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REBUILDING TRUST: GUARANTEED ACTIVE MANAGEMENT ANYONE?

"If you want something new, you have to stop doing something old" – Peter Drucker

Followers of Star Trek are familiar with the deductive Mr. Spock; cold, logical, data driven and the inductive Captain Kirk; predisposed to make a mental leap to solve a problem. Copernicus is also famous for making a leap. In the case of Copernicus his genius was a change in perspective, imagining the movement of heavenly bodies from a new vantage point.[1]

It's time to do the same with active management, to imagine it from a different vantage point. Self-evidently active management (especially for listed equity) is in retreat, for some, it is in the midst of a full blown crisis. The proximate cause of investor disillusion is serial under-delivery and high fees. Add to this regulatory intervention, new technologies such as the atom splitting-like breaking down of the equity risk premium into sub-atomic factor premia, the limits of DC aspiration and the sustainability of traditional active management looks fragile. Or is it that the idea remains valid but it's the fee model, the terms of trade that are past their sell-by date?

There has been much discussion of alternative fee structures. The intention of many of the alternative approaches is to better align interests between the asset owner and the asset manager by detaching fees from the promise of excess return and linking them more closely to delivery. While a discussion around fee structures is welcome, the focus on fees misses a wider point.

[1] The inspiration for the concept of a different vantage point comes from George Cooper's recent splendid book "Money, Blood and Revolution"

Active management is part of a bigger financial eco-system that according to many critics is malfunctioning. The Kay report (and others) have concluded that the equity market exhibits short-termism, has excessive turnover and the quality of the engagement between investors and companies is poor. As such the equity market is not fulfilling its central role, to allocate capital efficiently AND to nurture this capital. Others have gone further and have suggested that finance more broadly is exploitative.

There are various explanations for this malaise. Some (e.g. Haldane) have proposed a neurological explanation. Evolutionary biology suggests that all our decisions are subject to the yin and yang of patience and impatience. The hypothesis is that we are living in a time where the "impatient" gene is dominating the "patient" gene, which in turn, may explain unnecessary turnover, market myopia and excessive market volatility (i.e. that market prices are more volatile than the fundamentals).

The other (mainstream) explanation is that agency-based capitalism is the problem. The hypothesis is that collectively the business models and incentives of all the agents do not promote long- term value creation in the businesses in which the capital is invested. So, for example, asset owners (and their consultants) review the performance of their assets managers over a time horizon which is too short compared to the optimal alpha generation horizon of asset managers. Further, the typical benchmark-based approach to measurement accentuates this short-termism and trading hyperactivity (if managers underperform they risk getting terminated so have to "play the short-term game"). This focus on short term relative performance transmits itself (so the hypothesis goes) to corporates resulting in an unhealthy focus on short term stock price appreciation as opposed to long term value creation. Corporate managers' incentive structures help propel this short termism. Further the structure of the industry favors exit over voice, with the result that effective engagement with the corporate is another casualty of this agency-based capitalism.

One could argue that the consequences of the individual agent decision-making were not intended (asset owners are not deliberately setting out to damage the long term value creation of their investee companies) but an unintended pass-through.

Others are more damning. For some, finance is not simply a pass-through of bad behaviors of the agents. Under this hypothesis delegation creates informational asymmetry. The agents with the superior information seek to exploit their informational advantage and extract rents (excess profits). Through momentum and pro-cyclical behaviors this creates system instabilities.

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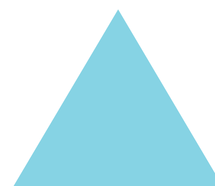

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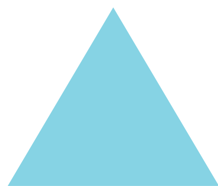
So how do we address this malaise? Many solutions have been put forward but none get to the heart of the issue. It is time to learn from Copernicus and change the vantage point of active management. By so doing we can start addressing these systemic issues. The answer is to introduce a new model of active management (which could sit alongside the current model).

Under this model the asset manager pays the asset owner a fixed annual fee (to be negotiated, but say 25 bps) and keeps all of the return over the agreed benchmark. So the manager delivers the agreed market return (the asset owner retains the market risk) plus the fixed annual fee. In effect this results in guaranteed active management.

The advantage to the asset owner is clear, no fees but a guaranteed (but small) alpha. From a societal perspective this also addresses the following issues:

1. The investment chain is shortened dramatically eliminating many of the agency issues.
2. The asset manager can align the investing time horizon to its value creation process (there is no pressure from the asset owner nor the consultant as performance measurement and management is not needed).
3. The asset manager is incentivized to exercise voice over exit. They have an incentive to engage with investment companies as they are now in effect acting as the principal. This should rein in corporate misbehavior, encourage the right sizing of corporate incentives and reduce unnecessary turnover.
4. Asset managers would self- regulate growth in assets and capacity as there is no incentive to raise capital in excess of the amount that can be deployed to generate the “alpha”.
5. Asset managers will naturally raise assets when there is a clear market opportunity and return capital to the asset owners when the opportunity set is less fertile. This should result in anti-cyclical behavior. This should be a positive externality for society.
6. Over time this should result in re-setting the time horizons to be more consistent with both the saver and to corporate long term value creation (and the right-sizing of corporate incentive structures).
7. Most critically this new model helps to rebuild trust in the savings industry.



The philosopher Onara O'Neill has an interesting perspective on trust. To quote; *"… trust, in the end, is distinctive because it's given by other people. You can't rebuild what other people give you. You have to give them the basis for giving you their trust. …you also have to provide usable evidence that you are trustworthy. How to do it? Well, every day, all over the place, it's being done by ordinary people, by officials, by institutions, quite effectively. Let me give you a simple commercial example: The shop where I buy my socks says I may take them back and they don't ask any questions. They take them back and give me the money or give me the pair of socks of the color I wanted. That's super. I trust them because they have made themselves vulnerable to me".*

Changing the perspective (like Copernicus) as suggested above starts to address some of the much discussed dysfunction in asset markets, can help in making markets less pro-cyclical, strengthen the capital allocation process and should help in attenuating the prevailing short-termism in markets and provide savers with a valuable additional source of return.

Clearly asset manager business models need to be re-set for this new model. However, if they really believe that they can generate alpha this model should be a strong incentive to re-organize themselves. By making themselves "vulnerable" they will help restore trust in the savings industry whilst at the same time having the prize that they keep the majority of the excess return they generate.

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