Perspectives

There are too many active managers

TOWERS WATSON

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Actually...it's not the quantity, it's the aggregate cost that's the problem

In this paper, we outline a simple thought experiment[1] which shows that the investment industry is sub-optimally structured from the perspective of the end saver. We will leave the question as to why a sub-optimal structure persists to a future paper (spoiler: it is all about the incentive structure).

The thought experiment

Let us build for you a vast virtual warehouse filled with all the securities in the world. For simplicity we will talk of equities and bonds but you could put everything in there, even private assets. If it helps you to think about it, we can build a big extension and fit in the entire world's real estate. The idea is to introduce the notion that the stock of investible assets is largely fixed (yes, there is some coming and going at the edges), and also to note that, at this level of abstraction, certain details such as country of listing, or currency are not important.

What is important is that the assets throw off cash, in the form of dividends, coupons and rents. Therefore, periodically, the warehouse doors open and a fork lift truck delivers outside a big pile of cash. This cash clearly belongs to the asset owners, but we are getting a bit ahead of ourselves. First, we will introduce some further simplification.

When considering the world's investors – insurance companies, pension funds, sovereign wealth funds, endowments, retail investors and so on – we remember that they do not hold any physical assets. Instead they rely on a registration system which links them to particular assets in the warehouse (this bit is very close to reality). For simplicity we could give all investors the same asset allocation (a proportionate share of every asset in the warehouse) but this is not a necessary step. If one investor wants to own only equities, they just need to find other investors who want to own less in equities.

Now, the main point should be clear – but because it is fundamentally important to the thought experiment, we emphasise that the shuffling of ownership rights between investors adds no value in aggregate. Collectively they already own what is in the warehouse and there is no point in shuffling ownership rights back and forwards repeatedly. The only thing that matters is the cash that the fork lift truck delivers. At our current level of abstraction not even the price of the assets matter.[2]

The next step is to introduce the asset manager intermediaries.[3] We could assume that particular investors use different types of asset manager – such as investor number one uses a single index-tracking manager; number two uses several active managers and so on – but we do not need to. Instead we will use a broad brush and assume that the index-tracking managers oversee 15% of the assets in the warehouse, active asset managers oversee 80% and hedge funds 5%.[4]

Now for the exciting part – the opening of the warehouse doors and the arrival of the fork lift truck. The money belongs to the asset owners, but the asset managers need to be paid for their services. For the purposes of the thought experiment we will pay the index-tracking managers US$1 for overseeing 15% of the assets. The active managers then get US$40 (for 80%) and the hedge funds get US$15 (for 5%).[5] In aggregate the asset managers are paid US$56 for overseeing the assets within the warehouse.

This is a thought experiment so accuracy is not the primary consideration here. However, for those who would appreciate a more tangible link with reality, the 2012 revenues for global asset managers are estimated to be in the range of US$180 billion[6] to US$350 billion.[7] This reduces the money received by the asset owners directly. We will be able to improve the situation very simply and elegantly. Before we do, however, it is worth asking whether the asset owners get anything useful for this money paid away. Index-tracking managers are useful to society because they perform the necessary oversight for minimum cost. Being somewhat provocative we will also argue that only a small subset of the active managers and the hedge funds are useful to society. To make the argument we will relax the assumption that the contents of the warehouse are static. In reality there is a flow of new assets into the warehouse through (initial) public offerings, rights issues and the like. There is a very important social function to be performed in deciding which new assets get into the warehouse (and which are rejected), and at what price (price does matter occasionally). In our thought experiment we assume that the active managers and the hedge funds populate a spectrum. At the useful end of the spectrum, they police the access to the warehouse by filtering out bad assets and correctly pricing the new ones. At the bad end of the spectrum, they charge asset owners an active-level or hedge fund-level fee for a passive-like product.

The simple solution

As this is a thought experiment we can wave our magic wand and transfer 70% of the portfolio duties to the index-tracking managers.[8] Their revenue would increase to about US$5 if they play hard ball and leave their fee rates unchanged. In the real world, we would hope they act more generously and reduce their fees. To reduce the number of moving parts, we will leave the hedge funds alone and so the active managers see their assets under management drop to 25% of the total.[9] This means their earnings would fall from US$40 to US$13. The total payment for oversight services now comes to US$33. In one easy move we have saved asset owners US$23, or 41% of their original cost. Of course, there is also scope for hedge funds to reduce their fees which would generate yet more savings for asset owners, but we do not want to overly complicate the story at this stage.

This is excellent news – for the asset owners. If possible to pull off in reality, asset owners would have something like US$74 billion to US$144 billion, each year, to credit to the accounts of their beneficiaries, the end saver. Clearly the news is not as good for the asset management industry and its employees. But capitalism has shown a remarkably consistent ability to recycle jobs and simultaneously raise living standards. In other words asset manager employees could end up in more value adding roles elsewhere in finance, or even in the wider economy.

Back to the real world

We do not actually believe that savings of the magnitude quoted above are immediately available in the real world. However, the thought experiment is instructive. Some activities are useful, and therefore valuable to society, but some are not. Here we have singled out the excessive shuffling of ownership rights (that is, pursuit of ‘alpha’) as value destructive. The thought experiment clearly shows we need more (but not all) assets to be managed passively. It also shows that we have a serious ‘agency’ problem[10] in our industry. None of us is going to voluntarily ask for a 41% pay cut, and few of us will voluntarily retrain, but if we were really putting our clients first, we should. One thing we have not discussed above is the socially useful function of adapting portfolios to fit the risk level to the mission of the investor. This is an important role undertaken by the industry but is not part of our current focus.

Catalysts for change

Even if against the interests of the asset managers, could we see change in the right direction nevertheless? We see a number of possible catalysts as follows:

Regulation

Much could be said here but we will simply note that a regulatory trend is emerging around the world, looking to cap the total charge that can be levied on defined contribution (DC) pension assets. While we are supportive of these moves in terms of direction, any change to incentive structures brings both intended and unintended consequences. So the overall impact of these moves will depend on the details, and will also only become fully apparent over time.

Growth of DC pensions

A related point is that as DC pension assets grow, they have the opportunity to contract on a different basis with the asset management industry.

Up-skilled asset owners

As a group of seriously large asset owners starts to emerge they will change the demands they place on asset managers. This will be driven by the increasing size of the in-house teams, their growing consciousness that they are universal owners,[11] and the likelihood that they will take more asset management (security selection) in-house and apply more rigorous cost containment practices to their external providers.

A new moral environment

This is more speculative, but we would claim society now holds a different view of what is ‘fair’ relative to its view of the last two or three decades. For us the defining moment was during the global financial crisis – in the USA it was the riots outside AIG offices when bonuses were announced; in the UK it was the vandalising of the house of the former chief executive of RBS. Since then we have seen the Arab Spring and the Occupy movement and, most recently, a fierce debate emerge over high-frequency trading in our own corner of the world.[12] Within financial services public anger has, so far, been directed at the banks, but the asset management industry is arguably only just below the radar.

> “We should have less active management. Not none, but less.”

Conclusions

It is clearly rational for an individual investor to hire an active manager to try and do better than all other investors. In the same way that it is rational for one person to graze an extra cow on common land. Unfortunately this just launches an escalating arms race, and the eventual, assured conclusion is a societally-sub-optimal outcome as noted in the thought experiment. We can find no logical flaw in the warehouse argument. We should have less active management. Not none, but less.

We have also noted, however, that the intermediaries are not going to volunteer to change the system. The potential catalysts for change we have suggested are likely to be slow moving. If we wish to see faster change we will need to change the incentive structures that govern behaviour within the industry. This is an area ripe for interesting research, but the pressure for change will have to come from the asset owners. This may sound daunting to many asset owners, but the start could be as simple as changing the terms of new mandates. Ultimately, however, more holistic change will be required – spanning relationships, contracts and organisational design. While this will be hard work we have demonstrated that there is considerable additional value that can be captured by asset owners on behalf of their beneficiaries.

Footnotes

1 This thought experiment is our version of Warren Buffett's story of the 'Gotrocks' family from his shareholder letter in 2005. See http://www.berkshirehathaway.com/letters/2005ltr.pdf.

2 We are currently considering a closed system, with no new investments entering the warehouse, and no change in the composition of investors. When relaxing these conditions price will become necessary.

3 The same logic will apply to any group of intermediaries, including consultants, but the scale of the numbers will change.

4 These are illustrative numbers. Calculating the true proportions would be straightforward if data were available for all investor types, or data for asset managers could be accurately attributed across the three components. These numbers are our estimate of the true picture.

5 The fee rates we have used are drawn from our experience and are chosen to represent actual averages in the market.

6 Our calculation from the data in Boston Consulting Group's *Global asset management 2013, Capitalizing on the recovery*, 2013.

7 *The Complete Firm 2013: Competing for the 21st Century Investor*, Casey Quirk, 2013.

8 We are using a simplified thought experiment to make a general point. In the real world the rapid growth in smart beta could be interpreted as a form of transferring responsibility from active management to index-tracking management.

9 We are explicitly assuming that prices can be set efficiently, and the flow of potential new assets can be judged appropriately, with only 30% of the assets being managed actively. This is a judgement on our part as the optimal proportion cannot be known, and may not even be constant through time.

10 Agency problems arise because an agent has self-interest and therefore does not act purely in the interest of the principal employing the agent. At the time of writing, http://en.wikipedia.org/wiki/Principal-agent provides the clearest explanation available on the internet. Wikipedia is an openly editable resource.

11 The universal owner idea is that certain large asset owners exist in the very long term with exposure to the entire market and economy – this situation implies that they should be more interested in the progress of the whole market than any single component.

12 This debate was sparked by the publication of Michael Lewis's new book, *Flash Boys: A Wall Street Revolt,* 2014. We are not expecting this debate to spill over to the wider public, but it is instructive in that it has generated strongly held and opposing opinions suggesting that some areas of finance are sufficiently complicated that our general level of understanding is not high enough. This alone should give us pause for thought.

Thinking Ahead

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