Willis Towers Watson

Thinking Ahead Institute

# To bonus or not to bonus?

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***This paper represents the personal opinion of Tim Hodgson. It should not be construed as representing the views of Willis Towers Watson or any other member organisation of the Thinking Ahead Institute.***

With apologies to Shakespeare, the title of this paper poses an interesting and topical question – if not in the same existential league as The Bard's original. Towards the end of August 2016 there was great fanfare in the UK financial media regarding the decision of Woodford Investment Management to cease paying bonuses to their executives. Daniel Godfrey, the former chief executive of the UK's Investment Association, announced similar intentions for his soon-to-be-launched investment trust. With the greatest respect to the individuals involved, these moves mean that, to the nearest whole number, the proportion of assets under management on which bonuses are paid is still 100%. And so we must take a normative stance with respect to the question – what *should* industry pay structures look like? Are these organisations the first movers on the trend to a new normal?

**Let's start at the beginning: this is a competitive industry, bonuses drive effort, and we need that extra effort to ensure that our asset manager gives us the best returns. How do you respond to that?**

Well, yes, it is a very competitive industry. But it is striking that there is very little differentiation in fee levels, so it would appear that the competition is based on pretty much anything except price – always the track record, despite the regulatory addendum about its worth; brand; attributes etc. Then you state that bonuses drive effort. The reality is, I believe, much more nuanced. But does a bonus drive effort? First, it is my belief that no-one is driven purely by monetary incentives. Second there is the open question of whether variable pay structures are, in fact, partly de facto fixed. When the level of bonus is largely expected, its effectiveness can be questioned. Then there is the question of whether increased effort causes better outcomes? First, over the short term, the outcome in a high noise-to-signal environment (like our industry) is driven more by luck rather than effort. Over the longer term we would hope that effort (actually we are interested in 'skill'; effort is likely to be necessary for skill, but it is not a sufficient condition) was in some way associated with better outcomes as the impact of noise reduces; but this is a belief not a proof. Second, I assume that what really matters to asset owners is the level of the absolute return. On this basis, all the efforts asset managers spend on beating the benchmark are somewhat misplaced, given that alpha is a negative-sum game after costs. Society ends up paying too much for price discovery. Third, and worse, academic evidence suggests that above a certain level, increased effort can even detract from an individual's performance[1,2,3]. This can be a result of over-deliberation or narrowed focus of attention along with other factors.

The latter research finding is echoed in Dan Pink's book[4]. He argues that the traditional carrot-and-stick motivators can be effective for rules-based, routine work but can actually be counter-productive for many of the more complex activities in today's society. Instead, what drives people in today's world are autonomy, mastery and purpose. To these we would add great colleagues and recognition/status as two further powerful motivators. So sorry for the long-winded response, but I find no first-principles basis for bonuses being necessary in investment.

**OK, but bonuses by definition make pay highly variable. Therefore they allow base pay to be kept low and that benefits investors.**

I will start by repeating myself. It depends on expectations. If an individual expects to receive 100% of their target bonus then, in reality, the pay is not variable – it is de facto fixed. You may be able to retain them by only paying 90% of the target bonus, but I think we are kidding ourselves that paying no bonus is a viable strategy in the current environment. Consider 2008, a 1-in-100 bad year for the industry and a clear example of an occasion when zero bonuses would have been expected by an outside observer – and yet bonuses were still paid, even if at a reduced rate. So my argument so far is that pay is not as variable as it would appear. The second strand targets your statement that the structure benefits investors. I will argue the opposite, that the structure has allowed the level to rise and this is against investor interests. I have already argued that bonuses do not contract as much as expected if the outcome is bad. Conversely, if the outcome is good bonuses quickly expand beyond target levels. In the jargon, this pay structure contains optionality, and in a noisy environment that option is very valuable to the holder (the employee). It is the investor that pays that value.

**You're starting to get technical, so let's simplify this conversation: 'people respond to incentives' as the Stephen Landburg quote goes. Bonuses are significant financial incentives and so people will respond.**

That is true. But will you get the response you hope for? Rolf Dobelli has written a great book on the errors people make in their thinking[5]. It comprises 99 short chapters, with one per error. Number 56 is titled 'How bonuses destroy motivation' and concerns the error called motivation crowding. Dobelli relates a story of Swiss academics studying the reaction of people to their town being considered as the site for storing nuclear waste. Surprisingly 50.8% were in favour which the academics attributed

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[1] Dan Ariely, Uri Gneezy, George Loewenstein, and Nina Mazar showed in three separate experiments that increasing the potential for outcome-based financial rewards resulted in worse results above certain levels. *Large Stakes and Big Mistakes*, Review of Economic Studies, vol. 76, 2009

[2] Deci, Koestner and Ryan produced a meta-analysis of 128 experiments which concluded that extrinsic rewards undermine intrinsic motivation. *A meta-analytic review of experiments examining the effects of extrinsic rewards on intrinsic motivation*. Psychological Bulletin 125(6):627–668, 1999

[3] Weibel, Rost, and Osterloh produced a meta-analysis involving 46 laboratory and field experiments that controlled for the nature of the tasks found a negative relationship between tangible rewards and performance for interesting tasks (ie tasks perceived as challenging, enjoyable, or purposeful), and a positive relationship between tangible rewards and performance for less interesting tasks. *Pay for performance in the public sector benefits and (hidden) costs*. Journal of Public Administration Research and Theory 20(2):387–412), 2010

[4] Dan Pink, *Drive: the surprising truth about what motivates us*, 2009

[5] Rolf Dobelli, *The art of thinking clearly,* 2013

to factors such as national pride, common decency, social obligation and the prospect of new jobs. The team decided to repeat the survey but the second time mention a hypothetical $5,000 reward funded by taxpayers if they approved the proposal. Those willing to endorse the proposal fell to 24.6%.

A second, reasonably well known example is from children's daycare centres. There is always a deadline for collecting the child, but parents are often late which means the staff have to stay on as they can hardly leave the child on the street. Those centres that introduce a fine for late pick-ups experience a significant increase in lateness. The previous moral obligation to be on time gets replaced by a transactional payment which absolves the late parent of guilt. What these examples show is that even small payments lead to motivation crowding, meaning that tasks that carry no extra reward get ignored. So, absolutely, people respond to incentives –but incentives are complicated things and they are not just monetary. For example, Dan Ariely is a behavioural economist who has conducted many experiments. He has found that higher rewards can increase performance (in simple tasks) up to a point – but beyond that point, as rewards get higher, performance reverses.

Bringing this back to investment, I agree that bonuses have an effect. I just don't think it works out in the clients' favour. Bonuses are paid from profits, so what influences profits? Alpha, the stuff we want, will help. But it tends to be fairly small. Beta, or market return, tends to be bigger than alpha and a strong market return will boost earnings and profits substantially with no effort required. The other big influence is adding assets, which is good for profits but generally dilutive for existing clients. So I believe that the incentive structure you are defending will actually stimulate inappropriate, if not value-destructive (for existing clients), behaviours. Let me ram that point home with two examples. First, consider parenting children – and I know I am treading on potentially dangerous ground. Children want money, and parents have roughly two choices: pay fixed weekly pocket money, or pay an amount for doing particular jobs. I would contend that with the latter system children, and particularly teenagers, will quickly learn to game everything, and will demand to be paid for things they should be doing anyway. Second, think about medicine which is also a high-skill activity where you want top talent to reside. Is there any role in medicine where you would be more confident in your treatment if the person were receiving a bonus? Would you want your surgeon to get a bonus if you didn't die? For how long would you need to live post-operation before it was acceptable for them to receive their payment?

These thoughts lead us to culture. Do you want to employ a firm where people are passionate about what they do – in which case, by construct, they don't need the bonus – or a firm where people are motivated by the pay cheque (they are also allowed to enjoy the work, but take away the bonus and they will move on)? Why do we have to pay someone a bonus for doing the job they are already paid for doing?

**All the asset management firms are doing is paying the going rate for the job. You can't argue with that!**

You are correct. But your statement is descriptive (or 'positive') and we set out to explore this subject from a normative perspective – not what is; what should be. Let me just mention that I am not arguing for low pay – that would be unrealistic, and not necessarily in the end savers' long term interests (not over paying is in their interests, but they should pay the appropriate rate for the skill involved – it is about the value proposition). What I am arguing is that we have got ourselves to the wrong 'going rate'. Logically this implies there has been a market failure. That notion will be offensive to some people, so let me try to justify it. As above, I argue that the investment industry is not truly competitive, in the sense that market share is not going to the lowest-cost / lowest-price provider. What is happening with passive management at the moment shows what should be happening within active management if competition were real. The reason behind the lack of competition stems from the asymmetry of information, which gives rise to the even more important asymmetry of understanding. The latter means that there isn't, or has not been, a balance of power between the buyer and seller of investment services. As a consequence we now have a high-wage, high-margin industry which demonstrates that the seller has been able to set a high price. To improve the client value proposition either the wages or the margins need to give a little. I have said that I am not arguing for low pay, so am I arguing for lower returns to the shareholders of asset manager firms? No. I am arguing for a switch to a new path. On Day 1 there should be no change to either pay or margins. The improved client value proposition would emerge slowly over time, and I am ambivalent where that is funded from.

**You're going to have to explain. How does leaving things as they are lead to future improvement?**

The key is to change the structure, rather than the initial level of pay. So take the current level of remuneration, or some recent average if you prefer, and make that fixed. So no investment professional sees their earnings fall, and the clients pay no more. However, the value of the option goes away. So now, in a bumper year, investment professionals still collect their fixed pay, and shareholders collect a very large margin. In a poor year, pay is protected and margins contract. If investment professionals want to re-leverage their earnings, they can use their significantly higher fixed pay and buy equity in their business. This is part of the Netflix model[6]. What happens under this structure is a breaking of the link between pay and market returns. Instead, pay is more likely to be linked to a measure of inflation, which over time we would expect to be materially lower than market returns. That's where the long term gains come from. We are talking about dividing the pie between employees, owners and clients. Having fixed the amount going to employees, the tussle will be between owners and clients. It is my belief that there will be enough far-sighted owners to release some of that value back to clients via lower fees, which would be the start of price competition. Of course, we could approach the argument another way – and break the link between fees and assets (ad valorem) which would 'allow' some rapid adjustments in the prices charged to clients.

[6] *How Netflix Reinvented HR*, Harvard Business Review, January-February 2014

**But whether the adjustment is in the short or long term, reducing the pay prospects will simply mean the industry cannot recruit the same level of top talent.**
Maybe. I have two responses. The first is macro, and borderline facetious: how much top talent does an industry need to recruit when its aggregate value-add is negative after costs? The second point is about historical context. Both the numbers employed and the level of pay within investment have grown decade after decade. Not only has the level of pay grown in absolute terms, it has grown relative to other occupations to the extent that it is now broadly comparable with investment banking pay. I have heard it said that the last time financial services accounted for the same percentage of GDP was 1929. What is a reasonable expectation for the direction of pay from here? Would society be better off if at least some of that top talent went into a different sector? It seems to me that as an industry we need to think about how to divide the spoils. Top talent will always command a premium. But we have a situation where fee structures and remuneration structures have allowed all participants to share in the super-normal growth.

**So your problem is with average pay levels, not top talent being significantly rewarded?**
You can read my last statement that way. I have views, but I am trying to make an objective case and minimise the intrusion of values-based judgements.

**OK. But if we take away large amounts of discretion over the pay of 'average', or perhaps younger, employees then we are less able to signal to them how much they are valued.**
I am tempted to refer back to Dan Pink and what really motivates us, but instead why not think of a system where 'long term bonuses' are paid via promotions that lead to higher base salaries. Someone doing a better job than another should get promoted quicker and hence end up earning more, with both receiving appropriate signalling. I am aware this leads us into 'Netflix territory'. What do you do when a previously strong individual on a high fixed salary starts to do a less-good job? The Netflix model I mentioned earlier is relatively aggressive in how it deals with those situations.

**'Interesting' – that's in quotes. That means getting rid of bonuses would place greater importance on management significantly improving other (softer) skills, which are not currently needed as bonus setting does the heavy lifting.**
Agree! However, as a reminder, we have been considering this from a normative ('should be') position – we don't know if the investment industry has those skills in sufficient quantity. In fact, the practical journey from where we are now to that future state is largely unmapped. We don't even know if it is possible…

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To repeat the opening disclaimer, this paper represents my personal opinion – but it isn't long enough to be a comprehensive position. I have written it because I find the decisions of Woodford Investment Management and Daniel Godfrey interesting and, directionally, correct. This is because I believe the current structure of compensation in our industry is unsustainable. Despite what I have written above, I am open to the idea that zero variable pay is also the wrong end point. That lies in the detail which I have studiously avoided – in order to create a clear (I hope) position to debate.

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