Long-term low friction

An investment framework which works for the beneficiaries rather than their agents

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> *"I think corporate governance has now reached international concern. The main reason is the advent of the capital market explosion of organisations such as hedge funds, private equity funds, state-owned enterprises, sovereign wealth funds, pension and mutual funds of all varieties, and combinations of them all. This array has created for corporations and their boards a 'zoo' of owners with different stripes, teeth, sensors, claws, vision, strength, will, and attitudes."*[1]

Doyen of US corporate law and corporate governance Ira Millstein has taken to describing the confusion of shareholder voices that companies now hear as a zoo. Different investors have vastly different views, he reports, not least about the time-frame over which the company should be seeking to create value. The range of derivative interests investors may have – and the scope to sell the company's shares short – adds to the potential confusion. Investors may well argue for actions which are contrary to the traditional shareholder's interests.

This cacophony and the confusion it causes show that all is not well in the investment chain. There is a real risk that the system works against the interests of the beneficiaries, you and me. Frictional costs – the implicit and explicit costs associated with market transactions – get in the way.

Millstein did not go so far as to identify which members of this menagerie are hippopotamuses, which are giraffes, and so on. But what should be clear is that no investor wants to be a chimpanzee.

Let me explain.

1 "Directors and Boards amidst Shareholders with Conflicting Values: The Impact of the New Capital Markets", Ira Millstein, Financial Reporting Council's Charkham Memorial Lecture, July 9 2008 (see http://www.frc.org.uk/press/pub1651.html)

Being true to our evolutionary heritage

Chimpanzees annoy economists. The typical chimpanzee has foibles over food: it prefers frozen juice bars to peanut butter, for example. But give that chimpanzee a food item and its preferences change. Typically, a chimp which has peanut butter in its hands is unlikely to trade it for frozen juice, even if it actually prefers frozen juice. The mere fact of ownership has changed the chimp's preferences: what it owns, it places a higher value, for no apparent reason.[2]

It is not the fact that chimps show this tendency – known as the endowment effect – that annoys economists, (although it does make it tougher for them to argue that the effect is a modern human foible rather than something bred into us by millennia of evolution). It is human displays of the endowment effect that really frustrate economists.

In experiment after experiment, people consistently show that they would rather hang on to what they have than trade it for something that they might otherwise value more highly. To economists, this makes no sense. We are not being rational and are wasting the chance to trade up.

The one place the economists do have the upper hand is in investment markets. The only people who consistently suppress the endowment effect are professional traders.

Behavioural psychology explains this anomaly. Studies show that the one way to reduce the endowment effect in the rest of us is to give us not an item itself but a token representing an item – in just the same way that the part-ownership of companies which shares represent has been turned into a token, a security. That is why there are no chimps in Millstein's zoo.

For neo-classical economists, this is a triumph. Man come overcome his evolutionary impulses and learn to behave in the coldly, cleanly and rationally – like the best economic models. So far as they are concerned, the endowment effect was a hangover from the evolutionary past that worked then, but is no longer appropriate now.

But is the endowment effect really so useless? Is rational economics leading us to invest in ways which, by ignoring our chimpanzee heritage, are damaging our financial well-being?

Would we be better off freeing our inner chimps and letting them invest as evolution has taught them to? We would hang on and make the best of what we have, rather than trading it away – but, as the old saying goes, a bird in the hand is worth two in the bush.

Frictional costs

Even the most rational economist would accept that there are circumstances where the propensity to trade away the bird in hand is wholly irrational. Where the cost of trading is such that it wipes out the benefit of the exchange, a trade is

2 Law, Biology and Property: A New Theory of the Endowment Effect, *William & Mary Law Review* Vol 49 (2008) (http://web.wm.edu/law/publications/lawreview/documents/vol49-6_jones.pdf?svr=www)

the wrong thing to do. This cost can either be in the form of risk – you get something different from what you thought you were bargaining for – or where the frictional cost of the trade itself is disadvantageous. The two birds in the bush may not be preferable – or at least not so preferable that it's worth the cost of catching them.

There are frictional costs for investors throughout the investment chain. These frictional costs are increasing – to no apparent benefit – serving considerably to erode the value of investments over their lifespan.

This means there is an opportunity for greater efficiency in the investment system by managing long-term investment in ways which minimise those frictional costs. This relies on two things. First, on believing it is worth retaining and not trading items with which we have been endowed. Second, on seeing investment not as trading in tokens representing companies but as in part-ownership of companies themselves. I call it long-term, low-friction investing.

Friction arises at investee companies in ways which are well understood in the literature on the principal-agent problem:

* There may be high fixed employment costs, unrelated to performance
* Differences in investment time-horizons between managers and shareholders may lead to shareholder value destruction
* Management may benefit from deal-making and empire building which adds no value for the shareholders
* Corporate advisors may encourage such deal-making because they benefit from it, irrespective of the benefit to the shareholders
* Management may fail to intervene to turn around underperforming operations

While there is much less of a literature on the principal-agent problem within the investment industry, in the same way, friction arises within the investment chain in much the same way:

* There may be high base management fees, unrelated to performance
* Differences in investment time-horizons between fund managers and clients may lead to value destruction for clients
* Fund managers may favour excessive trading which adds little value for the clients
* Other market participants may encourage such trading because they benefit from it, irrespective of the benefit to the shareholders
* Fund managers frequently fail to intervene at underperforming companies

Agency problems in companies

The principal-agent problem arises because those professional managers – the agents – may have interests which differ from those of the owners of the company – the principals. As the managers succumb to the temptation to act in their own interests rather than in those of the owners of the company, the owners face frictional costs and the erosion of value.

There is a long-standing understanding of the principal-agent problem within the corporate structure. That is because it is now many years since corporate owners first appointed professional managers to run their businesses. I will deal rapidly with each of the areas of potential frictional cost in turn before turning to the investment chain, where the principal-agent problem is less well understood.

High fixed employment costs, unrelated to performance

There continues to be much heat and light about executive pay. The problems are nowhere near as severe as the media would tend to suggest. However, the persistence of so-called payments for failure – where executives receiving significant rewards even when they are perceived to have done a poor job for shareholders – demonstrates that there is a problem. The wisest remuneration committee chairs will admit that measuring performance is difficult and so ensuring that pay awards are only made when performance justifies it is all but impossible.

The wisest remuneration committee chairs will admit that measuring performance is difficult

There is also an upwards ratchet in pay expectations, far in excess of inflation. When asked to justify this, the reason is always competition for talent with foreign – for which read American – companies, or with the financial attractions of private equity. Pay at US companies is notably higher than anywhere else in the world, unchecked because institutional investors there lack the tools to discipline pay structures, and also in many cases the will to do so. Pay for the managers of private equity businesses does not always reflect strong performance for the underlying investors, but sometimes just the performance and pay of the private equity fund managers; I develop this a little further below.

Differences in investment time-horizons between managers and shareholders may lead to shareholder value destruction

In a paper I wrote several years ago, I identified three main drivers of the failure of executive pay to drive value for investors. My 'three Ts' were tax, trust and timescales.[3]

The issue of timescales is often critical to the failure to match pay to performance. Institutional investors are investing over 10-year and greater periods; yet managers of companies are rarely incentivised to create value over these sorts of time periods. Their pay schemes are annual first. Even so-called long-term pay schemes measure performance over no more than 3-year horizons. This risks driving behaviour which may appear to add value over shorter periods than the investment time frames of their owners, missing opportunities and creating frictional costs.

Management may benefit from deal-making and empire building which adds no value for the shareholders

It is no wonder in this context that there are frictional costs from short-termism and risk-taking. A manager may have more incentive to take a low bid for an asset now rather than invest to build greater value which will only become apparent to the market in five or more years' time. Or, conversely, a manager may take the risk of a major acquisition, even though all the evidence suggests the bulk of M&A fails to add value.

3 Paul Lee, "Not Badly Paid But Paid Badly", Corporate Governance: An International Review, Vol. 10, pp. 69-74, 2002 (http://papers.ssm.com/sol3/papers.cfm?abstract_id=312103)

Corporate advisors may encourage this deal-making because they benefit from it, irrespective of the benefit to the shareholders

Investment bankers get paid for advice on transactions. The quaint City tradition of the corporate broker – a standing financial adviser to the company – is only attractive to the banks as a loss-leader for the lucrative deal-advice role. It is no surprise therefore that advisers often call for drastic changes to companies, and that they search for companies that their clients could acquire or offload parts of their business to.

Similarly, as discussed below, other voices that management hears from – the animals in Millstein's zoo cacophony – often favour major transactions over a steady-state business.

Management may fail to intervene to turn around underperforming operations

The stockmarket demands a 'story' about a stock, something that forms the basis for a strong recommendation from the sell-side analyst for a trade. Business as usual is terribly dull and is not going to produce the trading volumes which drive fee revenues for the analysts. So management faces a chorus of zoo chants calling for dramatic change rather than mundane good management.

For the company, the analysts are the most prominent and active end of the investment chain. Management, with an eye to its share-based pay structures, conscious therefore that the views of analysts can have a significant impact on their own wage, can get sucked into ignoring the day-to-day running of the business, preferring instead to drive the big picture story of dealmaking or major restructuring. This may lead to a failure to turn round an underperforming business.

The bust that follows works for the traders in the stockmarket and the sell-side analysts – who can trade profitably both as the shares boom and as they bust. But the boom and bust does not work for the underlying long-term owner, who faces only frictional costs and a failure to drive full value from the underlying operations of the business.

Agency problems in the investment chain

Just as in the corporate sector, the interests of principals and their agents in the investment chain diverge frequently. It is only recently that studies are beginning to reveal the extent of this.

Great value is being lost through frictional costs. Not just that – the problem is getting worse. In February 2008 investment consultant Watson Wyatt revealed that the average pension scheme has nearly doubled the level of fees it pays for investment activities, an increase over just 5 years. Every year, pension schemes now pay 1.1% of their assets away in fees, compared to 0.65% revealed in the firm's 2002 equivalent study. Slipping into some jargon (alpha is outperformance of an index, beta is the index performance – which can be achieved for minimal fees), the firm says:

> *Investors naturally assume they are paying these high fees to reward manager skill or alpha, but that is not usually the case. Instead, they are paying 'alpha' fees for 'beta' performance… Clearly this is a very good deal for managers, but not necessarily for their investors.*[4]

4 "Funds paying over 50% more in fees than five years ago", Watson Wyatt, February 27 2008 (http://www.watsonwyatt.com/news/press.asp?ID=18689)

In other words, fees have doubled with no apparent benefit to performance; the benefit is instead flowing to the investment industry. By failing to be chimpanzees, and hanging on to what they have, pension schemes are risking losing a very great deal.

Let us consider each frictional cost in turn:

High base management fees, unrelated to performance

Just as in the corporate sector, there can be high fees which are unrelated to performance in the investment chain. In many ways, this is because it is all but impossible to differentiate between skill and luck in the investment industry. A poor but lucky fund manager can outperform on a regular enough basis to appear to justify significant pay – when in practice, an unpaid chimpanzee with a dartboard could have performed as well.

The most public example of pay structures in the investment chain not being related to performance is in the private equity field, which has typically retained its base fee level at 2 per cent even as the scale of funds being raised and (eventually) invested has ballooned. It was more possible to justify this high level of base fees when the funds were smaller and fixed costs had to be supported by smaller asset bases. But now that $10 billion private equity funds are not unheard of, an annual 2 per cent base fee goes a great deal further. Other commentators have noted that the leaders of private equity firms can pay themselves millions out of these base fees, whether or not they perform for their clients. Private equity appears to be an industry where economies of scale do not exist.

A recent study by Ludovic Phalippou, a professor at University of Amsterdam Business School, is entitled *Beware of Venturing into Private Equity.* This addresses the argument, often made, that private equity investment solves the principal-agent problem by ensuring company managers feel keenly the pressure of their owners, and have their interests closely aligned. Phalippou makes the simple point that the private equity fund managers are not the owners – they are another agent for the owners – and highlights ways in which the interests of the underlying beneficial owners and these agents can differ.[5]

In effect, private equity shifts the principal-agent problem from the corporate sphere into the investment sphere. As Philippou indicates, this can be reflected in high fee levels which do not depend on performance, and which erode any outperformance which has been generated.

Private equity is not unusual; similar problems arise across fund management. Friction is escalating throughout the investment chain. As Watson Wyatt has identified, the more institutions shift their money into so-called alternative assets, the more fee levels overall are increasing. The consultancy firm suggests that these higher fee levels eat away at most if not all of the outperformance which the investments generate. The frictional costs erode the benefit.

Differences in investment time-horizons between fund managers and clients can lead to value destruction for clients

Recent events in the banking industry have demonstrated all too well the risk that incentive pay will focus on the wrong time-period. Too many traders made very

5 Ludovic Phalippou, "Beware of Venturing into Private Equity", Journal of Economics Perspectives, Forthcoming (http://ssrn.com/abstract=999910)

significant annual bonuses for deal-making in relation to instruments whose (lack of) profitability was only visible much later. As the credit crunch has bitten banks have lost huge sums on transactions for which they have already paid out bonuses.

Traders who are incentivised over annual periods do not need to worry about the long-term profitability of the instruments they create and trade: they do not tend to worry about the small risk that these instruments will destroy value, provided that most of the time they will appear to be profitable. They can be paid significant bonuses in the bulk of the years. On the rare occasions when everything goes wrong, they only carry a little blame. They are, to use the graphic image, picking up pennies in front of steam-rollers. Only they are being paid more than pennies for doing so and they know that the steamroller is more likely to flatten the shareholders and underlying investors rather than themselves.

The risk/reward balance is wholly asymmetric, so it should be no wonder that there are significant frictional costs in this system. Similar structural problems are replicated across the investment industry, with investors well rewarded for taking risks where they benefit from the upside, and the client faces the downside.

Even if performance fees are well-designed, there is no guarantee they will actually generate the outperformance they intend; often over time they lead to the same level of performance but a higher level of fees. Take investment trusts – collective investment vehicles which ought to be most attractive to individual investors. These have seen a vogue for introducing performance fees, accompanied by a reduction in base fees. A recent Grant Thornton study found that over 45% of the industry now had some form of performance fee in place.[6]

However, despite the best intentions of these investment trusts, there is no evidence that performance fees have improved returns. Grant Thornton found that the performance of funds without performance fees was better than that of those with them. Yet the introduction of performance fees has led to an increase in overall fee levels paid to the fund managers. Higher cost, lower performance: a chimpanzee could see that this is not a great deal for the underlying investor.

Higher cost, lower performance: a chimpanzee could see that this is not a great deal for the underlying investor

Fund managers may favour excessive trading which adds little value for the clients – other market participants may encourage such trading because they benefit from it, irrespective of the benefit to the shareholders

Watson Wyatt has identified that pension fund performance is eroded by a quarter of a percent a year through commission charges – and this was before they identified the more recent escalation of costs. If commissions have risen as rapidly as other costs – and given the increase in trading velocity, this seems very likely – then the frictional cost will be nearer 0.5% a year, a still more significant brake on overall performance. There is some incentive for fund managers to pay generous commissions to sell-side analysts because they are a way of outsourcing some of fund managers' own costs of understanding companies: so-called 'soft' commission is used as a way of paying for investment research. The principal-agent problem means that frictional costs are not managed, and in some cases encouraged.

6 "Performance fees: a question of purpose", Grant Thornton, August 2008, (http://www.grantthornton.co.uk/publications/performance_fees_a_question_o.aspx)

Almost all professional investors fall into the trap of excess activity. This is astonishing given that the most lauded investor of this – and perhaps any – era, Warren Buffett, talks openly about the need for inaction. Using the image of a baseball game, he says investors should wait for a 'fat pitch', a poor ball off which they can hit a home run. This is easier for them than for baseball players. Investors do not have an umpire calling strikes and rushing them into action. They can simply wait and do nothing until they get the favourable opportunity.

Buffett's investment strategy can be summarised as buying assets rarely and only when they are unloved and therefore cheap; buying in sufficient quantity to have influence (which helps him to manage the principal-agent problem within investee companies discussed above); and holding those assets to something approaching perpetuity.

This strategy is absolutely minimum friction – buy and hold, and hold again. Many investors claim to be following a Buffett-like investment strategy. It is vanishingly rare to find one who actually does.

A further form of excessive trading is the way in which institutional investors shift money between fund managers. They do so in search of better performance. But the evidence suggests that they move money – enduring the frictional costs of transition, forcing sales by the outgoing fund manager and purchases by the replacement – at just the wrong time. They move, having suffered underperformance of the benchmark index, to a fund manager which has recently outperformed the benchmark. Experience indicates this historic outperformance evaporates soon after the institution moves its money. What drives this shift in performance is not clear, but it is probably some combination of the frictional costs of higher fees charged by more successful fund managers, and the randomness of fund manager performance.

Fund managers frequently fail to intervene at underperforming companies

Fund managers – generally the owners' only agent in direct dialogue with investee companies – would be best placed to address these agency issues and so minimise the frictional costs. But the cost to the individual fund manager of doing this is quite significant, and the benefit flows to all shareholders. Since most fund managers are seeking significant relative outperformance, they have little incentive to spend the money required to limit the frictional costs of the agency problem within investee companies. Indeed, when a fund manager with a benchmark-relative performance hurdle is underweight a company, his performance is enhanced by its underperformance.

So while the underlying client – you and me – feels the costs of the underperformance in absolute value terms, the fund manager does not. In fact, the client will also face a further frictional cost of the fund manager's additional performance fee from presiding over an investment in an underperforming company.

Taking it personally

These are the features of the investment chain cost burden for institutional investors – which of course are just organisations aggregating the investment needs of individuals. The waste associated by these high frictional costs is felt ultimately not by abstract investment organisations, but by the individuals who depend on them for their long-term financial well-being.

It is still worse for the individual investor investing on their own account. Individuals are prey to a further level of friction at the level of their usual gatekeeper, the Independent Financial Adviser.

IFAs' principal income comes from the commission they earn for placing their clients into investment products. The conflicts of interest this risks producing may best be illustrated by an incident from my own personal investment life.

A fund which my IFA had advised me to go into some years before and which had performed reasonably but by no means spectacularly had followed the trend prevalent in the investment market of increasing its base fee level. This was a UK-only fund and yet was proposing to increase its base annual fee level well over 1 per cent. I felt this was excessive and withdrew my money, saying I was going to find a cheaper investment vehicle. As a result of this decision, my IFA sacked me as a client. Now admittedly this IFA had not made much commission out of me ever, and none at all for the prior few years. Nevertheless, he might have considered me a decent bet for the future. He sacked me because I wouldn't accept a significant increase in fees from a fund whose performance was not noticeably different from the index. I have not bothered to find a new IFA.

In aggregate, these frictional costs matter a great deal. An individual who saves £5000 a year for their retirement – let's assume a standard 7 per cent return (before costs) over the 30 year life of investment and use only the frictional costs calculated by Watson Wyatt, without considering the frictional costs faced within the investee companies – would be entitled to a pension pot of around £410,000, rather than the £450,000 which would have been his if pension funds had not agreed to the increase in fees that they have faced over the last five years.

A long-term low-friction fund which worked to minimise frictional costs could reduce the burden below Watson Wyatt's former calculation of 0.65% annually; halving that number would lead to a pension pot of around £475,000. At current annuity rates of about 5%, the individual in a long-term low friction fund would benefit from an annual payment of £24,000 rather than the £20,000 which is what the current pension fund industry could be expected to produce.

A pay rise of 20% for life is something that we would all aspire to. Pensioners who are better off by some £4000 a year is surely something which, in an aging society, we should be aiming for. That added value across the whole aging population would also drive a far healthier economy. Long-term low friction investing is a very significant opportunity for us all.

Trying too hard

We are trying, as both individual and institutional investors, to get smarter and smarter about the ways in which we invest. But the evidence suggests that any increase in returns we gain – in the smart jargon, the alpha – is eroded by the additional friction we face in getting there. As the investment trust industry has found, performance fees do not drive better performance, just higher fees for their fund managers. Moreover, the FSA has just revealed the result of a study into its substantial efforts to increase the financial capability of UK people: the main finding was that financial education seems to have no positive effect on investment decisions.[7]

Perhaps we are just trying too hard. Perhaps we should try to take fewer decisions, stick with what we have got and improve our returns by avoiding frictional costs. We should free our inner chimpanzee and obey the endowment effect. We would boost returns both by reducing trading, avoiding the frictional costs in the financial industry, and by being a good owner, minimising the frictional costs in the corporate sector.

It's possible that this message is beginning to seep through. The International Organisation of Pension Supervisors recently published a Working Paper which identifies international trends in the industry.[8] This highlights an increasing trend to reduce the decisions participants of DC schemes are asked to make: "there is a growing concern that too much information is not necessarily a good thing". Instead, default funds are increasingly being used as a substitute for providing information to members. But that assumes that the default funds are run in the interests of the beneficiaries and not of their agents. A move to default schemes which are long-term low friction would remove the burden of potentially poor decision-making from the shoulders of the pension scheme members, and leave them with greater pensions for their retirements.

A long-term low friction fund would deliberately design itself to minimise the frictional costs at investee companies and in the investment chain. It would open the gates of the zoo and achieve far better performance for the individuals whose returns are now being eroded by the frictional costs in the current investment machine.

Paul Lee works in the fund management industry and writes in a personal capacity

7 "Financial Capability: A Behavioural Economics Perspective", FSA Consumer Research Paper No. 69, July 2008, (http://www.fsa.gov.uk/Pages/Library/research/consumer/2008/index.shtml)

8 IOPS working paper No 5, Information for Members of DC Pension Plans: Conceptual Framework and International Trends (September 2008), (www.iopsweb.org/document/59/0,3343,en_35030657_35030263_39051707_1_1_1_1,00.html)

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The RSA is an Enlightenment organisation devoted to finding innovative practical solutions to today's pressing social problems. Through its 27,000-strong Fellowship it pursues its mission: to help people be the people they need to be to see the change they want in the world.

The citizens of the future will need to be self-reliant, engaged and other-regarding if they are to create a principled and prosperous society. This is nowhere more true than in financial matters. The Tomorrow's Investor project, the first stage of a prolonged RSA engagement with these issues, aims to facilitate this goal, both practically and intellectually.

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