An idea for long term incentives – the Active Management Partnership.

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In the last issue, I talked about some ways to avoid significant annual charges on your investments, especially if you use ISAs or SIPPs. Since active managers in aggregate cannot help underperforming a passive, low cost alternative, the intelligent approach is quite simply to avoid them.

Just think for a moment how attractive fund management is as a business. You put up a small amount of capital. Your customers invest potentially huge amounts with you, on which you make a "small" charge. Your customers generally lose money compared with a passive alternative, but miraculously you don't lose your customers. Why not?

This requires some exploration of psychology. Whilst big pension funds some time ago began moving money away from expensive active managers to much cheaper passive managers, how come they and their advisers became seduced by the idea of hedge funds? So it's not just Joe Public that loses objective reason where investment is concerned.

The psychology of human misjudgement really does repay study. Our minds are just not wired in a way to take sensible decisions in relation to uncertainty and the future. A perfect example is commission to an "advisor" – there's no reason to think that the advice is objective, or even sometimes much use, but we don't think it through, preferring the feeling of comfort and reassurance. Really successful investors seem to be aware of these tendencies and to train themselves into habits of mind which lead to more objective and more disciplined analysis.

But back to analysing the big con… Intelligent investor (II) to fund manager (FM):

II: "Why should I put my money with you? You are going to charge ¾ % every year in the future, of which ¼% goes to the broker. Surely I'll be better off in an index tracker or ETF?"
FM: "You're paying for my investment expertise. You have to pay for performance – surely there's nothing wrong with that? Your broker's done the research and recommended me – look, he's authorised by the FSA and everything!"

II: "The broker hasn't actually told me he thinks you will outperform. What he's done is list the 6 of your funds which have outperformed in the last 18 months, just like that huge advert you have at some of the big stations in London. Nothing about the 20 funds which have underperformed. And, looking at it myself, I can't find any record of your 10 year performance anywhere! Why should ¼% of my savings be taken every year in the future to reward the broker for such rotten advice?"

FM: "We get almost all our business from brokers. We find that unless we give good commissions, we don't get the business. And, even if you were to come direct, we would have to charge the full ¾ %, because giving you cheaper terms by coming direct would annoy our brokers and they might stop recommending us altogether." II: "Well, I'm not very

impressed. I'll give you one last chance. Why should I pay so much to you, when a passive option is so much cheaper and logic suggests that it should outperform over time?"

FM: "Because I'm confident this fund really will outperform in the long term, enough to pay for the ¾ % per annum charges I levy, as well as the additional costs from turnover within the portfolio".

II: "Are you confident enough to only be paid anything if you really do outperform? I'm prepared to be generous after the event, if you do well. No commission to any broker, either.

FM: "Well, er…"

There seem to be two "establishment" views in relation to fund management performance. The common academic view, which incorporates the theoretical world of the financial economists, is that investment markets are very competitive and too efficient to leave anything on the table after expenses.

So any manager who outperforms is simply lucky.

The other view, which is believed by all those whose living is fund management, or fund manager selection, is that there are a few people out there who can and will outperform – the challenge is simply to find them, and it's worth paying lots for the service

I believe the truth is somewhere between the two. There are indeed a few individuals with the right skills, application and mentality. In fact, I believe that a number of private investors do outperform over time. But the emphasis is on "over time". If you realise that a company is objectively worth much more than the current price, and if your judgement genuinely is better than that of the market, you can buy. It's a matter of waiting until the market finally realises, which can take quite a few years. In the meantime, the price can fall much further, in which case you have to be confident enough not to worry. But if someone's looking over your shoulder every few months, you could easily get sacked before the wisdom of your decisions is proved.

Solution? A genuine partnership: If the fund manager's proposition is that he will outperform, and that's the reason to invest with him, I believe it's quite simple to set out something that makes sense to the investor. But it's a long term commitment on both sides. I've only ever found a couple of fund managers prepared even to consider the idea – read on and you'll see why. They have to be confident in their skills, to be wealthy enough already not to need fees now, and they also have to have the patience to get rich slowly with you, rather than quickly at your expense.

I call this idea the Active Management Partnership (AMP). Uniquely, the contract terms ensure a genuine identity of interest between investor and manager. No commission is paid to advisers. Those managers brave enough to offer this contract would attract huge sums and publicity, and might transform the UK's investment market. Their incentive to have a long term ownership focus would also improve corporate governance.

AMP principles can be applied to any sort of brief. They could also apply to any sort of fund for holding the assets. This is a long term relationship. The manager is paid 30% of out-performance and nothing else. There are no annual fees. To perform, the manager has to beat an agreed index after expenses. Any period of underperformance has to be completely made up before any profit-commission is paid.

The investor commits for a minimum of 8 years, as does the manager. Earlier withdrawal by the investor is possible; any accrued but unpaid performance charges at date of leaving would be levied together with a penalty equal to say 3%, plus 0.5% for each year remaining of the 8 years.
The management places a meaningful proportion of its total wealth as investment in the fund. This ensures that there is no incentive to take cynical "punts" with investors' money in the hope of securing a large performance fee. Performance is assessed by comparing the fund with a notional fund invested in an agreed benchmark replicating the fund's actual tax position but assuming no other charges, dealing or otherwise. The comparison will first be made after 3 years from start-up, annually thereafter.
A profit-commission, if positive, will be paid equal to 30% of the amount by which the value of the actual fund, marked to market, exceeds that of the notional fund. The manager must be in a financial position not to need remuneration; no problem for a large financial institution. Direct investment costs such as brokerage and custody are met from the fund, as is the cost of an independent performance-monitoring service,

This very simple arrangement makes it clear that the manager has every incentive to aim for long term out-performance but, vitally, that he will not be penalised for short term under-performance, as the investors are locked in. But the manager is constrained in a number of ways as well, including having committed his own money, which he is never permitted to extract before the 8 year period, or when he ceases to be manager if later. Contract terms thus ensure an identity of interest between investor and manager. What more can intelligent savers and investors ask for?

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