From short-term salesmanship to long-term stewardship:

A paradigm shift in the asset management industry

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Content:

Introduction

'We have changed from a profession with aspects of a business, to a business with aspects of a profession,' according to John Bogle, founder and former partner of Vanguard. In the past thirty years, asset management has evolved from a profession to a distribution-driven industry, and shifted from a client-driven approach to a product-driven approach. In fact, a growing body of opinion suggests that asset management in its current form does not add value. By far the lion's share of global savings is controlled by financial conglomerates. These are respectable institutions, of course, but many of them have a short-term focus within an activity they do not even consider their core business. Of the investment funds that are actively managed by the conglomerates, the long-term performance of the majority[1] lags behind the index. Apparently, they fail to convert our savings into profitable production capacity.

This paper will first analyse the main developments on the demand side, with a specific focus on the challenges perceived by (Dutch) institutional clients[2]. Subsequently, we will look at the supply side. What is the position of the asset management industry in 2012? In order to bridge the gap between what clients want and what asset managers offer, asset management will have to reinvent itself. The tools and options to do so are readily available, but it will require a paradigm shift in the industry. We need to transition from short-term salesmanship to long-term stewardship.

1. Developments on the client side

The current crisis hit pension funds hard. Stakeholders such as participants, regulators, supervisory authorities, politicians and the media keep a watchful eye over everything they do. The financial position of many pension funds is under pressure, and the public is keenly aware of the cause: in the outside world it is all too eagerly pointed out that it is the 'incompetence' of pension boards who fail to implement proper risk management that is

1 Please refer to Ellis, 2010.
2 I write from a Dutch clients' perspective; international investors largely face the same challenges.

at the basis of this position. Many pension funds have performed poorly during the crisis. They may, perhaps, have anticipated the direction of financial markets, but the magnitude of the downturn took them by surprise. Furthermore, diversification offered very little solace in recent years: the majority of all investment categories were under pressure. Who ever said that investing is easy? The philosopher Kierkegaard once said: 'Life can only be understood backwards, but it must be lived forwards.'

"Pension boards are confronted with substantially increasing complexity and regulation."

Increased complexity and regulation

Pension boards are confronted with substantially increasing complexity. Things will never return to the old days, when everything seemed so simple and pension funds were managed on funding ratios. The impact on assets and liabilities will have to be calculated and assessed for several generations of pensioners. In addition, the volatility of the environment makes pension funds more vulnerable to sudden changes. Under these circumstances, the threat of more stringent supervision based on tightened rules and regulations is always imminent. Part of these rules and regulations are of an international nature (Solvency II, for instance), while others are of a national nature. In the Netherlands, for example, the Minister of Social Affairs and Employment offers pension funds a choice between two management models, described in a legislative proposal (the 'Improved Governance of Pension Funds Act'). In the first model, the trustees (employees, employers and pensioners) are supervised by independent professionals in a mandatory supervisory board. In the other model, the professionals are in control. In addition, as a result of the introduction of the Financial Assessment Framework (Financieel Toetsingskader), the rules concerning the valuation of pension liabilities have become much more rigid and complex.

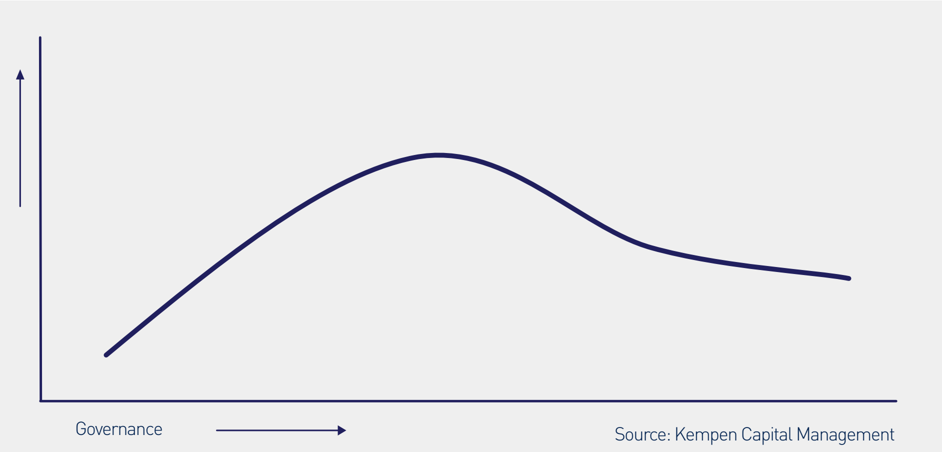
In response to the increased complexity and regulation, many pension funds turn to each other for refuge. In the Netherlands, for instance, the consolidation wave in the pension market led to a reduction in the number of pension funds to approximately 350, down from about 1,000 in 2005.

Higher competence requirements for board of trustees

One of the consequences of the credit crunch was that supervision has been tightened up tremendously, and today, supervisors demand that pension boards are very well-informed about investment risks. In several studies[3], supervisors have found that in many pension funds, the complexity of the investment policy is insufficiently commensurate with the level of risk control and the available expertise. In addition, a substantial number of pension funds lack sufficient countervailing power compared to the asset managers, in the form of independent and adequate risk management at pension fund level. Aside from this, some funds are unable to control the financial risks of illiquid and innovative investments and to provide an adequate and independent picture of the valuations. Over the past few years, several governance measures were implemented in Dutch pension funds.

According to Molenkamp and Van Welie[4], there is a positive relationship, to a certain extent, between governance and return. However, governance can also be taken to extremes, in which case costs can rise dramatically without the benefit of increased effectiveness (please refer to Figure 1).

Figure 1: Return on governance



Pension funds are thus increasingly confronted with tightened supervision as the credit crunch has landed many funds in the danger zone with their funding ratio. Investment decisions are increasingly bounded. There is a trend among pension funds to allow supervisory authorities more and more influence on their policy, as a result of which bad decisions are taken[5]. This is a substantial risk that pension funds are exposed to, which gives rise to the question of whether or not pension fund boards have the level of competence required for their task.

The challenges pension funds are dealing with also receive increasing international attention. 'Good governance leads to good performance,' as Keith Ambachtsheer recently argued in the British Parliament[6]. A good management structure, based on a clear mission statement, offers the best protection against myopia (please refer to the box).

"Good governance leads to good performance."

Effective pension management

At the end of 2011, 35 representatives of 21 institutional investors from nine different countries convened in a meeting chaired by Keith Ambachtsheer of the International Centre for Pension Management in Toronto to discuss the main challenges for the boards of their organisations. They identified five challenges:

1. Good governance	Formulate the organisation's mission and mandate and implement a roadmap to improve board skills
2. Sensible investment beliefs and organisation design	How to acquire cost-effective scale and a long-term mindset?
3. Robust risk management	Formulate the risk appetite of the fund and create a robust framework
4. Effective stakeholder communications	Develop a pro-active approach to communicating and consulting with key stakeholders
5. Financial sustainability	Design a pension arrangement to 'fine balance' benefit adequacy, property rights clarity, risk allocation and cost

3 De Nederlandsche Bank Pension Fund Governance Study, 2010; Report of the Frijns Monitoring Committee on risk management and investment policy, 2010.
4 Please refer to Molenkamp and van Welie, 2010.
5 Our experience on the basis of empirical surveys with trustees is that they want 100% matching of nominal liabilities under the current Dutch regime in which liabilities are discounted against market rates and 0% matching if liabilities were discounted against a fixed yield.
6 Please refer to *The Ambachtsheer Letter*, November/December 2011, 'Can Pension Funds Shape the Future of Capitalism?'

Short-term focus

Good governance is necessary, but not yet sufficient. Too often the problems have come from 'me too' behaviours from Trustees who are overly fixated on peer risks and reputational risks. Given these psychological factors and the fact that there is asymmetry of information between asset managers and their clients, slick marketeers always manage to sell the latest hot product. The Internet, China, climate change, commodities, precious metals; you name it – product developers have had a great day. It is not uncommon for such funds to be introduced at the peak of the market, so that the likelihood of really good returns is small. The only ones who profited from these funds were the sellers as they were pocketing handsome fees. Unfortunately, this type of product pushing adds no value whatsoever. On the contrary, it just leads to a situation where clients cannot see the forest for the trees.

On top of this, accounting and regulation have also tremendously increased the short-term pressure for Boards of Trustees. Since liabilities are discounted at market rates the solvency of pension funds, which have an investment horizon of at least 30 years, is measured on a weekly or even daily basis.

In his book entitled *Behavioural Investing, a Practitioner's Guide to Applying Behavioural Finance*, James Montier calls attention to the type of ADHD that afflicts both the financial industry and its clients. Since 1950, the average holding period of professional investors in Wall Street stocks has decreased from eight years (back then) to eleven months (currently) – and no, this is not just the casino capitalism of the United States. The average holding period on the London and Frankfurt stock exchanges is just ten months. This has nothing to do with investing, it is pure speculation. Institutional and private investors, asset managers, supervisors, politicians and the media all fuel each other in this short-term behaviour. The huge decline in the average holding period seems to be mainly caused by investment banks, high frequency traders and hedge funds. To quote Paul Samuelson: 'Investing should be dull. It shouldn't be exciting. Investing should be more like watching paint dry or watching grass grow. If you want excitement, take 800 dollars and go to Las Vegas.'

"Investing should be dull. It shouldn't be exciting. Investing should be more like watching paint dry or watching grass grow."

Even asset managers who do have a long-term investment horizon run the risk that their clients base their assessment of their performance on short-term considerations. Imagine, for instance, a universe of one hundred very successful fund managers who have a true alpha of 3% and a tracking error of 6% (information ratio of 0.5), with a normal return distribution. Over a period of fifty years, half of these successful managers will have a period of three consecutive years of underperformance. This means that many of these fund managers will be fired by their clients despite the fact that they are skilful.

One of the main problems that has come up on the client side over the past few decades is an obsession with benchmarks. The late, great, value investor Bob Kirby opined: 'Performance measurement is one of those basically good ideas that somehow got totally out of control. In many cases, the intense application of performance measurement techniques has actually served to impede the purpose it is supposed to serve.' Benchmarks are sticky, my first employer used to say, both for the portfolio manager and the client. The idea has led to such a high level of framing that clients started to develop a short-term, budget-focused, accountant-like frame of mind instead of a focus on maximising long-term real returns.

More in control

Increased complexity and regulation, higher expertise requirements and a focus on short-term results have all combined to fuel the need among pension boards to be more in control. Pension funds should be aware of the risks. The risk profile of a portfolio can be measured based on the past, but professional risk management also requires looking to the future. In the past, people used to consider only the risks on the asset side of the balance sheet. In recent years, the focus has shifted to risk management, including the entire balance sheet, that is, including the liabilities recorded against the assets. To an increasing extent, pension funds take integrated balance sheet management as a basis. The investment portfolio is split into a matching and a return-seeking component. The matching portfolio is mainly used to track the liabilities and absorb their interest-rate exposure, and the return-seeking portfolio is used to generate additional yield to be able to index against inflation. The mismatch risk between assets and liabilities can be adjusted by changing the weights of the two portfolios.

"Professional risk-management requires looking to the future instead of measuring the past."

However, the majority of pension funds and insurers do not have the requisite expertise available within the organisation to achieve this level of control. For this purpose, they require the support of professional asset managers. But are the asset managers capable of delivering such an intensive client approach?

2. What is the position of asset management in 2012?

The asset management profession exists by the grace of expertise, discipline and reliability. What is the position of asset management today, in 2012? Unfortunately, we are forced to conclude that the asset management industry on average fails in all three aspects.

To start with, expertise: over the past twenty years, we have seen the rise of a jungle of investment funds, and in the long run, most of the managers (60%) fail to outperform the index[7]. The following three statistics[8] provide a fairly accurate insight into the performance:

- The results of an international CEM benchmarking survey show that the worst performing pension funds (4th quartile), after deduction of expenses, lag 3% annually behind the best performing pension funds (1st quartile) over a longer horizon. Keith Ambachtsheer attributes the difference to good governance[9].
- The results of a performance study of American mutual funds show that net of fees there is also a 3% performance difference per year between the 1st and 4th quartile. The short investment horizon, the high turnover rate of the portfolio and transaction fees are the most important explanation[10].
- At the same time, the time-weighted returns versus money-weighted returns of these mutual funds show that private investors lag behind an annual 3% in return by buying high and selling low. Fear and short-term greed are listed as the main causes[11].

"The asset management industry fails in expertise, discipline and reliability…"

7 Please refer to Ellis, 2010.
8 I refer to this as 3 times 3%; please refer to Dijkstra, *Het Financieele Dagblad*, 28 September 2009.
9 Please refer to Ambachtsheer, Putting clients first in an industry that generally doesn't, RAFI Seminar 2009; data based on CEM database.
10 Please refer to Malkiel, Conflicts of Interest & the Fiduciary Challenge, RAFI seminar 2009.
11 Please refer to Cremers, 2007.

These three observations demonstrate that short-term investment behaviour is the main cause of disappointing returns, for private and institutional investors as well as for their asset managers.

As far as discipline is concerned, the picture is not much rosier. The crisis has exposed the failure in risk management. The models on which risk management is based have proven faulty. A problem that, as becomes apparent from Professor Amin Rajan's first paper for the 300 Club, even the academic world, for that matter, is unable to solve[12]. The theories of normal distribution and efficient markets proved as solid as quicksand. Even more serious a problem is the (t)error of benchmarks and peer groups, which causes managers to monitor one another and the index frenetically without adding value for clients.

> *"…this failure can be attributed to financial conglomerates, lack of focus and short-term career-risk."*

With respect to reliability, promises have been broken over the past few years, such as in the field of liquidity. In the early years of the crisis, for example, several funds were 'gated' due to lack of liquidity in the markets, in long-only funds and hedge funds as well as in structured products. In particular, the 'product push' approach with its singular focus on one's own high margins, was detrimental to reliability. In brief, one can say that there were obvious causes for the damage inflicted on the confidence investors should be able to place in their asset managers. Finally, Bernard Madoff's Ponzi scheme was the proverbial straw that broke the camel's back.

In my view there are three main causes to which the asset management industry's current failure in these three aspects can be attributed.

1. FINANCIAL CONGLOMERATES

During the years of rapid growth, in the 80s and 90s, an increasing number of asset managers were either listed on the stock exchange or merged with a listed financial conglomerate. The global trend of 'bigger is better' led to tremendous consolidation, giving rise to a financial industry consisting of very large 'all finance' institutions. Interestingly, a greater number of asset managers in Europe than in the US are part of a large financial conglomerate. The US has many more smaller boutiques in the form of employee-owned firms. By consequence, Europe has a much larger number of investment

Figure 2: The more focused asset managers outperform the financial conglomerates

Asset Management	Number of Funds
1. Dodge & Cox	4
2. First Eagle	5
3. Calamos	8
4. SouthEastern	3
5. Royce	26
6. American Funds	14
7. Harris Associates	7

)rganisational Structure
; publicly held, nonconglomerate firms are in boldface)

Firm	Equal-Weighted % Outperformance
PIMCO	76
Vanguard	76
T. Rowe Price	71
Franklin Templeton	71
Janus	70
ING	69
Nuveen	65
American Century	64
WM Advisors	64
Davis	62
Fidelity	62
Waddell & Reed	61
USAA	61
Oppenheimer	60
Prudential	59
MFS	59
New York Life	58
US Bancorp	57
Columbia Mgmt.	56
AllianceBernstein	55
Banc One	54
Neuberger Berman	54
Lord Abett	53
Van Kampen	52
Scudder	52
Federated	52
Evergreen	51
Wells Fargo	50
Citigroup	50
Goldman Sachs	49
Morgan Stanley Adv.	49
Eaton Vance	49
The Hartford	48
John Hancock	47
Putnam	47
Dreyfus	45
Strong	44
Delaware	44
Thrivent Financial	44
Trusco Cap	43

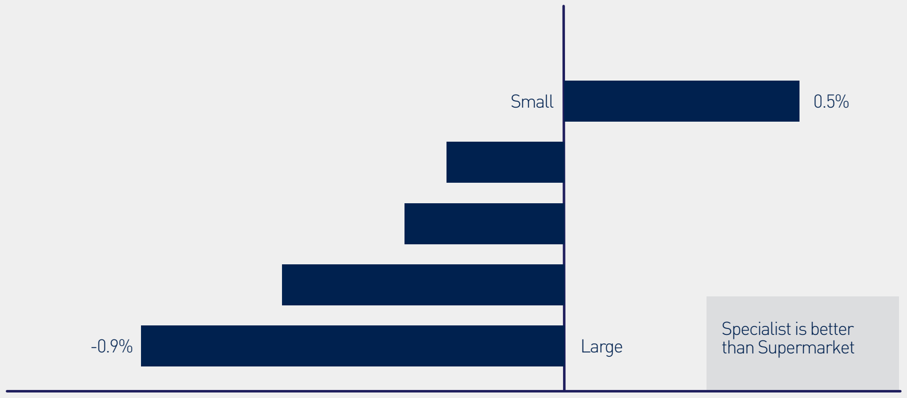
Note: Performance rankings ignore the impact of sales charges and include on
Source: Fidelity Investments.

Number of Funds	Asset Management
58	48. Merrill Lynch
62	49. Aim
42	50. Nations Funds
60	51. American Express
32	52. Black Rock
24	53. Pioneer
38	54. JP Morgan

Source: John Bogle, Financial Analyst Journal, November/December 2005

12 Please refer to Professor Amin Rajan, the 300 Club, *The Death of Common Sense*, April 2012.

Figure 3: Smaller funds outperform larger funds (annual outperformance in %)



Source: Cremers en Petajisto (Yale) "How active is your fund manager?", 2006

funds than the US, and they are much smaller in size[13]. Their common feature is that they are primarily distribution-driven rather than quality-driven[14].

One of Keynes' famous statements says: 'It's better for reputation to fail conventionally than to succeed unconventionally.' Pension funds often decide in favour of good reputation, scale, size, convenience and presumed solidity and security. This is in keeping with the old maxim that 'big is beautiful'. But large size is an impediment. The chances of success decrease as the assets under management increases. What is important is performance; the larger the company, the harder it proves to be to achieve outperformance. A study by John Bogle showed that smaller asset management companies with a limited number of funds perform significantly better than large asset management companies with a large number of funds[15] (see Figure 2). In sports, we see a similar effect as a result of focus. All Olympic records in athletics are held by specialists rather than decathletes. Another study, by Cremers and Petajisto, of Yale University, confirms these conclusions in an analysis of the size of investment funds. The more assets an investment fund has under its management, the worse the long-term results. The average annual outperformance of small investment funds is 0.5% compared to -0.9% for the large investment funds (see Figure 3 which shows the long term performance of US mutual funds in size quintiles). Similarly, the best wine is often found in smaller vineyards.

2. LACK OF FOCUS

Driven by a product focus (and a profit motive) instead of a client focus, sales departments of financial conglomerates and large asset management firms market funds that appeal to the public. In many cases, this boils down to marketing yesterday's winner, for instance in the form of creating an IT fund close to the peak of the IT bubble. Both the client himself and the manager jump on the bandwagon. The question of what the client really needs is insufficiently addressed. Before long, this approach will leave the client disillusioned with rather disappointing absolute returns. But, as we see, the relative returns of the actively managed investment funds of financial conglomerates are disappointing. As a result of an excessively short investment horizon, index-hugging (driven by an obsession with benchmarks), and higher turnover and transaction fees, most investment funds fail

> *"Smaller asset management companies with a limited number of funds perform significantly better than large asset management firms with a large number of funds."*

13 Europe has 26,000 mutual funds compared with 8,000 in the US. The average fund size in Europe is only 160 mln against 1.2 bln. in the US. The median size in Europe is just 25 mln. (see The Economist).
14 Please also refer to 'The pros and cons of being a bank-owned manager', Phil Davis in FTfm, 21 May 2012.
15 Please refer to Bogle; equal weight outperformance of all mutual funds in the US 1993-2004.

to deliver added value after active fees. It is no wonder that passive index trackers are one of the fastest growing segments of the industry. This form of investing is attractive to investors as it is convenient and efficient – a computer can do the work – and the fees are low. Index trackers are a commodity. If you are clever and arrange things well, using the right technology, it can be a good high-volume product. The biggest disadvantage is that tracking a market-cap index by definition means investing most heavily in yesterday's winners, as their earlier success ensures that they carry the heaviest weight on the indices. In addition, many passive products proved to entail substantial risks, as was the case in securities lending and collateral pools, in which cases the seller typically collected the proceeds while the buyers were exposed to the risks. Another important ethical disadvantage of passive investing is that it leads to a situation where shareholders are not involved in the corporate governance of the companies in which they invest, and by consequence show little shareholder commitment. This is a good example of free riding behavior. If there are too few parties left who actually examine the price-discovery of markets, passive investing simply turns into gambling. Passive investing is, therefore, not always cheap or even logical.

"There is a fundamental mismatch in horizon between the interests of pension funds and the interests of asset managers."

3. SHORT-TERM CAREER RISK

When business managers run asset management firms their primary focus is on the short-term interests of their shareholders. They want to secure their bonus and their job. They will therefore be disinclined to take risks that may, in the long run, add value for the client. At the same time portfolio managers are under pressure from benchmarks and have to achieve short-term success or their career will be jeopardised. In a recent Quarterly Letter (April 2012), Jeremy Grantham, founder of the investment management firm GMO, referred to Keynes, who as early as 1936 realised that in the world of finance, preserving your job is the main goal in every instance. That is why it is important never to be the only one to bet on the wrong horse, he explained. The result is that professional investors are mainly interested in the moves of other investors. This leads to herd mentality and a price-setting mechanism in which prices are far above or far below fair market value. Of all market inefficiencies in pricing, this is by far the worst, according to Grantham.

Achieving short-term success in asset management is by definition based on luck instead of skill. To put it bluntly, there is a fundamental mismatch in horizon between the interests of pension funds and the interests of asset managers, especially when these managers are part of a financial conglomerate.

We can safely conclude that there is a wide gap between what clients need and want, and what many asset managers can or are willing to offer at this moment. The asset management industry will have to reinvent itself, but institutional clients will not be able to avoid the necessary soul-searching either.

3. Towards asset management 2.0: from short-term salesmanship to long-term stewardship

If any industry should be client-focused, it is the asset management industry. The ideal would be a sustainable partnership with a long-term aim, in which transparent communication and mutual trust are important features. What we see much more often in practice, however, is that asset managers combine a product focus and short-term focus. The 'industrialisation' of asset management has depersonalised the relationship between the client and the asset manager. Particularly in the Anglo-Saxon world, the role taken by many consultants has created a wedge between the asset manager and the client, leaving very few moments of 'physical' contact.

> *"Industrialisation of asset management has depersonalised the relationship between the client and the asset manager."*

4. INTEGRATED CLIENT SOLUTIONS: FROM PRODUCT PUSH TO CLIENT PULL

The strongest growth in the past five years in the Netherlands could be observed in the rise of integrated client solutions, also known as fiduciary management. For many pension funds and insurance companies this provides the solution to the lack of expertise in an increasingly complex environment – like insourcing your own professional investment department. The objective of fiduciary management is to relieve clients of a burden. It is a comprehensive solution centred on achieving the clients' long-term goals. So, investing is not a goal in itself it's just a means to an end. When the investor outsources tasks and responsibilities to a fiduciary asset manager, it is important to ensure that the asset manager concerned is in control. Conditions in this respect are that the asset manager should have in-depth knowledge of the issues and problems that pension funds and insurers are confronted with, and that he has ample experience in collaborating with boards of trustees[16].

> *"The strongest growth in the past five years in the Netherlands could be observed in the rise of fiduciary management."*

Fiduciary management in the Netherlands is ahead of its counterparts abroad. In the United Kingdom we currently see developments that show some resemblance to fiduciary solutions. At present, however, asset management in that country is still much more product-oriented than client-oriented in nature. Their products are selected by consultants for the benefit of the pension funds. In this type of model, the asset manager and the final client communicate rarely, if at all, let alone about balance sheet management. The consultants therefore try to wear a fiduciary hat, a role they refer to as implemented consulting. However, a number of aspects are of crucial importance to fiduciary managers: they have to understand the liabilities, develop a disciplined dynamic asset allocation approach, implement a robust risk framework, and select the right specialist managers. Only the latter responsibility is core business for those consultants, while the first three aspects are skills they are currently trying to master.

Fiduciary managers select both passive index trackers and active asset managers for their clients. An extensive due diligence process is an important element of the selection procedure for both. In the selection process of passive managers, effectiveness and efficiency

16 Please refer to J.B. Molenkamp, 'Fiduciary Management; panacea for pension funds?', Netspar NEA Paper 12, 2008.

are key. As far as active managers are concerned it's crucial to determine what the critical success factors will be. Obviously, one would like to select experienced managers with a distinctive philosophy and disciplined process and the skills to achieve long-term above-average returns. But more important in my view one should select firms who show new leadership. Those are long-term focused specialised firms who have aligned their interests with their clients'.

Two case studies of putting clients' (long-term) interests first

In 2000, during a crisis meeting with all of his partners, Jeremy Grantham, founder and partner of GMO, scratched his head in puzzlement. The setting is the time when the price of growth stocks rises sharply and the value style of GMO has been through a really rough patch in the past few years. Clients are throwing in the towel and leaving GMO by the dozens. The assets under management have been cut in half in just a few years. 'Have we really taken a wrong turn?' Grantham wonders. At the end of the meeting, the partners decided to stay 'true to investment style' as they feel that it is not in the best interest of their clients to include these extremely expensive growth stocks in their portfolios. Over the next five years, GMO's view proves correct. Clients return by the dozens. Today, they manage over three times the amount of assets they had under management in 2000.

End of 2005, Jorik van den Bos stares out of the window of his employer, a large listed Dutch financial conglomerate. Since 2000, he has managed a global high dividend fund. It proves a resounding success. Its excellent track record helps the fund to grow from zero to 5 billion euros in less than six years. But in the past year, Jorik and his team find it harder and harder to invest the large inflow in a prudent and responsible manner. Their equal-weight philosophy becomes almost impossible to maintain. He is held in high esteem within the group. Large new clients are knocking on the door, and he wonders whether he should let them in, or whether he should protect the interests of the existing clients in the fund instead. He is convinced that future performance will be jeopardised if the fund continues to grow. Earlier attempts to close the fund failed to meet with the approval of his employer. Together with his team, he finally decides to vote with his feet and to leave. They join in 2006 a boutique manager who attaches great value to a 'capacity constrained mindset' in the clients' interests. They start over, with 300 million euros. The strong track record over the first six years has been continued since.

"One should select firms who show new leadership. Those are long-term focused specialised firms who have aligned their interests with their clients."

New leadership

What we need is new leadership in the sector to restore the confidence of our clients. We need to move away from distribution, marketing and product pushing. Proceeding along the same path is not an option. Long-term stewardship is pivotal in the new approach. Superior asset management requires creativity and decisiveness. Creativity is mainly a matter of art and science, while decisiveness is determined by culture. Art involves skills, focus, specialisation and passion for the profession. Science concerns competence and expertise with respect to our profession. Culture is all about whether small teams of portfolio managers are encouraged to stick their necks out, and whether the right preconditions have been established for decisive action. To realise all this, three conditions have to be met.

"Portfolio managers should have skin in the game and eat their own cooking."

1. ALIGNMENT OF INTERESTS

The first condition is that the interests of the client, the asset manager and the employees are aligned. More and more academic studies reveal that this is a crucial aspect[17]. This can be realised by giving employees co-ownership of the company and allowing them to invest in their own products, or as Americans would say: 'have skin in the game' and 'eat your own cooking'.

The results of a study by John Bogle show that mutual funds of employee-owned asset management firms deliver better long-term investment returns than mutual funds managed by large financial conglomerates where asset management is not core business (see Figure 4). The results of a study by Evans demonstrate that turnover, transaction fees and management fees are substantially lower in US mutual funds in which portfolio managers have invested a significant portion of their own wealth, than in funds in which they do not co-invest. Hence, the net returns for clients in these funds are substantially higher. Wingens and De Jong find roughly the same conclusions for mutual funds managed by European asset managers. Co-investing with clients is more often found in entrepreneurial, privately owned companies. What this means is that when returns are disappointing, not only clients feel the pain but also the asset manager and its portfolio managers. What is even more important is that it ensures that risk is controlled even better. After all, the most effective form of risk management is a situation where the capital of the partners in a privately owned firm is also at risk when they take too much risk for the client. A good example in this respect is the collapse of the public company Goldman Sachs during the credit crisis. Before going public (in 1999), it had existed for 140 years as a private partnership, surviving a couple of world wars, the Great Depression and an oil crisis. Proper alignment of interests is as old as the way to Rome, for that matter. In Ancient Rome, for instance, it was customary to have all of the porters, builders and architects who helped build a bridge stand under it when it was time for the new bridge to be tested and the first carriage was to ride across.

For asset managers, leadership not least implies they have to deliver added value net of fees. This takes courage; the courage to take risks and to be a contrarian. The courage to invest in stocks that are out of fashion. In short, it takes the courage to stick your neck out in the interest of the client, even if it means putting your own career at risk. Asset management companies where culture, philosophy and ownership are in the hands of the portfolio managers themselves have a significantly higher chance of creating value for the client. A good asset manager will not sell clients investment products that he would not buy himself anymore because they are heavily overpriced. He has the courage to sell investment products that are out of favour but that will – in the long-term – add a lot more value in terms of expected returns.

"Proper alignment of interests was already understood in Ancient Rome."

2. FOCUS

The second condition is that the asset manager should be focused. The emphasis should be on a limited number of high-quality activities. The idea is not to offer everything, but rather

17 Please refer to Bogle, Evans, Wingens/de Jong and Malkiel.

to make choices under the motto: ‘We do things well or we don’t do them’. This means working with a modest number of specialised products and distinctive investment strategies. The results of the same study by John Bogle reveal a negative relationship between the number of investment strategies pursued by an asset manager and the results. In other words: the fewer investment funds, the better the results. If we look at a ranking of US managers, we see that the top ten are all relatively small and unknown firms (see also Figure 2). These are specialised firms, often owned by the portfolio managers themselves, with the right skills and expertise, who pursue the goal of delivering good long-term performance. They manage a limited number of funds; the number 1 ranked firm, for instance, has only four funds under management. In terms of the average performance of their investment

“The specialist retailer outperforms the supermarket.”

Figure 4: Employee-owned firms outperform

Asset Management
1. Dodge & Cox
2. First Eagle
3. Calamos
4. SouthEastern
5. Royce
6. American Funds
7. Harris Associates

Table 5. Relative Returns and Organisational Structure
(private firms are shaded; publicly held, nonconglomerate firms are in boldface)

Firm	Equal-Weighted % Outperformance	Firm	Equal-Weighted % Outperformance	Firm	Equal-Weighted % Outperformance
Dodge & Cox	98	Waddell & Reed	61	Goldman Sachs	49
First Eagle	97	USAA	61	Morgan Stanley Adv.	49
Calamos	91	Oppenheimer	60	Eaton Vance	49
So. Eastern / Longleaf	90	Prudential	59	The Hartford	48
Royce	79	MFS	59	John Hancock	47
American Funds	79	New York Life	58	Putnam	47
Harris Associates	77	US Bancorp	57	Dreyfus	45
PIMCO	76	Columbia Mgmt.	56	Strong	44
Vanguard	76	AllianceBernstein	55	Delaware	44
T. Rowe Price	71	Banc One	54	Thrivent Financial	44
Franklin Templeton	71	Neuberger Berman	54	Trusco Cap	43
Janus	70	Lord Abett	53	Merrill Lynch	40
ING	69	Van Kampen	52	Aim	39
Nuveen	65	Scudder	52	Nations Funds	38
American Century	64	Federated	52	American Express	37
WM Advisors	64	Evergreen	51	BlackRock	36
Davis	62	Wells Fargo	50	Pioneer	33
Fidelity	62	Citigroup	50	JP Morgan	32

Note: Performance rankings ignore the impact of sales charges and include only A-class shares.
Source: Fidelity Investments.

Asset Management
48. Merrill Lynch
49. Aim
50. Nations Funds
51. American Express
52. Black Rock
53. Pioneer
54. JP Morgan

Source: John Bogle, Financial Analyst Journal, November/December 2005

funds, the large financial conglomerates are at the bottom of the list. Where funds are concerned, the specialist retailer obviously outperforms the supermarket and it is clear that the smaller the scale, the better the results.

3. LONG-TERM COMMITMENT

The third condition concerns a strong long-term commitment. Both on the part of the clients and the asset managers it is crucial to move away from short-term-driven investment decisions. Apart from diversification, this is one of the few ‘free lunches’: time. If there is one group of investors who can afford this luxury, it is pension funds. After all, success in asset management depends on winning gold medals in the marathon, not the 100-metre sprint.

The most desirable future is where the asset manager is a professional expert, or ‘craftsman’. This expert is not employed by a financial conglomerate, but by a specialised boutique, and he makes his own decisions instead of blindly following the benchmarks. If the performance is disappointing, he is able to withstand the pressure from shareholders, clients, sales staff and management. He is able to navigate the storm. He is able to resist the behavioural biases to only buy after something has gone up. He is able to get clients interested in things that have become cheaper. He has a clear asset allocation mandate from clients to be able to act as a contrarian. He is able to convert the long-term savings realised by society into future production capacity, in a cost-effective manner. He believes in long-term shareholder commitment. He is a shareHOLDER. It is all about creating real added value. In 2009, Ben Inker, of the American investment management firm GMO, stated that while two-thirds of all corporate value lies out beyond twenty years, the market often trades as if all value lies within the next five years, and sometimes five months.

"Investing is simple, but not easy. You need patience and a willingness to be contrarian."

In this respect, benchmarks play an important role. The current obsession with benchmarks in the industry undermines investors' long-term real return objectives. Thankfully, there is a simple, although not easy (to borrow Warren Buffett's phrase) alternative – to use a value approach across a wide range of assets. Buy when an asset is really cheap, and sell when an asset gets highly expensive – buy low and sell high, a sensible approach to both the preservation and growth of capital. Valuation is the primary determinant of long-term returns, and the closest thing we have to a law of gravity in finance. Of course, there is a downside to this style of investing. In order to pursue a value-driven approach, you need two key traits – patience and a willingness to be contrarian. Unfortunately, these traits are still in short supply.[20]

Conclusion

Our clients face tremendous challenges. These challenges require from us asset managers that we reinvent ourselves. We need to shift from short-term salesmanship to long-term stewardship. This requires new leadership. We need long-term focused specialised firms who have clearly aligned their interests with their clients'.

In the first paper published by the 300 Club, Professor Amin Rajan stated: 'The "industrialisation" of investing has depersonalised relations between investors and their asset managers. Unlike their physical counterparts, like cars and computers, investment products do not have a definable shelf life, they do not deliver predictable outcomes, they cannot be pre-tested in a lab, and they do not carry a fit-for-purpose certificate. For good returns, what matters most are timing and market environment. These require a far higher degree of engagement between investors and their managers than has been the case over the past twenty years where dis-intermediation has become ever more pronounced.' Professor Rajan came up with a list of important requirements for asset managers and their clients to be successful in the long-term. In this paper, I add several requirements to his list.

For asset managers, it is essential to:

- Understand their clients' dreams and nightmares
- Manage expectations in what can and cannot be delivered
- Highlight proactive buying opportunities in periods of big price dislocations
- Have a capacity constrained mindset

20 Please refer to James Montier, FT September 20, 2011, 'Benchmark obsession undermines investor returns'.

- Create alignment of interests with their clients and staff
- Have a long-term investment horizon
- Have focus in their product offering
- Have a strong team culture

For investors, it is essential to:

- Create good governance: formulate the organisation's mission and mandate and implement a roadmap to improve board skills
- Seek better alignment of interests via common beliefs and long time horizons
- Gain deeper insights into what works at different stages of the market cycle
- Develop the mental agility and governance structure to capitalise on periodic market dislocations
- Minimise behavioural biases and herd instinct provoked by periodic volatility
- Formulate the risk appetite of the fund and create a robust risk management framework

'To dare' is one of the best verbs we have. Asset managers and their clients both have a responsibility to reinvent themselves and the way they work together. Like in a good marriage or partnership, rather than meeting each other halfway, this means that each partner should show 100% commitment. Asset managers as well as institutional investors should regain the courage to pursue long-term goals. We need to shift from short-term targets/salesmanship to long-term objectives/stewardship. In this respect, the notion of 'engaged shareholdership' is very relevant. What we need is the experience and knowledge of the professional 'craftsman' who understands the ultimate needs of its client, moulded into a modern version of the old profession. We need to deliver real returns, not benchmark returns. We need portfolio managers who will not allow themselves to get pushed around. Who can be patient. Who are willing to stick their necks out. Who have the courage to be contrarian and 'stick to their guns'. We need asset managers who will provide their clients with optimal long-term service and results: asset management 2.0 – a mature partnership.

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The 300 Club

The 300 Club is a group of leading investment professionals from across the globe who have joined together to respond to an urgent need to raise uncomfortable and fundamental questions about the very foundations of the investment industry and investing. The mission of the 300 Club is to raise awareness about the potential impact of current market thinking and behaviours, and to call for immediate action.

Current economic and investment trends will change the investing landscape over the next two decades and we are at a crisis point which presents huge risks to investors, according to the 300 Club. Moreover, the 300 Club believes that current financial and investment theory and practice run the risk of failing investors at their time of greatest need.

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