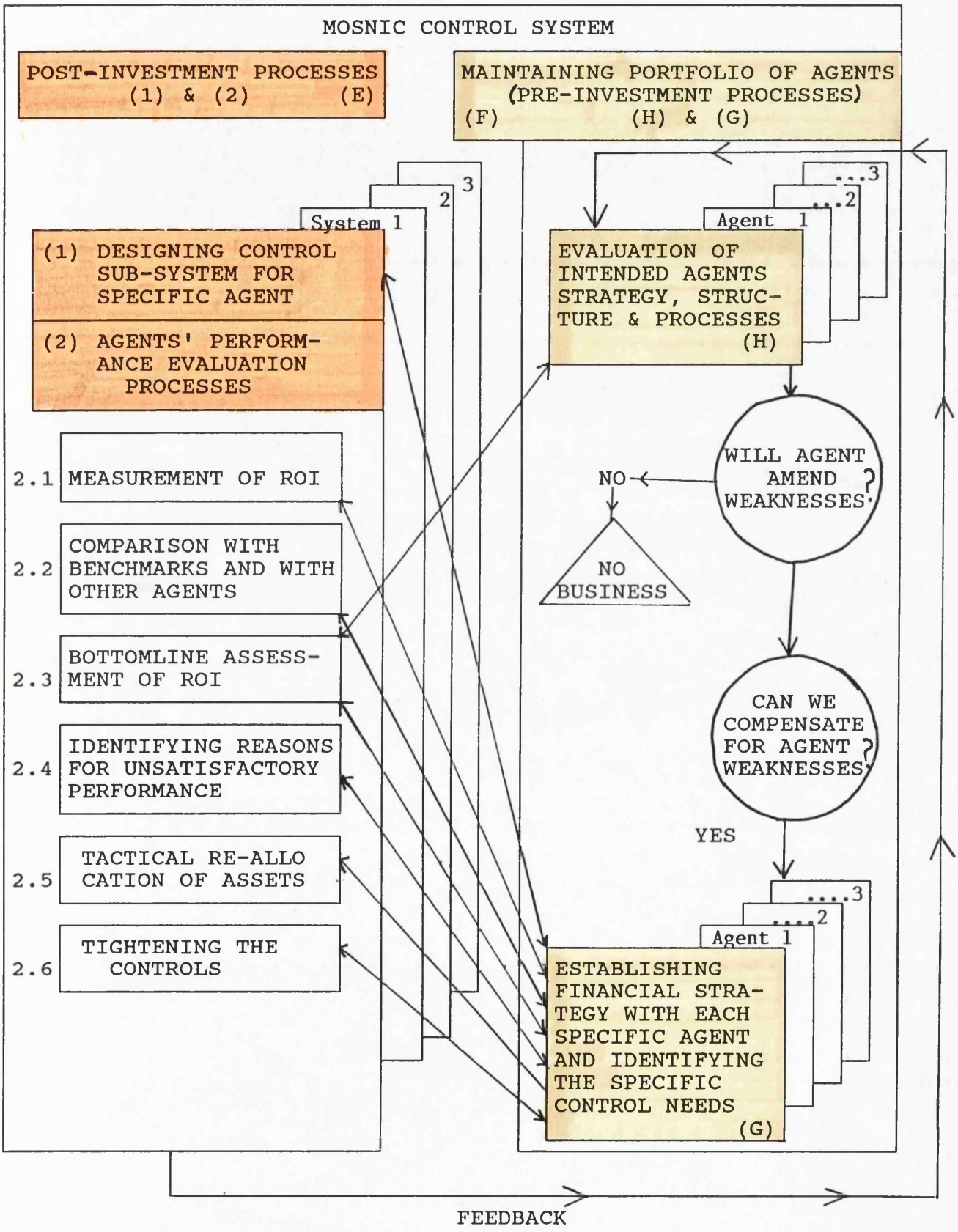
a basis for summarizing views on different securities in different situations. They therefore facilitate debate in the process of interaction between agent and stakeholders rather than provide definite calculations of how resources should be allocated.

Concluding Remarks on Working Hypothesis 4

Fig. 7.5 summarizes the insights gained from the analysis of the post-investment case studies concerning working hypothesis 4. It shows how the pre-investment processes for maintaining the portfolio of agents tend to determine the features of the post-investment control processes. Further, it signifies that the corporate control system comprises a number of sub-systems to cater for the requirement of monitoring the different strategy, structure and processes of agents.

The figure also depicts that, in evaluating the performance of portfolios, Mosnic used a multi-system to take on board several parameters (e.g. stakeholders' shifting objectives, transaction costs of terminating and hiring agents) which could not be reflected by ROI alone. Having dealt with one direction of the arrows in Fig. 7.5., in the next section the feedback relationship is explored.

Fig. 7.5
FEEDBACK BETWEEN THE CORPORATE CONTROL SYSTEM COMPONENTS



7.5. The Feedback of Agents' Performance Evaluation System to the Process of Maintaining An Appropriate Portfolio of Agents (Working Hypothesis 5)

The post-investment case studies show that based on the results provided by the multi-system used by Mosnic to evaluate the performance of agents, it had two alternatives to pursue, namely (1) to modify the financial strategy of the agent; or (2) to deselect the agent. If it opted for the latter option, (e.g. the case of Vontov) this would mean a change in the pre-investment strategic process, for example the re-allocation of assets either among the existing agents or to a new agent. The re-allocation of assets among the existing agents would mean that their current financial strategies would be modified. Accordingly, the control processes would need to be adjusted to cater for the new features of the agents' portfolio.

On the other hand, if Mosnic decided to modify the financial strategy of the agent due to the results of their performance evaluation, this meant a reconstruction of the agent's portfolio (provided the latter was prepared to amend his strategy). Accordingly, the Controller had to determine the control requirements of the modified portfolio which, as argued in working hypothesis 4, would impact the post-investment control processes. Hence, the dynamic and overlapping nature of the strategy formulation and implementation and control processes of investment houses operating through a portfolio of agents.

Concluding Remarks on Working Hypothesis 5

Fig. 7.5. also shows how the multi-system of portfolios' performance evaluation feeds back to the process of maintaining the portfolio of agents. The figure also reflects the feedback loop process by which the changes in the process of maintaining the portfolio of agents affects the post-investment processes.

7.6. The Detailed Conceptual Framework

In the light of the analysis of the specific agents case studies, the general conceptual framework developed in Chapter 4 (Fig. 4.1.) can now be elaborated into a detailed conceptual framework. This is illustrated in Fig. 7.6.* which is a product of Figs. 7.1, 7.2, 7.4 and 7.5.

In comparison with Fig. 4.1 (The General Conceptual Framework) Fig. 7.6 shows the following additional features. The strategy formulation in Mosnic (box B) emerged from a stream of financial strategies negotiated in an interactive process with a portfolio of agents (box G). It can also be realized that agents' strategy, structure and processes have a number of attributes (box C) which impact Mosnic's strategy formulation and control processes required to monitor the different agents (boxes G and H).

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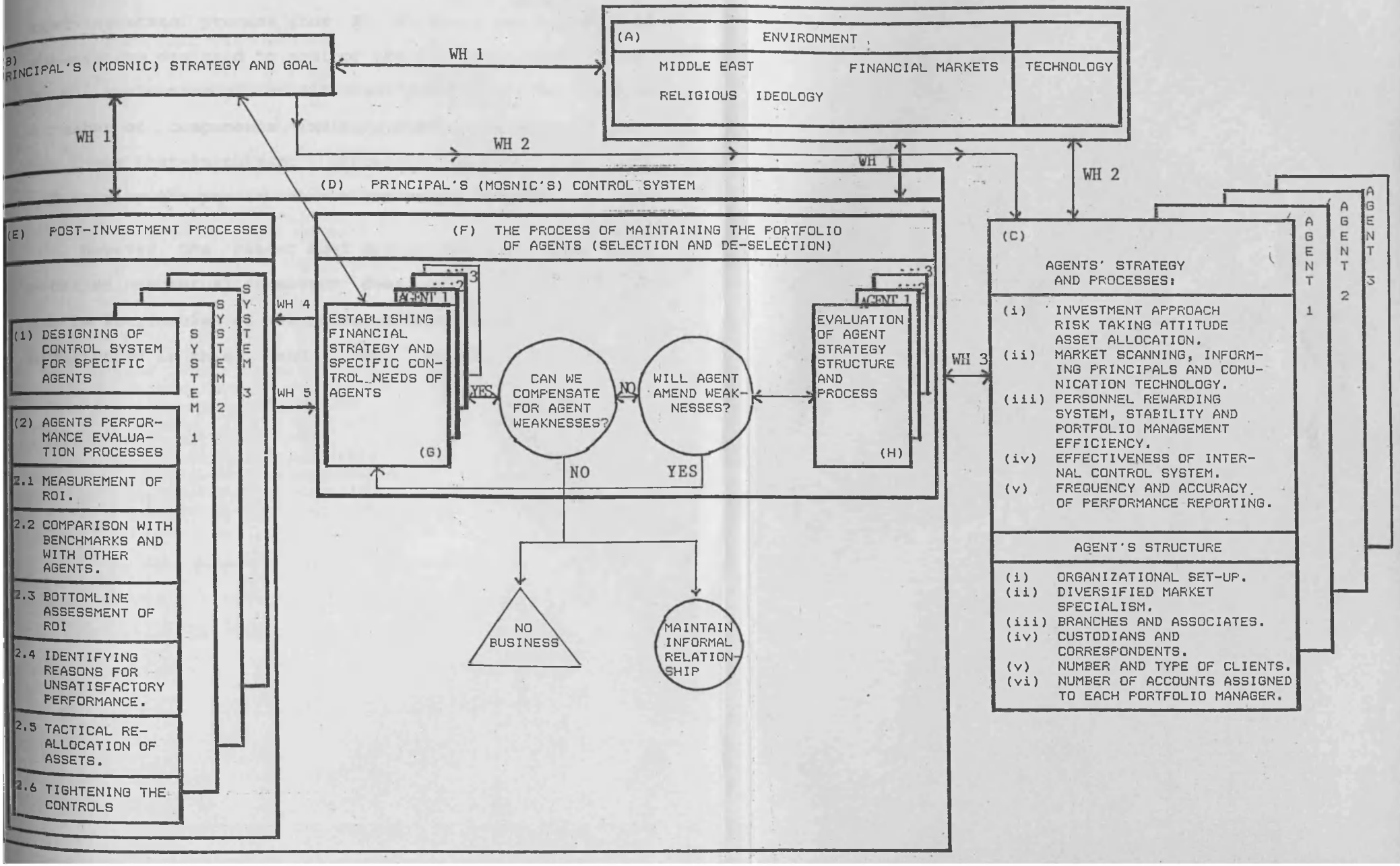
* The reader will appreciate that to make the detailed conceptual framework simple, I have not shown in fig. 7.6 the sub-attributes of factors inside box (C). For example, agent investment approach alone would need a box as big as Fig. 7.3 on page 343.

FIG. 7.6
THE DETAILED CONCEPTUAL FRAMEWORK OF THE RESEARCH



In addition, the figure demonstrates that in the post-investment process (box E) 1) there are a number of sub-systems designed to monitor the different agents; and 2) the evaluation of the different portfolios is based on a number of components (multi-system). It also reflects how these post-investment processes affect and are affected by the pre-investment processes (box F).

However, the reader must appreciate that even this detailed conceptual framework does not embrace all the subtle intricacies of the resource allocation processes as highlighted in this and the previous chapters.

CHAPTER-8

PRIMARY CONCLUSION ON STRATEGY AND CONTROLLERSHIP IN INVESTMENT HOUSES

MANAGEMENT ACADEMIC LITERATURE REVIEW AND IMPLICATIONS FOR THEORY

Introduction

Academics in the field of management are used to being informed by the literature at an early stage of the research. However, this research built its grounded theory first in order to contrast it afterwards with the different bodies of knowledge in the literature. Glaser and Strauss (1979) argue that:

"substantive theory faithful to the empirical situation can not, we believe, be formulated merely by applying a few ideas from an established formal theory to the substantive area. To be sure one goes out and studies an area with a particular sociological perspective, and with a focus, a general question, or a problem in mind. But he can (and we believe should) also study an area without any preconceived theory that dictates prior to the research, "relevancies" in concepts and hypotheses." (P33)

Thus, by inducing the grounded theory of this research from the detailed case studies, the researcher aimed at studying his problems without being over-influenced too much by pre-conceived theory which would dictate prior to the research relevancies and concepts. As explained in Chapter (1) figure 1.1, I started with some general ideas from literature.

Adopting the inductive approach to theory generation came naturally to me, a practitioner. My prior knowledge was largely that acquired from the field and I attempted to capture that with my initial case study. However, that

initial knowledge perception was not enough. I needed to do more field work. The initial case needed to be supported by the case studies of different agents in order to check for consistency. In fact, this process revealed far more complexity than initially realized. Only towards the end of the research did I, as a practitioner (and a researcher), consult the literature to examine what theories were there compared with the theory developed from Mosnic. This identified the similarities and differences between the literature and the theory advocated in this study in addition to what the latter can contribute to the former.

The above arguments are not meant to suggest that the practitioner conducting this research was not informed at all by the literature before starting this research process. In fact, the Controller (the researcher) used to consult the relevant literature very often to seek solutions for some of the managerial problems which confronted him. However, the Controller did not have a clear framework which would draw the boundaries of the control problems and hence be able to consult the relevant literature. Indeed, he needed to analyze his problem in depth through examing relations with different agents and then analyze it to identify the relationships which affect the control system and controllership functions in Mosnic.

In order to refresh the memory of the reader, I present next the distinctive features of Mosnic and the major findings emerging from the analysis of the agents'

cases.

THE DISTINCTIVE FEATURES OF MOSNIC AND THE MAJOR ISSUES EMERGING FROM THE RESEARCH

To determine which areas of the existing theory are to be consulted, it is useful to summarize the distinctive characteristics of Mosnic and the major issues emerging from the research.

STRATEGY FORMATION IN MOSNIC

In Mosnic, strategy emerged in a stream of decisions taken by the principals and the agents. Therefore, the sub-systems (models) of the agents were relevant to the formation of the overall corporate strategy. These models were presented by the agents as proposals subject to be amended to match with the stakeholders' perception of the markets' uncertainty. However, given the volatility of the financial markets, Mosnic could not confine itself to rational economic and financial analysis (carried out by the portfolio managers) alone to formulate investment strategy. Rather, Mosnic had to get into open negotiation with the discretionary portfolio managers' to ensure the compatibility of their sub-strategies with what the stakeholders' expect as an overall investment strategy. Hence, **I will need to review the literature on strategy formulation** to ascertain what insights can be gained to explain the situation in Mosnic.

CONTROLLERSHIP RELATED ISSUES

Mosnic decentralized its portfolio operations to a number of external discretionary agents. Thus, the agents

represent the accountable responsibility centres for Mosnic. The agents operated under the hierarchical structure of their own organizations but remained accountable to Mosnic for their performance. Hence, **it is necessary to try to draw parallels with the literature on the control of responsibility centres** in large multi-nationally divisionalized companies.

In Mosnic, control and strategy were intimately connected and hardly separable. The theory produced in chapter (7) indicates that interactive involvement of the control function was essential for the formulation and the implementation of the investment strategy. Indeed, some strategy processes (e.g, the tactical re-allocation of the assets, shifting the financial strategy, maintaining an appropriate portfolio of agents etc.) emerged as significant control aspects for Mosnic. Hence, **it is necessary to find out what the strategic control literature can offer** this thesis about the relationship between strategy and control and how that is influenced by the environment.

In Mosnic, the perception of risk by the stakeholders was not clear. As a result, management could not forecast the expected return on investment to set clear performance targets for the discretionary agents. This led to the problem of how to evaluate the discretionary portfolios performance based on ROI projections. Indeed, the portfolio management processes were too complicated to be understood by simple ROI calculations provided by the

agents themselves. Hence, discretionary agents accountability based on risk-adjusted future returns emerged as a critical issue facing Mosnic. Thus, it is in this context, that **the thesis needs to consult both the portfolio model itself and approaches to portfolio performance evaluation** provided by the finance literature.

In Mosnic, the role of controllership in strategic decision process was wide. The Controller was needed to help in attending to complicated portfolio management processes. His involvement in such processes raised the questions of his own independence and performance measurement. The interactive role of the Controller proved to be fundamental in facilitating the principal-agent interaction processes. The interactive management approach also triggers the discretionary agents accountability issue. **These problems are examined in the controllership theory** from the perspectives of interactive learning loop processes and management of strategic uncertainties.

In Mosnic, the selection of the agents was the most significant decision to be taken. This involved complicated processes and allocation of resources. Mosnic actually strived to select the best agents who were prepared to expend the maximum resources to take the best investment decisions while mitigating the divergence between the principals' risk taking attitude and their (the agents') attitude towards investment risks. **Both the finance theory approach to investment decision and agency theory will be reviewed in Chapter (9)** with a view

of advising on these problems.

Having described and analyzed the cases of the agents, the **professional literature contributed by portfolio managers will also be examined** to find out the differences and the similarities between what is advocated and the theory of Mosnic.

THE STRUCTURE OF THE LITERATURE REVIEW

Based on the problems and the distinctive characteristics of Mosnic enumerated in the previous paragraphs, the following structure was followed in reviewing the relevant academic literature. In this chapter, under Management Literature the following will be reviewed:

(1) Strategy formulation

(2) Control literature

In Chapter (9), the Finance Theory will be reviewed, and in particular the following relevant areas will be covered:

(1) The Modern Portfolio Theory and the risk-adjusted return methods for evaluation of portfolio performance.

(2) The Professional Literature contributed by the professional portfolio managers will also be surveyed in Chapter (9).

(3) The Agency Theory will be reviewed in the last section of Chapter (9).

MANAGEMENT LITERATURE REVIEW

(1) STRATEGY FORMATION

The distinctive features of Mosnic have indicated that strategy emerges in a stream of complicated decisions taken at different levels by the principal and the discretionary agents in an endless interaction process. The controllership role is a key to the strategy change. The powerful clues and logics for setting directions for the discretionary agents to search for the acceptable investment strategy are represented by a series of organizational processes. These processes involve the interaction of the Controller with both the discretionary agents and the stakeholders in making changes in the strategic goals manageable. Now, I take this strategy problem to some relevant theory in the field of corporate strategy to find out similarities and differences and to come-up with implications for strategy theory.

Quinn's (1978 and 1980) approach to the question of strategic decision calls for viewing strategy formulation within the framework of organization behaviour. Emphasizing the need for his study Quinn argues that many behavioural studies have been conducted in settings far removed from the realities of strategy formulation. He has also emphasized that other studies have concentrated solely on human dynamics, power relationships, and organizational processes, but have ignored the ways in which systematic data analysis shapes and often dominates crucial aspects of strategic decisions. Quinn concludes

that few of these studies have offered much normative guidance for strategists. Recognizing the contributions and the limitations of both approaches, Quinn has attempted to document the dynamics of actual strategic change processes in some ten major companies as perceived by those most knowledgeably and intimately involved in them.

Several important findings have emerged from Quinn's investigations. In fact he has concluded that neither "the power-behavioural" nor the "formal systems planning" paradigms completely characterize the way successful strategic processes operate.

Quinn (1988) further argues that effective strategies tend to emerge from a series of "strategic sub-systems", each of which attacks a specific class of strategic issues (e.g., acquisitions, divestiture or major reorganizations) in a disciplined way, but which is blended incrementally and opportunistically into a cohesive pattern that becomes the company's strategy. He further argues that the logic behind each "subsystem" is so powerful that, to some extent, it may serve as a normative approach for formulating the key elements of strategy in large companies. He proposes that because of cognitive and process limits, almost all of these subsystems and the formal planning itself must be managed and linked together by an approach best described as "logical incrementalism".

Quinn concludes his arguments by stating:

> *"such incrementalisn is not 'muddling'. It is a purposeful, effective pro-active management technique for improving and integrating both the analytical and behavioural aspects of strategy formulation." (P.95)*

Quinn's stance on incrementalism is supported by Pascale (1984) whose work describes Honda's success in achieving competitive advantage in Western Motorcycle markets. Pascale argues that the Japanese do not use the term "strategy" to refer to one competitive master plan of business. Rather, they think more in terms of "strategic accommodation" or "adaptive persistence", under-scoring their belief that corporate direction evolves from an incremental adjustment to unfolding events. Pascale further states that rarely in the view of the Japanese does one leader (or a strategic planning group) produce a bold strategy that guides a firm unerringly. Instead, he believes, what the Japanese value above all things is the ability of an organization to raise ideas from bottom to top and back again in continuous dialogue. He concludes that:

> *"As this dialogue is pursued, what in hindsight may be "strategy" evolves. In sum, "strategy" is defined as "all the things necessary for the successful functioning of organization as an adoptive mechanism." (Quoted from Quinn, et. al 1988, P113)*

Tomkins (1991), referring to Pascale's work, describes the story told by Pascale on how the Honda executives planned their entry to the American markets as a fascinating description of relatively uninformed risk and opportunism coupled with technological advantage which

was only seen as market worthy in the U.S.A. after the initial products offered in the U.S. market had failed. The story told by Pascale demonstrates learning and experimentation derived from incrementalism. The difference is that the Honda experiments were from real life and not from the pre-decision perceptions of the executives. Tomkins says the process described by Pascale did not seem all that logical. However, as Tomkins argues, it succeeded largely through a process of persistence and perception of opportunity as it unfolded. The conclusion drawn by Pascale is that the Japanese distrust single strategic plans as they believe that they limit peripheral vision which is fundamental for recording and reacting to environmental changes. Tomkins (1991) argues that this conclusion of Pascale at the very least supports Quinn's stance on incrementalism.

Now, we return back to look deeper into the version of incrementalism advocated by Quinn to compare this with the theory indicated by the case of Mosnic on the strategy formation issue to draw similarities and to find out differences and implications.

In general, one can draw parallels with Quinn to conclude that Mosnic has the extreme form of an incrementalism since the agents sub-strategies form the corporate strategy. Furthermore, Quinn argues that rational planning systems over-emphasize the prediction and the measurability of the organizational goals.

Similarly, Mosnic could not adopt a purely financial (rational) planning and measurement approach, because nature of the financial markets' turbulence and the unpredictability of the stakeholders' pattern of interaction with future market circumstances. The difference between Quinn's argument about over-emphasizing the measurability of organizational goals in planning systems and Mosnic's use of rational analysis is that in the latter's situation agents present their financial and economic analysis assuming applicability of the quantitive methods in predicting the future. But Mosnic does not take this as a good reflection of what would happen in the future markets. Thus, the Controller intervenes to help the agents understand how the stakeholders interact with the markets' uncertainties which means the process of amending (changing) the rational analysis is more frequent in investment houses. In other words, the rational economic and financial analysis are used by the investment house, but any one analysis can hardly remain valid for long as the financial markets change perhaps everyday.

The implication of the above is that in the investment houses pursuing their activity through discretionary agents, rational portfolio models/analysis are used to give the decision-maker the insight (which the principal's lack) but the organizational behaviour (the variable way the investors perceive risk, their market psychology, what others tell them, what they need, etc.) influence the formulation of strategy which means the

perception of risk by the principal and what they need supersedes the power of the agents' logic in formulating strategy. The reason why the stakeholders do not want to depend on the agents' quantitive methods is ascribed to their experience with the nature of the financial market uncertainty. This will be further elucidated in Chapter (9) with the review of the finance theory.

Thus, a further implication of this study for the arguments of Quinn is that rational analysis for the formulation of the strategic investment decision is not trivial in the investment process, but it gets revised and adjusted as the organization behaviour influences the post-investment complicated processes. The reader is to be cautioned, however, that the rational quantitative analysis carried out by the portfolio managers are vital for Mosnic to remain informed about the different views of these agents. This will also be discussed further in the finance theory version on the modern portfolio theory.

Quinn (1980) has described the process by which the strategic decisions emerge in large companies using the analogy of large rivers slowly moving in specific directions, contain within them various ebbs, flows and eddies which do not necessarily contribute in any direct analytical way to the general direction yet nevertheless, in aggregate, help to determine it. It is argued by Quinn that the flow of these rivers has direction, but no obvious beginning nor end. Tomkins (1991) comments on this analogy and says that in a company this could be

interpreted as the absence of a clear separation between strategy and implementation. Given the situation of Mosnic, one can draw another parallel with Quinn's conclusion about the overlap between strategy and implementation. On the other hand, this study implies further that the process by which the strategic decisions emerge and get implemented in the investment houses may be different due to the nature of the environment, the product, the role of external organizations' means, methods and people. In fact, there is no single point in time that the investment houses can assume their resources are optimally allocated. Resource allocation in investment houses depends on maintaining the appropriate portfolio of agents which are different in their strategy, structure and processes. This in itself is a complicated process. It involves discussing with different agents in different times and in different processes different investment goals which can hardly remain static. Thus, the formulation of any tight, analytical and holistic master plan to be assigned to the different agents for implementation is far too difficult (if not completely impossible) for organizations operating in the financial markets through a portfolio of different agents. In fact, investment strategy emerges from a fluid interaction between the principal and each agent. This interaction requires the presence of a capable controller to secure appropriate interpretation of the stakeholders' perception of the financial markets' uncertainty. Perhaps these markets' uncertainty are more difficult to forecast than

the other businesses risk.

Also, the implication of this argument to the strategy literature is that, in investment houses, it is difficult to set a limit for the time needed to create awareness of threats and opportunities, build consensus, select and train people for change and marshall resources. This is because in a discretionary investment process, due to the volatility of the financial markets, the strategy formulation and implementation happen all at a time in a continuous process. A key factor for the success of these processes is the intimate interaction of the owners with the discretionary agents and the Controller. Hence, a major message of this thesis to the strategy literature is that strategic decision in the investment houses operating through a portfolio of agents emerge and flow similar to different rivers which do not have confluences. These processes involve monitoring amending and even formulating the investment decisions demonstrated by the different discretionary agents. This can be viewed as incremental logic but in a different process from that of Quinn.

As one goes deeper to the discretionary investment decision levels in the investment houses, life becomes even more complicated than the picture given by Quinn. For example, as argued previously, the behaviour of the stakeholders which changes with the unpredictable uncertainty of the markets, supersedes the rational investment models presented by the discretionary agents.

This is even though the sophisticated risk-return analysis models are taken by the principals as an indicator to understand the methods and the means of the agents under the different market circumstances. This means Quinn's incrementalism is found in the discretionary investment decision formulation processes, but the process of strategic change does not embrace (adopt) agents-wide rational analysis as argued by Quinn. Rather, the agents embrace (each one in his strategy) the new objectives of the stakeholders.

Quinn portrays the top executive as if he develops his ideas about strategy and tests them through experiments in separable parts of the company. The process by which strategic ideas emerge is different in investment houses operating through the use of discretionary agents. This is because the externalization of portfolio management means that the strategic decision makers want to seek ideas of the external professional organizations (the agents). Thus, the principals do not have preset ideas to be tested. Indeed, the discretionary portfolio management process starts by the corporate executives of the principals (the Controller) asking for new ideas from the different parts (the agents) of the company. The principals may not have the expertise to set the broad strategic directions (as argued by Quinn) to be viewed by the agents. In fact, the agents advise the principal about the investment directions then the latter feeds in his requirement by the Controller. Hence, one can

conclude that the agents strategy and processes (the method and the means) influence the strategic investment directions.

Quinn argues that the direction is set by powerful clues or "logics" gradually established in the organization which enables sub-systems to bound their search for strategies. Then he gives a picture that when enough testing of each main idea has been achieved and sufficient knowledge gained, the chief executive goes public and announces the decision. Tomkins (1991) summarizes this process which is described by Quinn as that the chief executive declares the decision publicly after securing the knowledge that there will be support for it because the decision merely 'crystalizes' the views already put to him whether he subtley induced them or not. Tomkins further emphasizes that it is important not to read Quinn in terms of calling for a destruction of formal corporate planning or rational analysis. He adds that Quinn's fundamental point is simply that it is foolish to try to produce a total group wide analysis at one point of time and then to go ahead rapidly implementing that, ignoring changing external and internal environments. Thus, in Quinn's approach, rational economic and financial analysis will be vital in presenting proposals, examining relationships between strategic different decisions. Thus, Quinn does not dismiss rational analysis. On the other hand, in Mosnic there are numerous situations where decisions are made without much rational analysis. For

example, the decision of the stakeholders that bonds should represent the major assets in the portfolio. This in fact depended purely on the stakeholders' naive (not rational) perception of the nature of financial markets' uncertainty. They did not conduct rational analysis. They just depended on their experience with the stock markets and the bond markets. Sometimes the notion of risk as presented by the portfolio managers might not be a good reflection of uncertainty to the stakeholders. This will be further discussed in Chapter (9) which is about the Modern Portfolio Theory.

A major similarity between the strategic decision process described by Quinn and the discretionary investment process (the case of Mosnic) is that, in both situations, economic models are vital in presenting the proposals. However, as one goes deeper levels to the nature of the discretionary investment decision processes, Quinns' approach does not explain the process by which the clues and logics' are used to set the direction in the investment house to enable the subsystems (the discretionary agents) to bound their search for strategies. The major difference is ascribeable to two factors: first, the organizational complications in the discretionary investment decision processes and the multiple levels at which these decisions unfold; second, the involvement of the controllership function in the strategic investment decision processes. For example, the decision levels and processes in the discretionary

investment situation under this study involves the broad corporate investment decisions, the resources allocation processes to the main categories of the financial assets through the principal-controller-agents interaction. At further deeper levels (in the individual securities selection processes), the discretionary agents play a significant role. In the situation of Mosnic, the corporate logic or clue used to set the direction is the Controller's interpretation of the stakeholders' variable perceptions of risk. Unlike, the clues in the argument of Quinn, in Mosnic, the powerful logics and clues are not gradually established inside the organization to enable the subsystem (the discretionary agents) to bound their search for investment strategy. In fact, the powerful logics and clues are first to be established in external organizations, and second these logics change so frequently over time that most of them are actually established within the strategy implementation process. Indeed, because of the nature of: (1) the uncertainties in the fast-moving financial markets, (2) the role of the interactive controllership, and (3) the clear-cut independent tasks of the discretionary agents (each one is separately flowing river), the process by which the strategic decision unfold in the investment houses differ. Perhaps due to the revocability of the investment decision (i.e. due to the swift marketability of the held securities) and because there is often no time for the gradual establishment of the powerful logics and clues the process is different in investment houses. In fact,

Mosnic's problems in terms of gradual establishment of rational goals is more complex. The trouble the Controller had to deal with was how rationality could be used while events were coming along so fast that the stakeholders could not get time to think deeply and rationally about things.

Hence, a further implication of this argument for the strategy theory is that the establishment of powerful clues and logics for setting directions in the investment organizations to enable the subsystems to bound their search for strategies are contingent on the post-investment role of the Controller, the principals' environment and the means and the methods (strategy, structure and the processes) of the discretionary agents i.e. the subsystems themselves.

Quinn gives a picture of effective strategy as emerging from a series of strategic subsystems each of which attacks a specific class of strategic issue in a disciplined way, but which is blended incrementally and opportunistically into a cohesive pattern that becomes the company's strategy. This is exactly what happens in Mosnic except that each agent runs his own subsystem.

Quinn also argues that formal practices usually institutionalize incrementalism. If one takes the short-term financial strategies Mosnic used to negotiate with each agent as formal plans and compare it to Quinn's statement, many similarities can be observed between his

incremental logic and the issue of strategy formulation in investment houses.

According to Quinn the first reason for the institutionalization of incrementalism by formal practices is to utilize specialized expertise and to obtain executive involvement and commitment. Hence, most planning occurs "from the bottom up" in response to broadly defined assumptions or goals, many of which are long-standing or negotiated well in advance. The second reason, is that most managements purposely design their plans to be "living" or "ever green". He argues that these plans are intended only as "frameworks" to guide and provide consistency for future decisions made incrementally. He further supports his argument by asserting that:

> *"To act otherwise would be to deny that further information could have a value. Thus, properly formulated formal plans are also part of an incremental logic." (P.102 The Strategy Process: J. Quinn, et.al)*

In Mosnic, the planning system was not exactly occurring from "the bottom Up" in response to broadly defined assumptions or goals many of which were long - standing or negotiated well in advance. Perhaps it is coming bottom-up except the difference was that Mosnic was a big organization which included a number of agents. In this sense, it was coming bottom up from outside. Therefore, this had implications for controllership which had to consider monitoring strategy implementation by external organizations. In fact, the strategy process in

Mosnic started by the discretionary portfolio managers taking the initiative of submitting their investment model/strategy. Some agents prefer sticking to their risk taking policies if they would be held accountable for implementing their models (strategies). Other agents offered their models to Mosnic for triggering principal's risk taking factors as basis for negotiation. As argued previously, this can be viewed as an incremental logic which takes place in a process different from the one described by Quinn. However, in Mosnic, the logic of incrementalism did not wait for periodic (quarterly, semi-annual or annual) planning meetings. The strategy process (which involved the principals, the Controller and the agent) emerged in a stream of tactical decisions triggered by the following: (1) The situation in the financial markets which affected both strategic decision partners (the principals and the agents); (2) the shift in the stakeholders perception of risk; and (3) the shift in the discretionary portfolio manager's approach to investment strategy.

Quinn's logic of incrementalism has similarities with the situation of Mosnic in that the strategic decisions emerged from the on-going processes and were not formulated by corporate master plans, corporate master matrices or long run fixed portfolio mixes. However, these on-going processes were different in Mosnic because the formation of the strategic decision depended on the specialized expertise of the discretionary portfolio

managers which would then be meshed in the strategy process by taking from the controller in a fluid stream of interaction the stakeholders perception of the financial markets' uncertainty.

(2) CONTROLLERSHIP LITERATURE REVIEW

Strategic Control Theory Review

Having said that shifting goals caused agents' monitoring problems in Mosnic, we turn to consult some strategic control literature on this problem.

Perhaps, the commonality between Mosnic's situation and the existing theory on strategic control is that in the former's case it is debated in Chapter (7) that a meaningful ROI measurement is problematic. Indeed, the pre-investment case studies (e.g. MIP) in Chapter (5) have shown that the portfolio managers even though they use the most sophisticated techniques for rational economic and financial analysis, are still reluctant to set a standard ROI to be achieved. Their main problems are: (1) the volatility of financial markets; (2) understanding how the stakeholders perceive the markets' uncertainty.

Some authors e.g. Goold and Quinn (1990) argue that the practice of strategic control is problematic for a number of reasons. **First,** strategic control is devised in order to accommodate uncertainty and flexibility in the implementation of strategy. **Second,** there is difficulty in setting strategic goals that are suitable for

motivating managers. **Third,** there is risk of discouraging management judgement if strategic control systems are viewed as alternatives to ongoing management and not a support to it. **Fourth,** designing a strategic control system must enhance rather than destroy mutual confidence between management levels.

Goold and Quinn develop the following contingency model of strategic control (Fig. 8.1). They argue that the ideal circumstances for strategic controls should be in businesses with low environmental turbulence in which it is relatively easy to specify and measure precise strategic objectives. They argue that in such businesses a formal strategic control system could be set up and linked to personal rewards and should help to ensure that business remains 'on tract' strategically. However, where strategic goals can be set, but environment is highly volatile, a strategic control system may still be valuable. In such a situation, Goold and Quinn propose that management should be more ready to modify their strategic objectives as circumstances change. Also the link between achievement of strategic objectives and personal rewards should therefore be less mechanistic and compelling. Hence, the strategic control system should be less 'tightly' administered.

Fig 8.1
Goold and Quinn's contingency Model
for strategic control

Environmental Turbulence	Easy	Difficult
High	Strategic control system valuable, but should not be tightly administered.	Strategic control system problematic
Low	Strategic control system valuable than motivation.	Strategic control system for tracking progress.

Ability to specify and measure precise strategic objectives

On the other hand, if the environment is less volatile while setting and measuring strategic goals is difficult, the value of a strategic control process would be more related to monitoring business progress than to motivating management.

In situations where environmental turbulence is high and where it is hard to specify measurable strategic goals, the value of a strategic control system would be problematic. Under such circumstances, they propose that a constantly updated view of progress based on a more holistic view of the business would be needed and a `tightly' administered formal strategic control would be more of a hindrance than a help. Hence, they suggest a looser, more informal relationship between senior management and the business that stresses directional, long-term goals, rather than precise targets may be preferable.

Thus, Goold and Quinn suggest that the ideal circumstances for strategic controls should be in businesses with low environmental turbulence in which it is relatively easy to specify and measure precise strategic objectives. In Mosnic, the interactive involvement of the control function has proved to be a tool that enabled the stakeholders to manage the strategic uncertainties in a manner that was compatible to their perception of the investment risks. Indeed, one of the problems faced by the Controller was that he could not clearly distinguish between strategic planning and control. The two were merging together. Sometimes he would look into a control problem and would get ideas about strategic changes. Sometimes also while considering strategic issues suddenly he would be concerned about controllership. A good example of this could be the financial strategy change processes with the three agents studied in Chapters (5) and (6) of this research. Hence, in investment houses the whole processes could be meshed together.

In addition the interactive risk management system in Mosnic seems to have made it indispensable to depend on strategic controls to cope with the high turbulence of the financial markets. This is contrary to the argument of Goold and Quinn who suggest that if the environment is turbulent and goals can not be rationally set, then strategic control is problematic. Indeed, the uncertainties of the financial markets which hindered the

formulation of strategy were made manageable and sustainable day-by-day through the Controller whose active involvement in the strategy process on a daily basis made it possible to run strategy, operation and strategic control in a continuous stream. This system in fact gave the stakeholders the comfort that the complexities involved in the discretionary portfolio management process were greatly moderated by accepting the interactive role of the Controller in the strategy process.

A possible explanation of the difference between the argument of Goold and Quinn and the situation in Mosnic is that Mosnic has managed to develop the supporting systems in its processes that would enable it to change its goals (even on daily basis) in response to the turbulent environment in the financial markets and the performance of its portfolio agents. This was made possible by the characteristics of its control system and controllership function.

The implication of Mosnic's case to Goold and Quinn model is that, if the product is promptly marketable and if the control system is accessible by the controller in every moment and has the ability and flexibility to adapt to environmental changes, then, even if the environment is turbulent and the rational setting of strategic goals is difficult, organizations can still exercise strategic control on a day-by-day basis. Also day-by-day strategic control can be more effective if the business owners are effectively involved in the interactive management

processes with the Controller.

Another implication for the work of Goold Quinn is that the means and the methods (strategy, structure and processes) of the accountable unit (the agents) represent an influencing variable that makes strategic control even more problematic, e.g., (the Case of BJ-S Bank monitoring problems). In fact, the discretionary portfolio managers are not owned by investment houses. Thus, the Controller may not be able to intervene with them too formally to influence their strategy, structure and processes. Hence, strategic control could be ineffective without a fluid stream of interaction between the principals and the agents. Indeed, the controllership element has emerged (in the situation of Mosnic) as a factor which makes the interactive monitoring of the agents effective. This does not mean that the controller has the total power to compel the agents to re-shape their systems in a way consistent with the style the controller would like to exercise strategic control. The whole process depends on cooperative exchange of opinions, learning from each other and understanding the requirements of the fund owners.

This study also has implications for the strategic control literature in that the link between achievement of strategic objectives and personal rewards (either mechanistic or less compelling) may not be an effective or even relevant tool to secure the achievement of the strategic objective by the accountable unit. It is implied by this research that the function of controllership is a

key factor to keep the accountable unit satisfied on a daily basis with the strategic objective to be pursued. Perhaps, the role and the uses of control in investment houses is wider than its application in other businesses' strategy process.

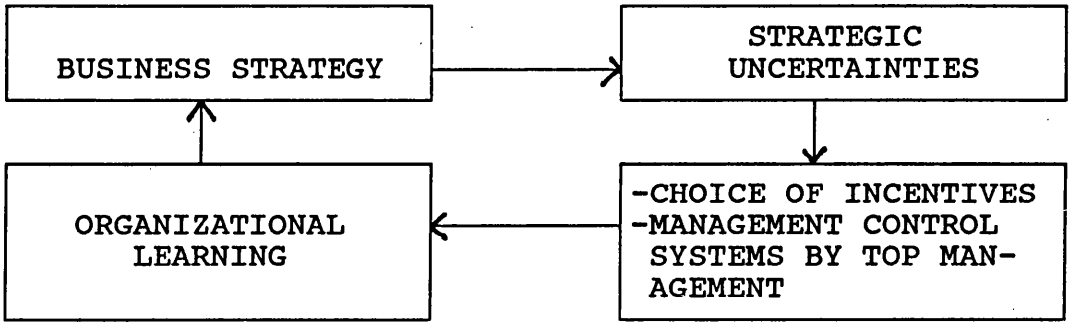
In fact, other authors, e.g. Simons (1990), argue that management control systems are used by top managers (1) to set agendas for the discussion of uncertainties that arise as the firm attempts to create competitive advantage; and (2) not only to monitor that outcomes are in accordance with plans but also to motivate the organization to be fully informed concerning the current and expected state of strategic uncertainties. Compared to this argument, in Mosnic there is no direct and visible relationship between the design of the management control system and gaining competitive advantage over other investment houses. This difference may be ascribed to the fact that the nature of Mosnic's operation does not put it in direct competition with other investment houses. Rather, it depends on the abilities of the external portfolio managers to achieve its goals within the qualitative parameters set for them and the strategic control system to monitor strategy implementation and goals achievement.

Simons uses four concepts in his model. These are: (1) limited attention of managers; (2) strategic uncertainties; (3) interactive management control; and (4) organizational learning. The recursive model (Fig. 8.2) developed by

Simon illustrates why management control systems should be considered as an important input to strategy formation. Recognizing that strategies can be both intended and emergent, he suggests his model to illustrate that emerging strategies can be influenced and managed - serendipility can be guided by top management who use formal processes to focus or gain rational attention and thereby generate new ideas, tactics, and strategies. Simon's model further indicates that management control processes, which are characterized as tools for implementing goals, can be instrumental in allowing the organization to learn and adapt overtime.

Compared to Simon's model, in Mosnic the processes by which the control system and the controllership input to the strategy formulation are different. Of course, there are also some similar features between the two processes, e.g. the organizational learning concept is important for strategy formulation in Mosnic also. A further situation of similarity is that the concept of limited attention can be applied to the relationship between the discretionary asset managers and the stakeholders (the principals). Most of the strategy and control processes in Mosnic were shared with the asset managers while other areas were delegated to the agents by necessity. The argument in Chapter (7) has established the fact that the allocation of the principals' resources to the individual securities,

Fig. 8.2
Source: Simons's process model of relationship between business strategy and management control system.



and the selection of the industry and the companies to construct the principal's portfolio are significant processes predominantly executed by the discretionary agents while responding to the Controller's input about the variable (shifting) objectives of the stakeholders. The latter has limited information about the markets and about the individual securities. Nevertheless, those discretionary agents were not subordinates who could be formally controlled through a line authority relationship. Thus, the controllership processes were key factor for Mosnic to maintain strategic control of the agents. Hence, the concept of limited attention is relevant for management control in investment houses, but in different ways. For example, the activities of a number of external agents demanded attention, but this was more important than paying attention to the organization's (Mosnic's) internal activities. In contrast, Simon's has emphasized the intra-organizational activities.

This study suggests that inter-organizational activities of the external firms is also important for the strategy process. Actually, the case of Mosnic suggests that the strategy of the firm is not the only factor which determines whether uncertainties should be considered critical to the achievement of chosen objectives. Rather, the strategy, structure and processes of the agents also impacted the objectives to be achieved by the investment organization (Mosnic).

Simons also argues that some aspects of the management control system are classifiable into interactive and programmed. He says: **"Interactive management controls allow top managers to be fully informed about such decisions throughout the organization."** Interactive control in Mosnic was operated in a different process because it was designed to allow the principals to be informed about decisions processes in external organizations (the agents).

A further comparison between Mosnic's interactive Mosnic's control system and Simons's interactive management control crystalizes more differences. Simons asserts that top management must decide which aspects of management control systems to use interactively and which aspects to programme. On the other hand, in the situation of Mosnic, the Corporate Controller interacts so intimately with the agents to exercise control and to resolve significant strategy matters at levels where the stakeholders (top managers) may not be interested to

describe or they may not have the technical capability to tell the Controller those detailed aspects of control to be interactive or programmed. Actually, these details are determined by the Controller. Hence, the role of the Controller, though important is not emphasized by Simon as key factor determining the features of control i.e. either interactive or programmed. The implication of this argument is that controllership is a key influencing factor that determines the nature of the strategic controls whether programmed or interactive.

Another implication for the work of Simons is that the means and the methods of the strategic unit to be controlled (the discretionary agents) influence and determine the nature of control either to be interactive or programmed and not only top management determines this.

Simons further argues that management control becomes active when business managers use planning and control processes to actively monitor and intervene in on-going processes. In the situation of Mosnic, the stakeholders use the control function for overcoming the difficulty of formal long range planning. Therefore, control is made interactive in the pre-investment stage i.e. before strategy formulation. Simons was not considering investment houses and did not, therefore, perceive the importance of the pre-decision role of the strategic controllership function in such organizations. In Mosnic, this role is difficult to separate from the top management role.

According to Simons, organizational learning is the way that an organization adjusts defensively to reality and uses knowledge to improve the fit between the organization and its environment. Hence, both the personal involvement of top managers and the defining characteristics of interactive control strongly influence the incentives to produce and share information. He further argues that the focusing of organizational attention and the interactive exchange of information stimulates learning throughout the organization about the strategic uncertainties that are perceived by top management. Hence, by focusing attention throughout the organization, top managers use interactive management control to influence and guide the learning process. This is actually what happens in Mosnic. The organizational learning processes in Mosnic demonstrated the relationship between the management of strategic uncertainties and the learning loop which extended outside the organization to the external responsibility centre managers (the external agents). Thus, there is some similarity.

The main message of these arguments to the contribution of Simons and the rest is that their models can be enhanced by further studying the relationship between the involved controllership function, strategy formulation and the interactive management control processes. In addition, the means and methods (i.e. the strategy, structure and the control processes) of the external accountable unit must not be ignored as they may

influence the corporate strategic control processes. This may seem to be specific to investment houses, but increasingly manufacturing companies operate through close relationships with suppliers and purchasers and so these 'agency-like' relationships may have similarities to Mosnic.

Moreover, the process by which the business managers interact with the external discretionary portfolio managers is far more complicated (due to the influence of the financial markets) than the straightforward recursive process pictured by the model suggested by Simons.

DECENTRALIZATION, PERFORMANCE MEASUREMENT, RESPONSIBILITY ACCOUNTING, AUTHORITY AND CONTROL.

A number of writers [Anthony, Bedford and Dearden (1984), Maciariello (1984), Vancil (1979), Wilson and Chua (1988) etc...] argue that measures of performance need to be established for organizational subunits that "link" each subunit to the whole. These organizational subunits are called "centres of responsibility" or "responsibility centres".

Similar to large multinational companies Mosnic strives to find ways of coordinating and controlling its diverse discretionary agents. However, the discretionary agents in Mosnic, as responsibility centres, seem to have different characteristics from those of the divisions in the large companies. Moreover, reasons for decentralization in the large companies may not be similar to Mosnic's

motives behind decentralization.

In existing management theory (Maciariello 1984) it is assumed that decentralization allows closer control and supervision of activities within the division than does centralization. In the situation of Mosnic, control within the external discretionary agent is only one of the many attributes to consider before selecting the agent. Even if control within the discretionary agents is not effective Mosnic may decentralize for many other reasons while compensating for the control weaknesses by other qualities in the discretionary agent. This is clearly argued in chapter (7) particularly the analysis of the agent selection cases.

In large companies, decentralization leads to better managerial motivation as the divisional managers run their own business, within broadly given constraints concerning the corporate strategies, goals, objectives and policies. This aspect seems to have similarities to the relationship between Mosnic and its external discretionary agents. Actually, there are differences as well. The discretionary agents have their own investment strategies and policies. The quality of their strategies and policies (means and methods) motivates Mosnic to select the agents to benefit from them. These strategies may constrain the principals' corporate strategy. On the other hand, the agents (if viewed as divisional managers) are reluctant to depend on the discretionary powers vested on them to run their business remote from the principals. Indeed, the agents

have always welcomed the involvement of the principals to share the accountability with them. We know from our grounded theory in this research that best performing agents do not get a direct reward. The rewarding process in Mosnic is different as discussed in the conclusion of chapter (6).

In large companies, decentralization facilitates better overall performance evaluation of various accountable units of the organization. In the situation of Mosnic there is no inter-dependence problems between the portfolios of the discretionary agents employed. Even comparison between the agents in terms of performance has been found problematic in Mosnic [see the analysis chapter (7)]. It is problematic because of the agents' differences in terms of means and methods (approach, culture, philosophy, etc. .....).

The most obvious similarity between Mosnic and large companies is that decentralization reduces the dysfunctionalities resulting from centralization. In large companies, and in Mosnic as well, centralization is avoided because of the potential dysfunctionalities which have to do with information processing constraints and the lack of expertise (particularly in Mosnic) in the corporate management relating to specific markets and the relevant investment activities. Bounded rationality is one of the reasons why large companies decentralize their decision making. Wilson and Chua (1988) offered bounded rationality as a reason for decentralization of decision-

making by stating that because human-beings are intrinsically bounded in their ability to process information, it is necessary to decentralize decision making. They add that at a point of development organizational activity will become too difficult and complex for the managerial capacities of one individual or small group of individuals located in one place. In all those reasons for decentralization due to the bounded rationality, the situation of Mosnic is similar to the large organizations.

However, Mosnic is somehow different from the large companies which decentralize decision-making to enable senior management to concentrate on longer-term strategic decision-making to local managers. In fact, the two decision levels, (level-I and level-II) discussed elaborately in chapter (3) integrate into one activity i.e., one decision process. Thus, in investment houses decision making is decentralized but again integrated in one process.

This argument suggests the need to conduct further research on decentralized decision-making in investment houses to understand the processes through which and why the decentralization (externalization) happens.

The existing management theory has emphasized the motivational implications of decentralization. This is in the sense that delegating decision-making authority to local managers in the large companies is intended to lead to higher levels of motivation. That is to say, if the

local managers of the large companies are only allowed to act on instructions from their senior managers they may be demotivated and feel frustrated at not being able to exercise any authority. In the situation of Mosnic, despite the discretionary autonomy given, the agents feel comfortable to work according to the principals' guidelines to avoid being accountable for unsatisfactory performance.

The implication of this argument is that the motivational impact of decentralization in the investment houses is less than its impact in the large multinational companies because, in the former case, local managers (the agents), and corporate managers (the principals) have the tendency to be cosy about sharing of responsibility. This is probably due to the higher turbulence in the environment and the fixed fee asset management contracts.

An overall implication of the preceding arguments is that academic literature on the issue of decision and control decentralization in large organizations provides first level parallels to the theory generated from Mosnic. However, at the deeper level of comparison, differences occur. This calls for further but deeper research of the issue of decentralization by practitioners in the large investment houses which are actually operating multinationally.

RESPONSIBILITY ACCOUNTING

Mosnic had difficulties in identifying financial targets for the investment activity assigned to the external discretionary agents. Thus, responsibility accounting has remained as a problem in Mosnic due to the potential unrealism in financial approach to the agents performance evaluation.

Wilson and Chua (1988) argue that responsibility accounting requires the identification of particular costs or revenues as the responsibility of certain individuals or group in an organization. To them, that means managerial accounting information is classified and reported by area of responsibility.

A long established fact in management theory with regard to responsibility accounting is that people should be made responsible for financial elements which they can control. On the other hand, people should not be made responsible for items of cost which they cannot control; neither should they be rewarded for revenues which are not a result of their efforts. Thus, based on the existing management theory [Wilson and Chua (1988), Anthony, Bedford and Dearden (1984) etc], a responsibility centre may be defined as one area of responsibility which is controlled by an individual.

If one compares how a discretionary portfolio manager operates (as an accountable unit) with the responsibility centre manager as defined in the academic literature, it

becomes clear that there are differences. First, a discretionary agent receives a fixed amount of fee calculated on the remaining market value of the securities in the portfolio regardless of the performance achieved. Thus, the principal does not possess a direct motivational tool to reward and penalize the agent. The agents case studies and analysis in chapter (7) shows that while portfolio performance differential can be materially high and significant (4%, 6%, 10%, 20% or even more), the impact of the performance differential on the fixed fee charged (on the current value of the securities) by the portfolio manager may be insignificant, negligible and immaterial compared to the portfolio differential loss or gain. Thus, the management fee element can not be used in the short-term as a flexible tool to influence the behaviour of the discretionary agent.

The other implication of this research to responsibility accounting theory is that the interactive portfolio management approach allowed the discretionary agent to liaise with the principals so frequently and closely, that the former was released from the short-term accountability of the investment decisions taken on behalf of the principals. Hence, the involvement of Mosnic's management with the portfolio managers in an iterative process of interaction was helpful for the effective management of risk but it made responsibility accounting difficult. Moreover, environment controllability impacts the level of accountability.

Another implication of this study is that the discretionary agents, as participants in setting the investment objectives of the principals, normally came up with their investment models indicating that acceptance of these models by the principals would make them (the agents) satisfied with the objective they would pursue. However, the principals' perception of the investment risks was so fluctuating that they often intervened to change the models proposed by the agents. This might make the agents dissatisfied with the amended strategy/models unless the Controller managed the process of intervention. Hence, an important factor that influences the effectiveness of responsibility accounting is the role of controllership.

CONTINGENCY APPROACHES TO ACCOUNTING INFORMATION SYSTEMS

One of the major problems confronting Mosnic management is agents controllability through a reliable information system. This is mainly because of the decentralization of information processing. An additional problem is the use of heterogeneous data sources to set up an information system to measure the corporate portfolio performance. The heterogeneity of information sources is a natural result of decentralization to different agents. Pursuant to the above problem, the Controller examined some of the major contributions in the information system contingency literature. Otley (1980) has reviewed and assessed contingency approaches to management accounting

by reference to what he considered to be a minimally necessary framework for the construction of a true contingency theory. Otley argues that the contingency approach to management accounting is an important theoretical development. However, he sees some lack of conceptual clarity in the current state of the art. Moreover, he suggests using different research methodologies to improve those commonly reported. Otley argues that a contingency theory of management accounting has a great deal of appeal and can offer a logical explanation for the bewildering variety of management accounting systems actually observed in practice. But, he points out that a number of reservations need to be expressed. He summarizes these reservations as follows. First, the nature of appropriate contingent variable requires further theoretical and empirical elucidation. He suggests taking a control based theoretical framework to ensure focus on the unpredictability of contingent variables that influence organization success. Secondly, he calls for the need to enhance research by taking organizational effectiveness as an important aspect of a true contingency theory of control system design. Thirdly, the 'tentative' link of the contingency theory of organizational design with organizational effectiveness renders it weak. Hence, Otley argues not to use 'structure' as 'the sole intervening variable' between contingent variables and the choice of the accounting information system. Finally, he suggests to study management accounting information systems in conjuction

with the inter-connected components that make-up an organizational control package and not in isolation from its wider context. Otley suggests that the above short-comings can be overcome by adopting an explanatory mode of research involving the careful observation of the operation of organization control systems over a period of time with the objective of including the major contingencies and mapping their inter-connections with all parts of the organizational control package.

An important research agenda proposed by Otley is the development of a theory of management accounting that explains how it is affected by various contingencies and how it is integrated into its wider context of organizational control mechanism.

Otley proposes that accounting information system is only one aspect of the over all control situation. Hence, hypothesized variables to effect accounting information system design are the same as those which are assumed to explain differences in organizational structure. If that is the case, he argues that it is unrealistic to expect purely statistical methods of analysis to unravel a complex pattern of interaction. The researcher must have a closer involvement and develop hypotheses as to likely relationships as he explores the organization he is investigating.

Marciariello (1984) points out the connections and differences between Management Control System (MCS) and information systems and argues that:

> *"information flows and management systems must be designed to support this management control process. ..... They are therefore more like structural elements of the MCS, where as the process is repetitive and goes on continuously with the organization. Another way to think about these connections is to envision the information flows as links between the control structure and the control process."* (Maciariello 1984 P. 212-213)

Cooper's (1981) work reflects on contingency theory of management accounting and emphasizes that it tends to be focusing on the choice of means to achieve given ends. His criticism of contingency approach to management accounting is reflected in his concern about issues of ends as well as means. His concern for 'ends' involves consideration of the alternative possible roles of accounting in different economic and social systems. He prefers to consider management accounting as means for ends wider than organizational accounting control which rests on specific economic objectives. Cooper further argues that the concern for means might involve consideration of alternative strategies of control. His critique of contingency theory suggests that environmental management, the creation of cultures and the encouragement of intelligent rather than consistent experimentation might be neglected forms of control. Thus, Cooper suggests that it is time to distinguish between good and bad controls based on the concern about means in the light of the ends.

Elaborating on the potential of contingency theory approach to management accounting, Hopwood (1989) argues that the patterns through which responsibilities and accountabilities are allocated, modes of organizational integration and coordination and procedures for employee evaluation and rewards are, nevertheless, now seen as having the potential to moderate either the forms that accounting takes or the ways in which it is deployed in an organizational arena.

The focal point in Hopwood's argument is that deeper researches of the emergence and change of accounting systems need to be conducted to advance our knowledge of the means by which accounting both change over time, and itself provides a basis for wider organizational changes.

Hopwood points to the current consideration being given to the roles which task technologies, corporate strategies and competitive postures, and even corporate cultures, can play in changing what is seen to be a desirable state for the accounting practice. He emphasizes that those factors have started to be viewed as having a relevance for the accounting condition.

In his study, Hopwood identifies two accounting research problems. First, a vast majority of accounting researchers focus on accounting on ways that either isolated it from its organization contexts, or were content to rely on the most abstract and generalized characterization of those contexts. Second, much of the

focus of accounting research was on increasing the technical rationality of the accounting practices and measurement methods. Hopwood criticizes both of the research approaches for 'partiality.'

Hopwood reminds those who criticized the contingency theory approaches to management accounting (e.g. Otley 1980, Dent & Ezzamel 1982, Coopers 1981, Robson and Cooper 1989 etc) that their earlier concerns were focused on the problems of particular notions of contingency embodied in prevailing contingency theories rather than the idea of contingency per se i.e. contingency of the nature of accounting itself.

He further believes that the works of these critics have not touched the essential notions of accounting and have taken for granted the technical and economical (rational) general roles that accounting is capable of serving.

The problem triggered by this research is how to study the complicated interaction between a number of contingent variables (not yet identified by academics or practitioners) and the AIS. Examples of these relationships are: (1) principals' strategy and goals with agents' strategy structures and processes to the extent these relationships pertain to AIS features; and (2) agents' strategy structure and processes relationship with principals' AIS.

Even those who criticize contingency approaches to accounting either for their instrumental rationality views

or for failure to understand accounting within a wider organizational and social functioning framework, have not yet realized the need for understanding accounting, social, and organizational functions in complex situations where structure is complicated by decentralization to agents.

Also, the contingency theory has not addressed the required limit of organizational control, i.e., what level of control is required. The case of Mosnic shows that in the initial stages the stakeholders were satisfied with selecting brand name agents and leaving them to operate on trust basis without the need for a formal information link. Then an investment Advisor was inserted to monitor the work of the agents more closely. At a later stage they decided to hire the Corporate Controller who was also expected to operate as a corporate information manager. The **Corporate Controller** was assigned wide powers to interact with all the agents as a gate-keeper between the principals and the agents. The level of organizational control became a function of what the Controller and the agents agreed and furthermore, investment houses are beset with the difficulty of defining what should be organizational control because the optimization of goal achievement is a process dominated by agents existing in different continents. Goal achievement has to be sought in markets beyond the scanning capacities of individual investment houses. Contingency approaches have not yet addressed these different organizational and social contexts.

The 'rational' approach to investment in Mosnic is mixed with the holistic approach of risk management. Investment strategies are extremely dynamic. For effective functioning, Mosnic management has no option but to use shifting frames and a variety of systems. Perhaps, the rate of contingencies between variables in designing systems for investment houses is higher than distribution and manufacturing firms for two reasons: (1) The influence of the agents' systems (2) The increased turbulence of the financial markets which lead to continuous shift in strategy.

The problems of the dynamic change of investment objectives which hinders complete dependence on rational management system in Mosnic, triggers further the need for questioning the existing management contingency approaches. As elaborately discussed earlier, in Mosnic organizational effectiveness is measured by controlling risk (uncertainty). Indeed, risk management in Mosnic has been carried out in an endless flow of interaction with the markets and with different portfolio managers. Thus, it was not that simple to set a quantified limit for Mosnic's objective. ROI measurement is a problem. This meant shifting standards for determining effectiveness. Given the nature of the markets' uncertainty, the principals have to revise the required ROI as time passes. This also means difficulty in appraising the agents short-term performance. Hence, perhaps the criteria for rewarding is not similar to the ones assumed by

contingency theorists. As far as punishment is concerned, it is not directly applicable to investment houses which adopt fixed fee asset management contracts. In other words, agents may not be rewarded for high performance nor they are penalized for unsatisfactory short-term performance. Punishing the discretionary portfolio managers is done through dismissing the ones who do not remain compatible in terms of strategy, structure and processes with the criteria set by Mosnic. Termination of the agent services in response to the short-term ROI means continuous incurrence of transaction costs resulting from shifting from one agent to the other, losing time, incurring cost of selecting and understanding the style and methods of new agents. This problem will be elaborately discussed in Chapter 9 which is about the finance theory. As far as contingency theory is concerned the above argument shows that the required level of control, the period over which to assess the effectiveness of control and the types of control may be different in investment houses from what has been addressed in the current contingency theory. Therefore, at a broad level the contingency theory is right. However, it does not help me very much. Perhaps the situation is different in investment houses than in running other types of organizations. It does not help me very much because what I actually need to understand in designing the process is not some broad contingencies but the detailed process. I have actually mentioned this point while discussing the work of Hopwood in the previous two pages.

In fact, I am not dismissing contingency theory. Rather, one would expect differences in an investment houses from the standard stuff on control system in the basic text books based on manufacturing and distribution organizations.

As hinted earlier, one of these differences is that Mosnic agents have fixed fee contracts. Viewing this, one can argue that the current contingency theory of management system would not take on broad the impact of agent personnel controls on the principal's organization effectiveness. Hence, this theory can be enhanced by studying how to exercise tight or even loose control on external agents to achieve organizational effectiveness.

Perhaps, unlike other types of organizations, effectiveness of organizational control in Mosnic is influenced by: (1) the financial markets (2) shifting goals and strategy process (3) agents strategy, structure and processes (4) stakeholders' religious beliefs and (5) technology. In addition the changing nature of the financial markets' uncertainty emerged as one of the major challenges for Mosnic's strategic control system. Thus, the role of the Controller is crucial in changing the control system.

THE ROLE, INVOLVEMENT, ACCOUNTABILITY AND INDEPENDENCE OF CONTROLLER AND THE IMPLICATION FOR CONTROLLERSHIP RESEARCH

Some of the problems faced by Mosnic in implementing its discretionary investments were how to specify the role of the Controller in interacting with the agents, how to secure the independence of the Controller in views of his involvement with both the principals and the agents and how to measure the performance of the Controller without releasing the agents from accountability as a result of his liaison with them.

Sathe (1982) argues that unlike operating executives, controllers are staff managers not measured on operating profit and loss (the "bottom line"). He suggests that:

> *"According to conventional thinking an appropriate criterion of effectiveness is the quality of information and analysis presented to aid operating executives in business decision making."* (P - xv)

Sathe has criticized this manner of controllers' performance measurement by arguing that it is too simplistic a view in today's business environment. He added that because of increasing organizational size and business complexity the operating executives, however bright and capable, simply do not have the depth of knowledge in the variety of disciplines needed to achieve maximum effectiveness. Hence, according to Sathe, staff executives such as the controller must become actively involved in the business decision making process - by recommending courses of action and by challenging the plans and actions of operating executives to ensure that

specialist knowledge and expertise get proper consideration when business decisions and actions are taken.

However, he believes there is a dilemma for involved controllers and others. He ascribes the dilemma to the fact that the controller has two seemingly contradictory responsibilities, both of which appear to be increasing in importance. His argument is that:

> *"On the one hand, the controller is responsible for providing assistance in the business decision making process.... On the other hand, the Controller is also responsible for the integrity of the financial information provided to external agencies and for ensuring that control practices conform to corporate policy and procedures. To discharge these responsibilities effectively, the controller must retain a sense of objectivity and independence from management." (P.1)*

The study also concludes that management seeking to increase the general level of controller involvement in the company could search for levers available to produce change. Moreover, Sathe has also discussed the consequences of controller involvement for company performance. To investigate this he has raised the following inquiries.

> *"Does active controller involvement help improve the company's financial performance? Does active controller involvement compromise controller independence? Does involvement stifle management creativity and initiative?"* (P.2)

Sathe believes that these questions are difficult to investigate because of a number of factors which affect a company's performance.

Sathe's argument on the paradox of controllers' involvement and compromise of their independence has touched on significant issues. However, the Controller's role in Mosnic involves the following: (1) independence, (2) performance evaluation, (3) stakeholders' risk management, (4) facilitating inter-organizational relationships, (5) influence on the organizational structure, (6) operating most dynamic investment strategies i.e. his task of making possible coping with the financial markets turbulences, and (7) interpreting the principals' requirement to the global portfolio managers.

The independence problem emerging from the Controllers' involvement was different in Mosnic. This study shows that the principals got involved through the Controller with the agents. This creates problems that are different from those in Sathe's arguments. For example, the principals involvement in portfolio management issues was likely to release the discretionary agents from accountability. It was the role of the **Controller** to lead Mosnic out of this problem which required from him careful orchestration of the principal-agent interactive processes. However, the dilemma which this triggered for Mosnic was how did this role impact the Controller's independence? The information of the case studies presented in the thesis was not enough to address this question. In addition, for the purpose objectivity, it may be more appropriate if this issue is researched by someone other than the author.

The above problem also complicated the Controller's performance measurement in Mosnic because of his involvement (1) in the agents' accountability; and (2) with both the principals and different agents at different levels of interaction.

CONCLUSION

The whole thrust of this research has been to understand how investment houses actually operate in working with external portfolio managers and exercising control on them. In following through the developing themes in this grounded research, the grounded theory that emerges from this process of research had ended up giving us a number of important insights into the nature of strategy and the nature of controllership in this type of organization.

Nevertheless, as this research developed I became more and more aware of apparent inconsistencies between techniques and tools (e.g. the modern portfolio theory) suggested by finance literature and what actually happens in investment houses. Now I will review specific areas in the finance literature to examine how and why these inconsistencies exist.

CHAPTER-9

SECONDARY CONCLUSION : REVIEW OF THE FINANCE ACADEMIC AND PROFESSIONAL LITERATURE

Objectives

This chapter attempts briefly to examine why the Modern Portfolio Theory (MPT) is not adequate for the portfolio management in Mosnic. The reader is reminded that although Mosnic has not prohibited the use of MPT by the asset managers, these agents were not left free to do everything they want based on MPT. In addition, the chapter discusses the relevance of the well developed portfolio performance evaluation techniques to the nature of this type of organizations.

However, this chapter does not examine the literature on capital budgeting because this research does not deal with direct investments. Rather, it is concerned with marketable securities portfolio invested through discretionary agents. Emphasis is also placed on the contributions made by the professional portfolio managers to find out their views about risk assessment.

THE MODERN PORTFOLIO THEORY:

Does it Help Mosnic?

The dictionary of finance and investment terms compiled by Downes and Goodman (1987) defines portfolio theory as follows:

> *"Sophisticated investment decision approach that permits an investor to classify, estimate, and*

control both kind and amount of expected risk and return; also called portfolio management theory or modern portfolio management. Basic to portfolio theory are its quantification of the relationship between risk and return and the assumption that investors must be compensated for assuming risk. Portfolio theory departs from traditional security analysis in shifting emphasis from analyzing the characteristics of individual investments to determining the statistical relationships among the individual securities that comprise the overall portfolio." (P.296)

Markowitz (1952) argues that portfolios can behave quite differently from the securities of which they are composed and that rational investors should be primarily concerned with their portfolios rather than with the securities they hold in the portfolio. Markowitz claims that the impact of a security on a portfolio is dependent on three factors:

1. The return on the security.
2. The uncertainty (risk) of return on the security.
3. The movement (covariance) of the security in relation to the movement of every other security in the portfolio.

It is also assumed that using the above information, an investor can put together a group of portfolios, each of which gives the highest level of return for its level of risk or the lowest level of risk for a given level of return. The investor can then select from these 'efficient portfolio's the one which best balances his desire for return with his tolerance for risk.

Portfolio theory is also built on the assumption that the organizational processes through which the investment

decisions emerge are simple and straightforward. However, unlike what is advocated by the MPT, the initial case study and the other five case studies demonstrated that Mosnic did not depend on the mean-variance analysis as a measure of risk. Rather, Mosnic felt the need for a more holistic approach to assess the risk of investing its discretionary funds through portfolio managers.

Apparently, the need for such an approach was dictated by the fact that the principals had to adjust their objectives in order to accommodate the changes that took place in the fast moving financial markets. This required a continuous process of interaction, which was carried out by the Corporate Controller between Mosnic and its portfolio agents, in which the latter were made aware of the stakeholders' perception of the nature of uncertainty in the financial markets to that they (agents) can reflect it in their investment strategy.

This process, which comprised the formulation of the corporate strategy and the pre - and post-investment controls, tended to be perceived by the stakeholders to be more comprehensive and useful in dealing with the nature of uncertainty in the financial markets than the simple mean-variance measure of risk. Indeed, such a process tended to help Mosnic to cater not only for the risk of investing its discretionary funds through portfolio managers but also the risk of managing the agents.

Cohen, Zinbarg and Zeikel (1987) also question the measure of risk advocated by the MPT. They state:

> *"A closely related question, and one that should be kept in mind as we further trace the development of modern portfolio theory, is whether standard deviation (or variance) is the most appropriate measure of risk. Most of the work stimulated by Markowitz uses historical price volatility as a guideline to the probable future variability of a security's rate of return about the mean. But if an investor is not in need of high liquidity and is truly a long-term holder, the price volatility per se does not really pose a risk. Rather, in this case, the question of concern is one of ultimate price realization risk of bankruptcy, for example - and not interim price volatility." (P.135)*

They argue that:

> *"There were (and still are) some very practical obstacles that restrict the use of the Markowitz model. An obvious drawback is that practicing investment managers have difficulty understanding the mathematics involved. Second, while security analysts and portfolio managers are accustomed to thinking about expected rates of return, they are much less comfortable in assessing the possible ranges of error in their expectations and are even less accustomed to estimating covariances among securities.*
>
> *Still another limitation in the use of Markowitz model is that each time a change in the existing portfolio comes under consideration, the entire population of possible securities must be re-evaluated in order to preserve the desired risk/return balance. This reevaluation, in turn, requires a large number of mathematical calculations. Markowitz himself pointed this out by observing that "an analysis of 100 securities requires 100 expected returns, 100 variances, and almost 5000 covariances." (P.135-136)*

They also comment that due to the complexities and the unworkability of these calculation problems, Markowitz suggested a simpler procedure - relating the returns on each security to the returns on an overall index of market

prices and thereby implicitly relating the returns on each security to each other security. Despite this simplification, this research indicated that even after relating the ROI of each security to the returns on an overall index of market prices, the MPT does not explain what processes should follow the determination of the ROI.

In addition to the above problems, Cohen, Zinbarg and Zeikel also give the following support to some of the economic consequences which Mosnic would bear if it were to change its agents every now and then and thereby restructure its portfolio.

> *"Even more significant than the sheer volume of computations required to apply the Markowitz technique is the fact that the portfolio alterations required to achieve constant portfolio efficiency may be so numerous that they can give rise to large, uneconomic transaction costs. This cost should be true even if portfolio managers reviewed their holdings as frequently as quarterly." (P.136)*

On the other hand, even portfolio managers have voiced their reservation concerning the use of MPT in the investment decision related to marketable securities. For example, Rosenberg (1986) argues that:

> *"some of the world's most formidable investors.... ..... and heralded investment experts..... argued that beta constituted a poor substitute for risk analysis. Their criticism emanated from the belief, even if beta were a good measure of past relative volatility, it was not necessarily a good predictor of future volatility. Most important, (such investors were) concerned with short-term market fluctuations. Their definition of risk centered on the probability of any company's being unable to meet investor expectations for growth in earnings, dividends, or book value over time -fundamentals not considered in beta calculations."* (P.125)

He further adds that:

> *"Time has healed much of the fundamentals versus beta controversy. Many of the original advocates of beta became disenchanted with its use. Others, such as Dr. William Sharpe of Stanford's Graduate School of Business and Dr. Barr Rosenberg of the University of California (Berkeley) School, presented provocative adjustments to historic betas -adjustments that combined numerous fundamental considerations to accomplish what all investors strive for: predicting future risk. Value Line, one of the better investment statistical services, now combines elements of MPT with past and projected fundamental factors to arrive at its risk proxies."* (P.126)

Chapman and Ward (1991), who use Markowitz's model as a theoretical framework argue that there are two basic reasons that justify the call for a wider perspective in terms of the objectives of a decision support system for portfolio management. **First,** a number of people are involved in the decision process, with different skills and responsibilities. **Second,** decisions need to be made on a real-time basis, most by those with the least seniority or authority, "the traders", with appropriate guidance from various levels of "management". They also realize that the financial control situation involves important information generation, evaluation and communication of appropriate information.

Although, the Chapman and Ward study is a move in the right direction, they only recognize a small part of the complications involved in the investment decision processes. Indeed, the findings which emerged from this study cast light on the detailed organizational strategy

and control processes which impact the way the brokerage firms formulate investment decisions.

Another problem, which was revealed by the agents case studies and which highlights a practical difficulty in the applications of the MPT in this type of investment, is the quality of data.

Mosnic had to make sure that the quality of information provided by the agents was reliable. This seemed to be more important than just emphasizing the technical analysis of the information by the portfolio managers who carried out estimation of the relevant data for selecting the securities. It was argued in chapter (7) that in selecting its portfolio managers Mosnic preferred those who had better capabilities of scanning the financial markets.

The quality of information problems has hardly been voiced in the finance literature. Indeed, rather than giving it adequate consideration and emphasizing its significance as a pre-requisite for good measurement and estimation, the finance (and accounting) literature implicitly assume that this problem has been taken care of.

Cohen, Zinbarg and Zeikel (1987) also draw attention to this problem by quoting from The Wall Street Journal the following:

> *"Which of many, many sources of information can you rely on? Where can you go for unbiased, accurate information? The vast, and outpouring*

of investment information, advice, alleged facts, and recommendations can be bewildering and confusing." (P.82)

FINANCE THEORY TECHNIQUES OF MEASURING PORTFOLIO PERFORMANCE

The analysis of the case studies in chapter (7) has led to the development of the detailed conceptual framework. A grounded theory produced in chapter (7) indicates that evaluating the discretionary portfolio is a complicated system which involves the use of a multi-system (See Fig. 7.6 The Detailed Conceptual Framework). Now, I want to consult the finance theory on this problem. Indeed my review of the MPT indicates that measurement of the portfolio performance is the final step in the MPT. To refresh the memory of the reader, the basic four steps argued by the Modern Portfolio Theorists can be summarized as follows:

1. Security valuation i.e. describing a universe of assets in terms of expected return and expected risk.

2. Asset allocation decision i.e. determining how assets are to be distributed among classes of investment, e.g. bonds, shares, precious metals etc.

3. Optimization of the portfolio i.e. reconciling risk and return in selecting the securities to be included, e.g. determining which portfolio of stocks offers the best return for a given level of expected risk.

4. Performance measurement i.e. classifying each security's performance (risk) into market - related (systematic) and industry security - related (residual) classifications.

The purpose of this section is briefly to review the MPT's performance measurement techniques (step # 4 above) with a view of finding out whether these techniques (1) can be applied to investment houses like Mosnic; or (2) match with the performance measurement system described in chapters (6) and (7).

Finance theorists (e.g Sharpe 1985) argue that the most widely publicized type of portfolio performance measurement is that used for external reporting to clients. Such bottom-line measurement is concerned primarily with the results obtained by the organization as a whole, with little concern for the manner in which the results were produced. Some investment managers routinely measure their own performance in this way; some sophisticated investors (e.g., corporate pension fund officials) measure their fund's performance; and a number of third parties provide measurement services for both investors and investment managers.

This study has shown that bottom-line measurement should go beyond the result as a whole to explain the manner (the methods) and the means expended by the asset manager to achieve the result even if it was negative. Without this wider understanding of the bottom-line approach the investment houses can hardly avoid switching from one agent to other and consequently facing the incurence of transaction costs which may put the invested capital into a real jeopardy.

Farrel (1983) argues that portfolio performance evaluation aims not only at assessing the success of the investment process in achieving the overall investment goals, but also at diagnosing the contribution of the individual elements that have made possible the achievement of the overall goal.

He further argues that performance evaluation should provide a feedback mechanism enabling the organization to emphasize those aspects of the process which are productive, and down play or reconstitute those which have failed to contribute to the investment goal.

Farrel demonstrates his arguments by describing the investment needs of a hypothetical pension fund to illustrate the sort of investment goals that the fund might establish. Based on that, he indicates three major aspects of the investment process that should be evaluated. These are: (1) asset allocation; (2) weighting shifts across asset classes; and (3) security selection within asset classes.

With respect to evaluating security selection, Farrel discusses two general methods of evaluation. These are: (1) comparison against asset-class indexes as well as against comparable managers within the asset class; and (2) risk-adjusted performance comparisons that derive from the portfolio theory and capital market theory.

Farrel concludes his argument on performance evaluation by consolidating the three aspects of perform-

ance asset allocation, weighting shifts across asset classes, and security selection within asset classes into an overall performance evaluation for his hypothetical pension fund.

Levy and Sarnat (1972) use the portfolio model to assess the performance of mutual funds and to test the degree to which efficiency criteria, based on realized return, can be used to facilitate current investment decisions. Taking mutual funds as a proxy for portfolios in general, they try to explain the risk-return pattern of mutual funds returns. Their theory is based on expected variables, and therefore, relates to the future. They attempt to test the ability of the various efficiency criteria applied in their book to predict the future on the basis of past data on risk and return.

In discussing measurement of mutual funds performance they argue that,

> *"mutual funds often have varying objectives, and as a result, the funds investment policies also tend to differ. Funds which emphasize capital gains attempt to invest mainly in growth stocks, while funds which emphasize current income, tend to build more balanced portfolios." (P. 477)*

They further argue that despite these differences, some investment objectives and policies are common to all (or almost all) of the funds. They give the following examples on the common policies: (1) to increase return through professional investment analysis, and by taking full advantage of scale economies in the management of the

portfolio; (2) to decrease investment risk by diversifying the portfolio.

With regard to investment decision Levy & Sarnat say:

> *" When deciding between the alternatives of investing in mutual fund shares, or directly in common stocks, investors must weigh the degree to which the funds have succeeded in achieving these two common objectives against the expenses incurred in providing the professional management. "(P.478)*

Accordingly, they argue that if a fund's mean rate of return is higher than the rate of return earned by an investor who randomly diversifies his stock market investments, one might conclude that the mutual fund has succeeded in achieving the first of its main objective i.e., increasing the average rate of return to investors.

They further argue that decreasing risk is not reflected in the average rate of return earned by mutual fund investors, but rather in the variability of the annual rates of return. Hence, they conclude that the smaller the standard deviation, the more stable the series of return, and consequently the lower the risk associated with such investments. Finally they argue that,

> *"to evaluate the investment performance of mutual funds, we require two variables; the mean rate of return and the standard deviation associated with these returns. "P. 478)*

As such, to evaluate a particular mutual fund's performance, they recommend to compare the funds' average rate of return and risk with the average rate of return and risk of investments randomly chosen from the stock

market, i.e. with an unmanaged portfolio. In emphasizing the benchmarks measurement of performance they suggest that:

> *"The accepted way to carry out such an evaluation is to compare the fund's average return and variability of a general index such as Dow Jones or Standard and Poor (S & P)." (P. 478)*

Levy and Sarnat extend their discussion to alternative measures of investment performance such as the reward-to-variability ratio. In their view, this method is based on the following formula which measures the price of unit of risk for all investors in a perfect market.

$$\frac{Ex_m - r}{\sigma_{x_m}}$$

Where Ex_m= the expected return of market portfolio

r = the riskless rate of interest.

σ_{x_m} = the standard deviation of return of the market portfolio.

Based on this formula, they suggest that a similar relationship can be defined for any portfolio say (i) as follows:

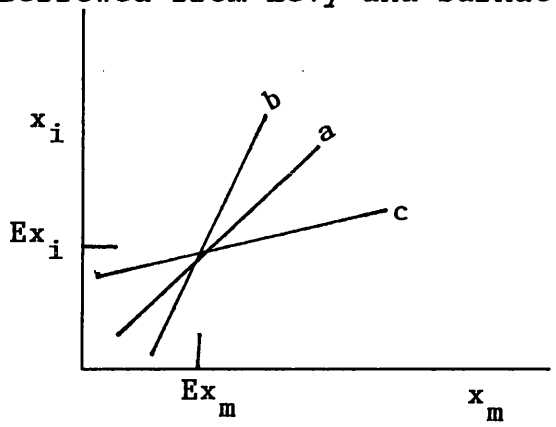
$$\frac{Ex_i - r}{\sigma_{x_i}}$$

Levy and Sarnat mention that Sharpe and others have pointed out that:

> *"The R/V ratio constitutes an appropriate measure of performance for efficiently diversified portfolios but should not be applied to single securities or small portfolios.*

They explain the concept of volatility by introducing the notion of a characteristic line which is explained in figure 9.1.

Fig.9.1
Three examples of possible characteristic lines
(Borrowed from Levy and Sarnat 1972).



The characteristic line of a particular security i (or mutual fund i) is defined as the regression line between x_i and x_m, where x_i and x_m denote the returns of $_i$th security (mutual fund) and of the market portfolio, respectively. Three examples of possible characteristic lines are drawn in figure 9.1.

The slope of the regression line, β_i, is a measure of the relationship between the change in x_i following a change in x_m. Levy and Sarnat call this relationship volatility.

Accordingly, if $\beta_i = 1$ (line 'a' of Fig 9.1, a 1 % increase (decline) in the return of the market portfolio is accompanied by 1 % increase (decline) in the return of security (mutual fund) $_i$. If β_i is greater than 1 (line 'b' of fig 9.1) i is more volatile than the market portfolio, that is to say it is an "aggressive" security which

rises faster than the average during a bull market, but also falls more than the average during a bear market. Using the same type of reasoning, a security (portfolio) having a characteristic line with a slope of less than 1 (line `c' of Fig 9.1) represents a "defensive" security (portfolio), i.e., one which rises more slowly than the average during a rising market, but also falls less than the average in a declining market. It is therefore, assumed that using beta analysis investors can come by a "super" defensive stock, that is one which has negative correlation with the market portfolio i.e., would have a characteristic line with a negative slope.

Indeed, Levy and Sarnat argue that whereas Sharpe takes the reward-to-variability as his performance indicator, Treynor replaces the standard deviation of the R/V ratio with volatility. This is expressed as follows:

$$\frac{Ex_i - r}{\beta_i}$$

Accordingly, they derive a performance measure which is appropriate for single securities and partially diversified portfolios, as well as for fully diversified portfolios.

Using the above measures, the performance of a security is judged by its deviation from the equilibrium relationship (characteristic line) implied by its volatility or systematic risk. Thus, the Treynor index is set out in terms of the different return (Ex_i) per unit of systematic risk.

According to Sharpe (1985):

> *"Unfortunately, it is very difficult to separate performance due to skill form that due to luck... A change should be made only when there is adequate reason to expect the advantages to outweigh the costs. Switching from one manager to another on the basis of minor differences in short-term performance will certainly incur transaction costs (as the new manager replaces old holdings with new ones that conform to his or her "style") but there may or may not be any improvement in future performance." (P. 681)*

Recommending moderate rationality in comparative evaluation of portfolio managers' performance, Sharpe suggests that differences in agents' past performance should be treated as interesting data. However, he argues that such data should be utilized only in exploring areas which may require detailed examination and discussion.

Sharpe concludes his arguments about rational methods of performance measurement by stating that:

> *"much more could be said about performance measurement. It suffices to indicate that, although some investment managers may not like it, performance measurement appears to be here to stay".*

LIMITATIONS OF RISK/RETURN TECHNICAL METHODS IN EVALUATING PORTFOLIO PERFORMANCE

In the following paragraphs an attempt will be made to find out if the works of Farrel (1983) and Levy and Sarnat (1972), in the evaluation of portfolio performance can help in furthering our understanding on how portfolio performance evaluation is tackled in Mosnic.

The study of Farrel builds on a hypothetical pension fund to describe the sort of investment goals that the fund might establish. As mentioned earlier, it emphasizes

three major aspects of the investment process that should be evaluated. However, Farrel does not consider the processes involved in allocating the assets through a portfolio of agents maintained by the investor.

Furthermore, his study does not describe the different levels of asset allocation which, in this study, involve the following: (1) corporate policy or strategic allocation of the resources, (2) tactical asset allocation by the agents. Each of these processes involve a number of processes.

The asset allocation processes identified by Farrel does not show the significance of the following processes (1) geographical allocation of the assets; (2) allocation of the securities in the portfolio by industry and company; and (3) allocation of the assets by currencies.

Diversification of agents or maintaining the portfolio of agents is a significant factor for investment decisions and asset allocation. Farrel argues that the prime determinant of whether the plan will meet the real-return target at minimum risk over an intermediate to longer period of time is the effectiveness of asset allocation.

The above argument can be relevant to many of the plan sponsors who have to state their long-term goals in terms of a real return on investment i.e. nominal return less inflation rate.

Farrel argues that the objective of an asset allocation is to blend assets together so as to hedge against adverse economic changes (reduce risk), and, at the same time, provide greatest opportunity for achieving a required long-term rate of return.

But, Farrel's work does not explain how to formulate a corporate risk management policy utilizing a number of risk management approaches obtained from a portfolio of discretionary asset managers. In Mosnic I am not talking about one portfolio and one decision maker. His debate of analyzing the performance of a fund by assessing the effectiveness of the asset allocation needs to be enhanced by looking into how financial institutions work. Moreover, this study suggests that the effectiveness of assets allocation to achieve satisfactory performance and to preserve the invested capital equally depends on the quality of the data and its analysis. The model developed in this thesis at the end of chapter (7) (fig 7.6) shows that the quality of data, and hence, the effectiveness of the financial strategy (asset allocation) depends on the means and methods (strategy, structure and processes) of the investment decision maker.

The second dimension suggested by Farrel in appraising the performance of a fund is to test the productivity of any changes in the weighting of the assets from the long-run-target asset allocation. According to this dimension, if the fund is over-weighted in international equities and under-weighted, for example, in

domestic equities over the period, one can measure the extent to which this would impact performance relative to the maintenance of a position in line with the long-term target. This argument means that for its implementation, one must first compare the return earned on the asset class to the return earned on the portfolio. This naturally leads to problems of measurement and comparison as highlighted earlier in this chapter.

From a technical and a rational point of view that can be lived with. On the other hand, this has not taken us forward to see what should happen after the measurement of ROI. In chapters (5) and (6) it was reported how MIP and Vontov Banks explained in detail in their performance report the impact on ROI created by over-weighting or under-weighting in certain securities. However, that was not more than a general indication and not a final appraisal. The case of Mosnic shows that under-weighting or over-weighting in certain types of securities maybe the result of the agent's specialization. If this is the case even if the ROI is negative the investor will not take it as a sign of non-productivity.

In fact, Farrel's dimension for assessing the performance of portfolios in terms of asset mix changes does not explain the processes involved in portfolio performance appraisal. The problem which has not been explained is the extent to which investors in the financial markets can be sure about the nature of uncertainty to set a long-term ROI target ? This study shows that this can hardly be

achieved. Thus, the debate made by Farrel does not explain how asset mix is changed and it does not show the process by which the investment decision makers (either agents or principals) agree on their perception of risk (uncertainty). This perception can change so frequently in investment houses. Perhaps in the case of pension funds because the ultimate objective of the investment is to meet certain liability and because the fund beneficiaries (the owners) are not active participants in the decision process, the setting of long-term target may be acceptable. However, this is not the case in investment houses where the fund beneficiaries would like to preserve their capital while behaving in a reasonably opportunistic manner.

Another dimension proposed (by finance theorists) to be used in portfolio performance evaluation is the technique of assessing the success of managers within individual asset classes e.g., domestic equities, international equities, and fixed income securities. This method is used by almost all the portfolio managers who report their performance to Mosnic. For example in their commentary on U.S domestic equity performance, MIP makes comparison with market indexes such as the S & P 500.

Some writers (Farrel, Levy and Sarnat, Sharpe) have also proposed evaluating portfolio performance based on measurement of risk-adjusted return derived from the risk-return theoretical frameworks. They argue that comparison can also be with performance of others specializing in the management of securities within the asset class.

However, comparison of performance without describing how to articulate the appropriate portfolio strategy could not help Mosnic. To understand the processes which should follow the comparisons, Mosnic needed an active role to be played by the Corporate Controller. That role involved attending to strategic change by learning from agents.

Treynor performance indicator (discussed by Levy and Sarnat), which is based on volatility rather than on variability, would not advise Mosnic in its portfolio performance planning and evaluation problems because it does not consider the processes and problems inherent in evaluating divisionalized portfolios.

Comparison of the return of a discretionary portfolio with the return of the market portfolio and consequently determining the aggressiveness of a security in terms of its volatility would hardly be of help to Mosnic as to how to manage the post-investment relationship with a portfolio of discretionary managers. Once again the problem is the use of ROI. Is it an indicator or is it for final appraisal? The debate in Chapter (7) on ROI shows that the essential idea behind measuring ROI is to use it as an indicator to compare returns obtained with those of one or more appropriate alternatives e.g other managers, benchmarks. Sharpe (1985) explains making relevant comparisons as follows:

> *"In some cases the focus is on the returns from "similar" actively managed funds, in other, "similar" naive or passive strategies are considered." (P.682)*

Thus, according to the finance theory it is important with either approach to choose relevant alternatives. In real life this is difficult because investors may not have the required quality of information to assert that specific benchmark portfolio can be feasible and can represent alternatives that might be employed if the portfolio being measured had not been held.

Indeed, Sharpe has strived to simplify comparison based on a single measure. He says:

> *"A single measure that takes both elements into account may be used. Alternatively, the comparison may be restricted to funds with similar exposure to risk, and their returns compared directly". (P.682-683)*

The debate in chapters (6) and (7) indicates that although the objective of the stakeholders conveyed to the agents can be the same, it is very often that the latter ends up constructing different forms of portfolio. ROI produced by each agent can also be different. There is nothing wrong with this. However, what is important is that agents who have different approaches to investment should not be compared with each other. Rather, the performance evaluation of each agent should be viewed in the context of his structure, strategy and processes. This means that if the quality of the decisions taken by the agents are sound and compatible with the conveyed guidelines, the principals should not respond negatively to the unsatisfactory short-term ROI.

Some practitioners in the field of portfolio management support the above view. For example, Williams (1986), argues that similar objectives are difficult to calculate. He says about this problem:-

> *"The idea of comparing one's fund with other funds that have similar objectives is very appealing. This is especially true since many fund sponsors are hiring managers with specific styles which cannot easily be compared with more diversified portfolios or with specialized portfolios with different structures or objectives. Unfortunately, developing a workable definition for "similar objectives" and finding a sufficiently large sample of funds which fit the objectives are two formidable problems. All funds have as their general objective making money without losing money. More eloquent statements suggest as objectives maximizing return without undue risk of loss of principal. These definitions of objectives are of little help since they include all funds rather than just "similar" funds.*
>
> *In theory it is possible to compare funds based on their level of risk, such as the percentage in equities. In practice it is not possible to find a sample of funds with exactly the same asset allocation as the sponsor's fund, so typically a range of allocations is considered. In other words, a fund with 63 percent in equities would be compared with funds having between 60 percent and 70 percent in equities. However, in a volatile period there can be substantial differences between funds having 60 percent in equities and funds having 70 percent in equities. Also, if the fund being measured has a very high or a very low percentage in stocks, there will probably not be many similar funds in the same category." (P.199)*

At the corporate level in Mosnic, aggressiveness of a portfolio may not be measured in terms of volatility as explained by Levy and Sarnat. For example, in Mosnic shares were categorically viewed as aggressive investments while fixed income securities are viewed as defensive. This opinion remained unchanged despite the arguments of the agents that in the long run shares would out-perform

bonds. The whole process depended on how each investor perceived risk. The Controller could not calculate in advance how the stakeholders would perceive markets' uncertainty. Hence, it seems that the volatility and characteristic line indicators of portfolio performance assume that risk is clearly conceived and stated by the investors, which is hardly the case in real world.

Both measures further assume investors' clarity about market risk and security risk. The Controller had to go through lengthy processes to clarify to the agents the stakeholders' perception of risk. Market risk has been a difficult concept for the stakeholders to understand. The stakeholders of a portfolio may have differences in perceiving risk. Moreover, the situation of Mosnic has shown that agents assigned the same objectives by their principals can be different in their style of investment risk management.

The conceptual background of the performance indicators discussed by Levy and Sarnat is the portfolio theory, which is set out in terms of "expected" variables. These variables pertain to forms of the probability distributions of future returns on securities, to their expected values, to their variances, and to the potential interaction among security return i.e., to their covariances. In Mosnic's situation, it is difficult to make it operational this way because it is not easy to pre-set for agents the stakeholders probability beliefs and their expectations regarding long-term future returns. The principal's probability

beliefs can be substantially influenced by the situation in the financial markets, which make them difficult to predict.

SUMMARY OF THE MPT APPROACH TO STRATEGIC INVESTMENT DECISIONS

The reader is to be cautioned that I am not arguing that because of the financial markets' uncertainty, the finance theory has no application in understanding problems. My major argument is that the nature of the financial markets' uncertainties and the way they are perceived by different investors is not adequately captured by the finance theory and its well developed instruments. In Mosnic, management could not act in the way the finance theory suggests to measure risk. Indeed, the way uncertainty is captured in finance theory is not convincing to the stakeholders.

Risk is more complicated than the way it is captured in the finance theory. The financial markets move so fast and the stakeholders carry on changing their perception of the markets' uncertainty. Therefore, Mosnic was not able to accurately measure the risk to adjust the required return. Even the portfolio managers who presumably have adequate sources of information could not agree on assessment of risk. At the end of the day risk assessment is also affected by the beliefs of the portfolio managers and what each agent considers certain or uncertain for Mosnic depending on a fluid stream of interaction with the principals through the Controller. Hence, measurement of risk is not the final solution for determining the ROI required by the

stakeholders. As argued before, the well developed techniques which measures the expected ROI do not explain how to assess risk taken on hiring an investment management organization rather than any other agent.

Agents could not operate without interacting with Mosnic. Why? Because MPT which is a well-developed technique adopts a simplistic notion of risk which emphasizes mean and variance. Because the stakeholders in Mosnic do not like dependency of some simplistic techniques or risk assessment which do not reflect the nature of uncertainty in the financial market, a holistic approach to risk was inevitable to manage the investment. In this holistic approach the agents needed to modify their MPT - based proposals by using the controllership model in Mosnic to obtain information about how the stakeholders perceive risk. The agents came to believe that information might not be specific. Hence, they needed to maintain fluid streams of interaction with Mosnic. Which meant the notion of risk is not adequately captured by the finance theory.

The main message of this study is that MPT is fine. But it assumes that by knowing a series of data the investment decision maker, even without examining the quality and the relevance of the data can modify the portfolio in the short-term taking any transaction cost which may come up. Based on the grounded theory in chapter (7) of this thesis, MPT is not workable as it is. However, I am not arguing that agents should not use the MPT to present data for their principals. Indeed, this is

a fundamental step in a long holistic process towards the formulation of the investment strategy. (The reader is reminded to refer to my debate on Quinns stance in chapter (8) to refresh his memory about my model of dealing with the strategic decisions in a holistic manner). My argument is that MPT assumes that information about the stakeholders' perception of uncertainty is specific. This is not the case in real life. I argue that discretionary portfolio managers cannot use the MPT technique which rests only on mean and variance analysis to manage the portfolios in a manner compatible with the stakeholders' perception of risk. The discretionary asset managers need to be informed by the Controller before they can claim accurate assessment of risk attached to projected ROI's.

The fact that the stakeholders' changed the structure of Mosnic by inserting an involved Controller (see chapter 3) and their interaction with the agents in the pre-investment and post-investment phase [Chapters (5) and (6)], reflects their discontent with the notion of risk (mean - variance approach) as captured by the finance literature. The arguments made by the chairman and the director in chapters (3) and (5) indicated that the type of the uncertainties they had experienced with the fianancial markets could not be managed through the MPT approach. The stakeholders wanted to have that fluid type of interactions described in chapter (6) to exist so that the asset managers could understand the formers' perception of uncertainty. One time measurement or risk and hence the ROI

the ROI was not workable. The holistic approach referred to in the preceding paragraph proved to be workable because it has reflected, through attending to unspecific information and processes, the risk which is critical to the view of the stakeholders.

EXTERNALIZATION OR INTERNALIZATION

Crowel and Mainer (1980) argue that in the more conventional approach a pension fund administrator selects, orchestrates and monitors asset management services supplied by banks, investment counselors, and insurance companies. A typical large sponsor employs six or more equity management firms, two to three bond managers, and perhaps a consultant to monitor investment performance and advise on manager selection.

They argue that externalization of portfolio is mainly due to lack of credibility when no in-house investment expertise presently exists. In such situation, on-the job learning seems foolhardy and hiring from the outside carries all the risks of recruiting. They further suggest the following reasons to stay in with the traditional pattern: (1) The use of outside services facilitates diversification of the styles or philosophies applied to fund management. (2) There is less risk of conceptual stagnation. (3) The survival of outside managers requires what motivate them continually toward excellence. (4) The use of multiple external managers avoids dependence on a few key people. (5) Investment

professionals have only limited career opportunities in a corporate environment.

However, in Mosnic beside these five reasons the issue of whether to externalize or internalize portfolio management was resolved long ago. These are some additional reasons given in chapter (3) under the need to operate through agents.

1. Funds were not large enough to justify the cost of establishing a huge in-house portfolio management team.
2. Investing abroad was considered the appropriate strategy for situation in the Middle East.
3. The high cost of internal management, imported technology, etc outweighed the other factors in favour of internalization.

AGENCY THEORY

A number of authors (e.g. Baiman 1982, 1990; Hart and Holmstram 1987; Eisenhardt 1989) have attempted to review the literature on agency theory. This section draws heavily from these reviews briefly to examine the implications of the detailed conceptual framework developed in Chapter (7) on the assumptions of agency theory.

According to Baiman (1990),

> *"An agency relationship exists when one or more individuals (called principals) hire others (called agents) in order to delegate responsibilities to them. The rights and responsibilities of the principals and agents are specified in their mutually agreed upon employment relationship." (P.342)*

In Mosnic such an agency relationship does exist with the portfolio managers. The principals delegate to the

latter the responsibility of investing their discretionary funds on their behalf. However, this thesis argues that some of the underlying assumptions of the available agency literature can hardly explain the nature of the agency relationship in investment houses.

In all agency models, individuals are assumed to be motivated solely by self-interest. An agency problem arises if the first-best (the cooperative) behaviour, which maximize the group's welfare, is not consistent with each individuals self-interest. This happens if the employment relationships are such that, given that everyone else is acting cooperatively, one or more individuals could make themselves better off by deviating from their cooperative behaviour. In this respect Baiman (1990) argues that definitely if one or more individuals are expected to deviate from their cooperative behaviour, others may find it in their best interest to deviate. Baiman concludes that the end result is that when cooperative behaviour is not consistent with self-interest behaviour (i.e. it is not self enforcing), the group suffers a loss of efficiency and all individuals are potentially made worse off.

However, because the unit of analysis is the contract governing the relationship between the principal and the agent, the focus of the agency models is on determining the most efficient contract governing this relationship.

However, the problem here is to what extent can we measure the loss of efficiency created by the divergence

between cooperative and self-interested behaviour i.e., the loss from agency problems? The experience of Mosnic shows that given the fluid interaction between the principal and the agent in the investment process, it was neither practical nor easy to quantify the loss of efficiency. This becomes even more complicated if the loss of efficiency resulted in a decline in the ROI which as argued in the previous chapters can hardly be used as the main measure for performance evaluation in Investment Houses.

Even if we accept that the loss of efficiency can be measured by the decline in the ROI, does that mean Mosnic should modify the asset management contract? The holistic approach developed by Mosnic to control the performance of its portfolio agents is far more comprehensive than the simple contractual monetary adjustment advocated by agency theory as a mechanism to reduce the risk of a dysfunctional behaviour by the agent. Indeed, the case of Vontov Bank in chapter (5) shows that what mattered was the adequacy and the compatibility of the agent strategy, structure and processes with the principals' requirements.

Agency theory also assumes that contracts are costlessly and accurately enforced by the courts. As a result, the contracts studied are comprehensive and complete in the sense that for each verifiable events, they specify the actions to be taken by the contracting parties. However, in investment houses asset management agreements do not usually specify the actions and processes

which will take place between the principal and the agent in the post-investment phase. Rather, the principal-agent relationship was characterized by a continuous process of interaction to help the agent understand what would maximize the welfare of the principals. Furthermore, even if the agent failed for reasons beyond his control to achieve the objectives agreed upon, suing the agent to enforce the asset management agreement was never envisaged by the principal. Indeed, the best option was to understand the problem of the agent through informal liaison rather than to modify the contract to set new financial terms.

On the other hand, Mosnic was very sensitive to the option of modifying the fixed asset management agreements or entering into new contracts with new portfolio managers because of the huge transaction costs which it would incur in such a process and the costly consequences of the lead time which the new agent would require to re-construct the portfolio according to the principals' attitude towards risk. The modification of the asset management contract was also costly due to the resources the principals would require to identify a new agent from a market where obtaining information about portfolio managers was very difficult.

Starks (1987) employs recent developments in agency theory to study the impact of compensation contracts on portfolio management in a restricted mean variance world. He argues that the agency problems in the fiduciary relationships could be caused by the following. (1) The

principal cannot costlessly observe the resources that the agent expends in managing the portfolio. (2) The principal cannot costlessly observe the agents choice of risk level. Accordingly, Starks assumes that agents may choose a risk level that is not compatible with the principals. However, the case studies in this thesis demonstrate that investment organizations can know a lot about the potential resources an agent would expend through rigorously analyzing the agent in the pre-investment phase. Stark's work would not help in unraveling the inter-connections of the factors that determine the features of the pre-investment procedures conducted by a principal to know (before contracting) the potential agent's resources, structures and processes. As such, Stark's study does not appreciate the role of the controller in understanding the pre-decision processes which take place between the principal and the agents.

The assumption of Starks that the principal cannot costlessly observe the agent's choice or risk level seems general. Indeed, the principal can describe to the agents their tolerable levels of risk even before entering into the asset management agreement. In addition the informal fiduciary relationships can be utilized as a process whereby risk can efficiently be managed.

This research shows that agents were motivated when the principals gave them more business, recommended other clients to them or at least did not withdraw the funds already entrusted with them. Indeed, the agents were most

motivated to preserve the interest of Mosnic whenever they felt that there was a mutual understanding and that there was a sound working relationship.

On the other hand, although the asset management fee issue was very important for the agent, it was a minor step in the agent appraisal stages. In the post-investment phase, the fixed fee was not used as a tool to control the behaviour of the fiduciary manager. Without necessarily motivating the agent by a fee increase, the principals aimed at maximizing the utilization of the agents resources through interaction and close working relationship. In addition, instead of monitoring the behaviour of the agent from the expended resources angle, the principals and the Controller sought the agents support in formulating the dynamic portfolio strategies to reduce exposure to risk and to maximize their portfolio ROI. Ironically, Mosnic experienced better ROI and better services with some agents who had little resources than some of those who were highly reputed. This throws doubt on the expended resource issue raised by Starks.

REMARKS ON THE AGENCY THEORY

It seems that all agency models seem to be trying to create coordination between a superior and a subordinate through a monetary adjustment. It is all to do with a monetary contract. It implies that the principal will pay the subordinate certain amount of money and then this will be modified to try and make the agent take into account the principal's attitude towards risk. That is almost all

what agency theory is about. The existing range of the agency theory is varying around this theme. As it has been debated in the previous pages, due to the assumptions of rationality and accurate assessment of risk (mean-variance) the mechanism involved in the agency models does not provide a holistic approach needed to make the principal-agent level of risk taking compatible.

Perhaps it may well be that additional attention in the area of discretionary investment management is required to enhance the agency theory. Then one could vary the way of dealing with agents. This has not yet been adequately researched.

As said previously, all agency theory is getting co-ordination between superiors and subordinates just by financial contracts. This thesis argues that one cannot control at a distance by measuring agents' financial performance based on ROI and adjusting it to uncertainty. This suggests that the whole basis (the bedrock) of the agency theory is undermined in this type of organization. This is because the agency theory assumes that you are detached and you can through a very simple monitoring mechanism make sure that interest of principal and agent is aligned in terms of risk and return. But, if you cannot actually get a clear relation of risk and return in the first place (a finance theory problem), you cannot possibly construct a contract. Hence, I argue that an adequate measurement of uncertainty is a pre-requisite to design an agency contract. Even after satisfying this

condition, the rationality involved in all the agency paradigms contradicts with saving transaction costs in managing the principal-agent fiduciary relationships.

Indeed, the fundamental commonality between all the agency models is that they all build on a simple form of monetary contract in order to try to get a common notion of risk-return attitude between the subordinate and the superior. The thrust of this thesis is about that it is impossible to have a simple notion of uncertainty. It cannot be captured through the quantitative probability analysis alone. It requires a fluid type of interaction between the principals and the agents before contracting and after contracting. Until that time theorists agree on how to measure uncertainty the development of sensible agency theory may be delayed for Mosnic type of financial institutions.

CONCLUSION

An important message to be derived from this chapter is that the theory of finance and particularly the MPT and perhaps the agency theory has stemmed-out from economic - based literature. Controllership studies have emerged from organization - based and other literature. The situation of Mosnic further confirms the fact that controllership literature in its behavioural perspective has helped in understanding the complicated organizational and human processes by which the portfolio management practice takes place in real life. Thus, if we really want to understand the management of investment houses, the two bodies of literature have to be fused together.

CHAPTER - 10

IMPLICATIONS FOR PRACTICE, SUGGESTIONS FOR FUTURE RESEARCH, AND CONCLUDING REMARKS

Section (A): IMPLICATIONS FOR PRACTICE

Implications for Investment Houses

This research can be of value to investment houses in the following aspects:

(1) Strategy

Formal strategic planning is a problem for investors in volatile financial markets. Investment houses in the Middle East (and may be in other parts of the world) are better-off externalizing the management of their portfolios to a well chosen portfolio of agents. Thus, agent's sub-systems can be a reliable support to formulate the investment strategy. Portfolio managers have different types of specialization and diversified input (information sources) to investment strategy. The best investment strategy can be formulated by negotiating with the discretionary portfolio managers taking into account their investment models. The negotiation process is important and requires open and continuous interaction between investors and their discretionary asset managers. This research suggests that the maximum benefit which could be derived from the principal-agent interaction process is by involving the controllership function to interpret on a timely basis the principal's perception of risk to the portfolio managers. Through this process, the investment houses can overcome the problem encountered in relying entirely on measurement-based assessment of risk.

The case studies in this thesis suggest that the portfolio managers who have been dealing with Mosnic started to appreciate the limitation of the MPT. There is no way that they can solely depend on aggregation in a single massive decision matrix where all factors can be treated quantitatively. They were flexible to maintain fluid interactions with the investors to arrive at a holistic understanding of their principals' goals. This finding can be of a value to a number of investors who still believe that the professional portfolio managers are miracle creaters through their technically well-developed models.

Integrating Sub-Systems:-

In fact, you do not need to nor can you integrate the systems of a number of external organizations. This has to do with different people, different approaches, different organizational culture, etc. It is advisable to benefit from their diversified experiences, means and methods. However, this should be on condition that there is compatibility to the investors' needs. Consensus creation between agents' strategy, specifity, tight control of agents can be very close to rigidity. Indeed, investment houses need effective controllership function to manage these problems. Even the most talented Controller cannot totally remove ambiguity. Some of it is inevitable in the strategy process. Seeking ultimate specifity in the total strategy can be very costly. The investors and the portfolio managers have to be ready at each process of stra-

tegy to attempt to visualize what new patterns might exist among the emerging models of the different portfolio managers. The most effective investment strategy to be developed with a group of agents tends to emerge gradually from an iterative process in which the principals learn through the Controller from the professional portfolio managers. In the financial markets investors can hardly end up with global formulations of total strategies.

(2) Strategic Control

This study suggests that investment strategy, tactical decisions,and operations emerge in one complicated process which includes monitoring the implementation of the investment strategy. Thus, the involvement of the controller can be an important ingredient for managing these complicated overlapping processes.

This study also informs the global investors that if they work with the controllership function on a day-by-day basis two problems inherent in discretionary investment control can be moderated: (1) The problem of shift in investors' goals due to environmental turbulences; and (2) The problem of operating a number of heterogeneous subsystems.

(3) Strategy and Religious Ideology (Value)

The case of Mosnic suggests that the personal religious values of the investors impact their investment strategy. This may not be different from the argument of Guth and

Tagiuri (1965) who believe that the managers' choice of strategy can be objective if they include their personal values among the elements they take into account in their analyses and decisions. This is because, according to Guth and Tagiuri, personal values are important determinants in the choice of strategy. Personal values are classified as: theoretical, economic, social, political and religious. Indeed, the religious values of stakeholders in some Middle Eastern investment houses tend to have a profound influence on their strategic investment decisions. This implies that the role of the controllership function can be a key factor in ensuring that such values are catered for by Western portfolio managers in the various decision processes. Hence, investors who would like to make their discretionary agents aware of their religious and/or other values, which impact the strategy formulation and goal setting, should consider involving controllers who are capable of communicating the stakeholders' ideologies to the agents and who can ensure that the latter has complied with them.

Ahmed (1987) argues that Islamic banks address the ideological objective of propagating the beliefs of Islam and the social objectives of helping the needy and providing cheaper finance for poorer customers. Discussing the profit objective, he believes that the spirit of Islam calls for making reasonable rather than maximum profit. He states that:

"Because the objectives of Islamic Banks were influenced by Islam, organization structure, the evaluation of performance and administrative controls were also affected." (P.599)

Indeed, the case of Mosnic implies that there can be a contingent relationship between the Islamic ideology of the organization and the design of its control system.

(4) Control System and Structural Constraints

Designers of control systems for investment houses which have similar characteristics as Mosnic need to look into other contingent variables which have influence on the design of their control system. These variables would include the discretionary agents' strategy, structure and processes, the financial markets, use of technology in corporate portfolio management, and the stakeholders' perception of risk and investment objectives. In Mosnic, information and communication technology also have emerged as contingent variables which influence the design of control system in investment houses. Information and communication technology tend to relate to both the principal's and agent's information technology. Hence, accounting systems in investment houses would require further development by looking into the contingent relationships between the information and communication technology used in the global investment business and the design of their corporate control systems.

(5) Style of Management

This study offers a different approach of management to investment houses. It advocates that rational analysis of securities, which is based on economics, should not be the sole source of formulating realistic strategic decisions. Within the interactive management style, the research suggests that corporate strategists, controllers, stakeholders together with discretionary agents need to work beyond the formal limits of the asset management agreement. The interactive management style provides a useful learning opportunity for investors to attend to maximum market information in achieving the best possible management of the strategic uncertainties.

Indeed, the interactive management style described in this study can be borrowed by investment houses particularly in the following concerns. The formulation of investment guidelines is a problem for investors, particularly those whose management style is similar to that of Mosnic prior to the recruitment of the Controller. Depending on the trust vested by the principals on the agents, the former can enter through an interactive trustful fiduciary relationship to seek the advice of the latter (the agent) in formulating the realistic investment guidelines. This approach is useful and keeps the discretionary agent satisfied with the objective to be pursued.

However, interactive portfolio management may trigger the problem of agent accountability due to the involvement of the principal in the portfolio management processes. Indeed, the model of Mosnic suggests that the role of the Controller was important in orchestrating the principal-agent relationship in a way that the interaction between the two parties did not hinder the accountability of discretionary agents for unsatisfactory performance. In fact, a complete approach of discretionary portfolio evaluation called 'the holistic or the multi-system' is offered by this study. [See chapter (7)].

(6) Staffing

Throughout this research the Controller's responsibilities have emerged as an integral part of the corporate management responsibilities. He was involved in the following: (1) strategy formulation, (2) agents selection, (3)interpreting to the agents the shifting risk perception of the stakeholders,(4) change of the investment strategy, and (5) change of the organizational structure through feed-backing to the principals about the portfolio of agents serving the investment houses. The implication of this for investment houses is that the Controller is important and should be viewed as a top management level executive who effectively participates in the formulation of the strategic investment decisions. Thus, the performance of the Controller has to be evaluated in the light of his contribution to strategy formulation and implementation and not on his skill of applying mechanis-

tic accounting techniques. The grounded theory of this research implies that this can be done without trade-offs in the Controller's independence and integrity.

(7) Skill

The case of Mosnic has highlighted the important role of the controllership function in the complicated strategy formulation processes, in undertaking strategic control responsibilities, and in maintaining the portfolio of agents. This required both special skills and specific job description for the Controller. Over and above these, the Controller's academic knowledge process proved to be important for refining the skills acquired from practice in field.

Implications for Investment Banks

(THE PORTFOLIO MANAGERS)

1. Better understanding of clients' needs

Professional portfolio management firms are currently facing heated competition in winning the businesses of global investors who themselves know a great deal about the international asset management markets. Given the difficulty of obtaining information about portfolio managers, which is not in favour of investors, investment banks are beset with the problem of gaining competitive advantage over the numerous financial institutions competing for the funds of global clients to manage them on a discretionary basis.

However, like Mosnic, these potential clients are likely to have reservations towards the sophisticated (quantitative) investment models which intended portfolio managers claim they can apply to achieve the highest ROI for the portfolio. In fact, intended agents also try to impress potential investors with their attractive historical performance data. Today's clients (e.g. Mosnic) are not likely to take for granted all the literature presented by the agents about their financial institutions.

Global portfolio management institutions also should be more receptive to the specific requirements of investment houses, particularly if the requirements are considered by the latter to be important (e.g religious beliefs) and/or are given more weight when choosing a portfolio of external discretionary agents. For example, if the agent is likely to stick to purely security analysis-based portfolio models without getting involved in a process of interaction with the principals to understand the processes involved in the latters' perception of risk, the investment house might be better-off not to select such an agent.

Furthermore, if the agent's internal control system is not reliable enough to safeguard the discretionary assets, the investment houses has to decide between (1) not selecting the agent or (2) catering for alternative control processes to compensate for the agent's internal control weaknesses.

2. Implication for Portfolio Managers Training Centres

The global investment world is dominated by measure-based training programmes to promote the skills of the portfolio managers. The newly hired portfolio managers' training workshops and even the training sessions designed for the experienced portfolio managers emphasize the sophisticated computerized MPT models for the selection of the securities. However, these training centres, which aim for promoting the competence of the professional portfolio managers, should also consider giving sessions on organizational behaviour and corporate strategy which are also vital for the newly hired and even for the experienced staff. This would qualify the professionals to perceive beyond the sophisticated mechanistic models. It would actually help them to deal with the portfolio management trade in its wider human and social contexts. Indeed, it is only through such a wide vista of knowledge that investment management banks can approach portfolio management with a holistic perspective that enables them to better appreciate the needs of their clients.

3. Implications for Religious Investment Organizations

This study develops practical ways and means of dealing in the Western investment markets for organizations which have Islamic religious ideologies which are different from those prevailing in the West and in the Pacific market block.

The research implies that the problem of interest and usury, which worries Muslim investors because it dominates the world financial markets, can substantially be overcome by involving a corporate controller as a buffer between the investors and Western investment banks. This should help in educating investment banks about Muslim investor's requirements and at the same time to interpret the stake-holders' ideological perception of investment risk to the Western portfolio managers. This risk is not only market or non-market risk. Rather, it is the risk of violating the religious percepts of the investors. In addition, an efficient controller would develop the necessary control system that would detect to these investors any violations of their precepts.

SECTION: (B)

SUGGESTIONS FOR FUTURE RESEARCH AND CONCLUDING REMARKS

AGENDA FOR FURTHER CONTROLLERSHIP RESEARCH

This is not the end of the job of the researcher. The Controller of Mosnic has other responsibilities to perform in the company. He is involved in the pre-decision analysis in areas other than the discretionary management of marketable securities. The corporate portfolio of Mosnic includes beside the marketable securities the following other forms of investme.

1. Real estate companies in North America and Europe.
2. Domestic real estate investments.
3. Direct participation in the mutual fund investments.
4. Direct participation in the leverage-buy-out deals privately placed by the specialized investment banks.
5. Venture capital (seed money) investments.
6. Direct investment in projects.
7. Acquisition of stakes in the equities of local companies.

In these types of investments, having made the investment decision through direct analysis of the deals, the Controller monitors the performance of the concerned external managing partners and investment banks. He is also involved in the direct investments strategy processes. All these areas need comprehensive researching from different academic perspectives. Indeed, accounting

and finance academic researchers have hardly tried to understand how the different types of business of investment houses work.

PORTFOLIO MANAGEMENT IN MANAGEMENT ACCOUNTING PRACTICE AND IN FINANCIAL MANAGEMENT

This study has strived to explain the role of the controllership function in investment houses. It questioned the adequacy of the MPT approach for resource allocation in investment houses dealing in marketable securities through a portfolio of investment banks. It became clear that, even with all the development in the MPT, the making of investment decisions can be extremely complex. It became clearer that it was not enough to perform sophisticated calculations to structure a portfolio of marketable securities to yield a standard ROI. Rather, professional asset managers and controllers in the global investment houses should extend their practices of portfolio management beyond the techniques provided by the finance theory and approach this type of decisions with a more comprehensive perspective which takes on board the corporate strategy, controllership and financial functions.

However, while I am not debating the capital budgeting techniques in this research which is concerned with marketable securities portfolios invested through discretionary asset managers, I would still add my voice to Tomkins (1991) who calls for distinguishing between the theory of finance and financial management as practiced.

He says about finance theory that it:

> *"..... is a set of analyses all based upon the world, and is not necessarily coincident with the view point of all practicing financial directors and managers. The theory of finance stems from the work of financially oriented economists and their efforts to understanding behaviour in financial markets." (P.73)*

As comprehensively debated by Tomkins (1991), it is evident from various empirical studies on firms' investment appraisal practices that net present value (NPV), or its derivative adjusted present value (APV), is not the universally accepted criterion by which to measure the worth of an investment project. Using the same logic, the expected ROI measured through mean-variance approach to risk is not the only criterion to construct marketable securities portfolios. Accounting students and finance theorists will need to understand the organizational processes which lead to the emergence of investment strategy in the financial institutions.

This research also calls for giving more consideration to the quality of information rather than just focussing on the sophistication of the quantitative analysis techniques as is currently the case in the finance theory.

PROPOSED INTEGRATION OF THE DIFFERENT DISCIPLINARY APPROACHES IN THE INVESTMENT DECISION

One of the main themes emerging from this research (conclusion to chapter 9) is the need for an inter-disciplinary approach to understand the investment of discretio-

nary funds in marketable securities through portfolio managers. Indeed, the heavy involvement of the controllership function in the decision making process and the development of the supporting control systems tended to have greatly helped Mosnic in satisfactorily managing both its investments and portfolio managers. Hence, a multidisciplinary approach to the study of such problems would likely help in unraveling the complexities of resource allocation in investment houses.

IMPLICATIONS FOR CASE STUDY RESEARCH

Accounting research methodology theorists (e.g. Scapens 1990) argue about methods of case study research that in a programme of case study research multiple case studies can be used for two purposes - replication (repetition) and theory development. Thus, these theorists argument is that a number of similar cases might be selected to replicate the theoretical explanations. They add that, alternatively, dissimilar cases may be selected to extend the theory to a wider set of circumstances. Thus, after Scapens, the differences between the individual cases will be determined by the direction in which theoretical extension is desired.

This practitioner research suggests that the case-within-a-case study method (e.g. the Controller's cases within the Mosnic case), beside extending the same case through further case studies (e.g. the five agents case studies on the discretionary agents of Mosnic), can

develop a rich grounded theoretical framework, capable of explaining a wide range of circumstances in details which cannot be reversed by further data. Moreover, the practitioner who has the access to the information and the expertise to understand the details is best fitted to conduct such vertical case study research.

THE GENERALITY OF THE SITUATION

Chapters (1) and (2) argued why this research is important and whether the case of Mosnic is representative or not. The author as a practitioner is in regular contacts with other investment houses in his region and Western firms specialized in monitoring discretionary portfolios assigned to different groups of asset managers. Based on these contacts, it was evident to him that this problem of maintaining a portfolio of agents, monitoring them, formulating strategy and holistically dealing with risk and ROI, also seem, to be experienced by large multinational organizations,governmental monetary agencies and central banks, and wealthy private investors. It is not a problem limited to the Middle Eastern Islamic investment institutions.

THE PROBLEM OF HAVING THIS TYPE OF RESEARCH DONE

In chapters (1) and (2), I have argued in favour of practitioner type of research and have emphasized that it has a legitimate place beside other types of research.

But the problem is how to have this type of work done.

The problem is embodied in the following:

1. Research students may not be allowed free access to get this sort of confidential information.

2. Even if they are allowed access to information, the controversy will be on the quality of information. As said before, this is a problem for the finance academics who are accustomed to over-emphasize the analysis of information without ensuring the quality of data being analyzed. I have already argued that the practitioner has a better position to examine the quality of his data.

3. Even if the student decides to act as a participant observer in the organization to be researched, this can be very costly and still reflect only a small part of what actually occurs.

Given the fact that global investment researching requires a lot of travel, costly interaction with sets of people scattered around the world, huge amount of data, efficient telecommunication facilities with the world and the collection of the relevant professional literature at high costs, ordinary academic scholars who have limited resources may not be successful in this type of research. Unless some interested organizations (financial institutions) stand behind the scholars or the scholars spend some time actually working in these institutions.

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