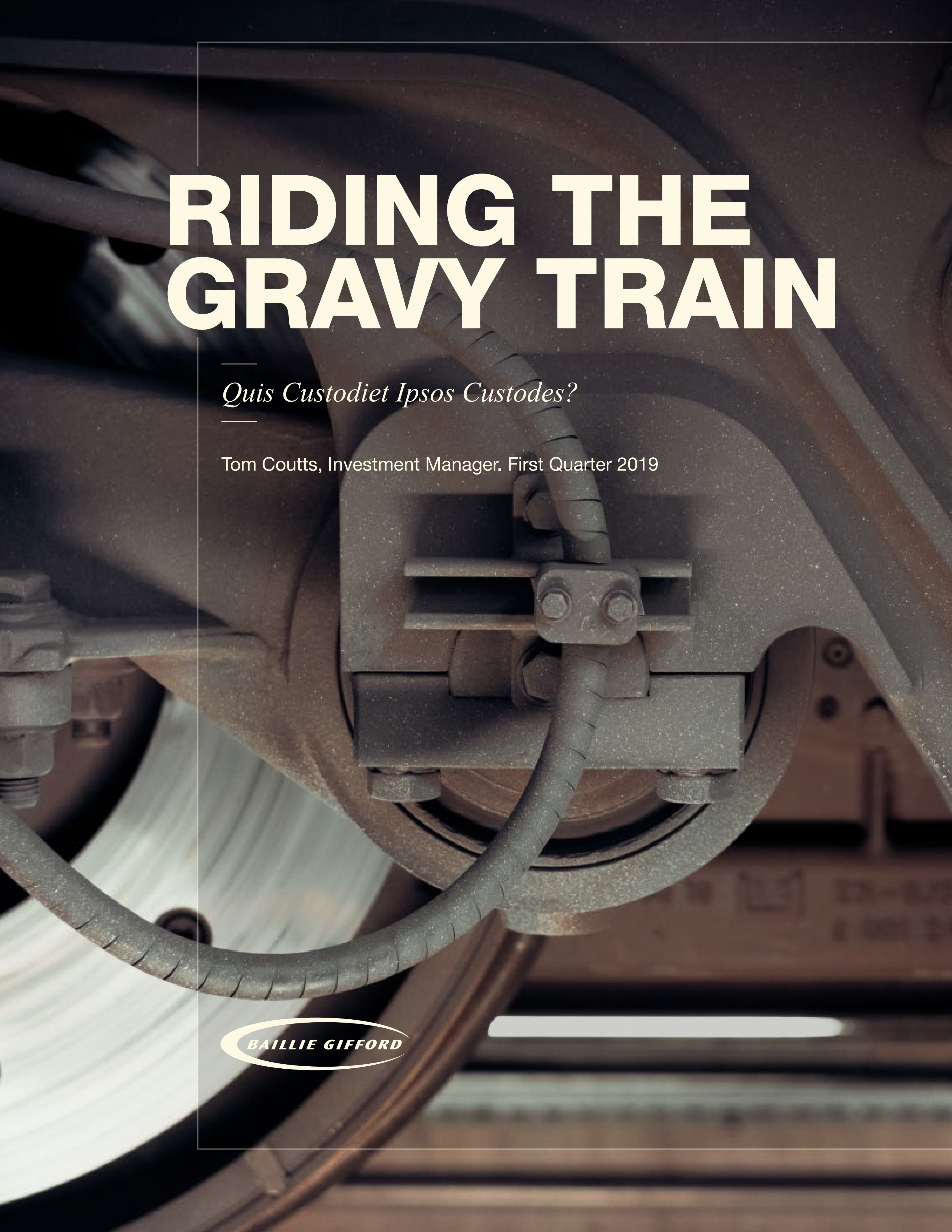

RIDING THE GRAVY TRAIN

Quis Custodiet Ipsos Custodes?

Tom Coutts, Investment Manager. First Quarter 2019

RISK FACTORS

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Tom Coutts graduated BA in Modern Languages from Oxford University in 1994. He joined Baillie Gifford in 1999 and spent a number of years in our UK Equity and European Equity Teams before moving full-time to the EAFE Alpha Team in 2017. He became a Partner in 2014.

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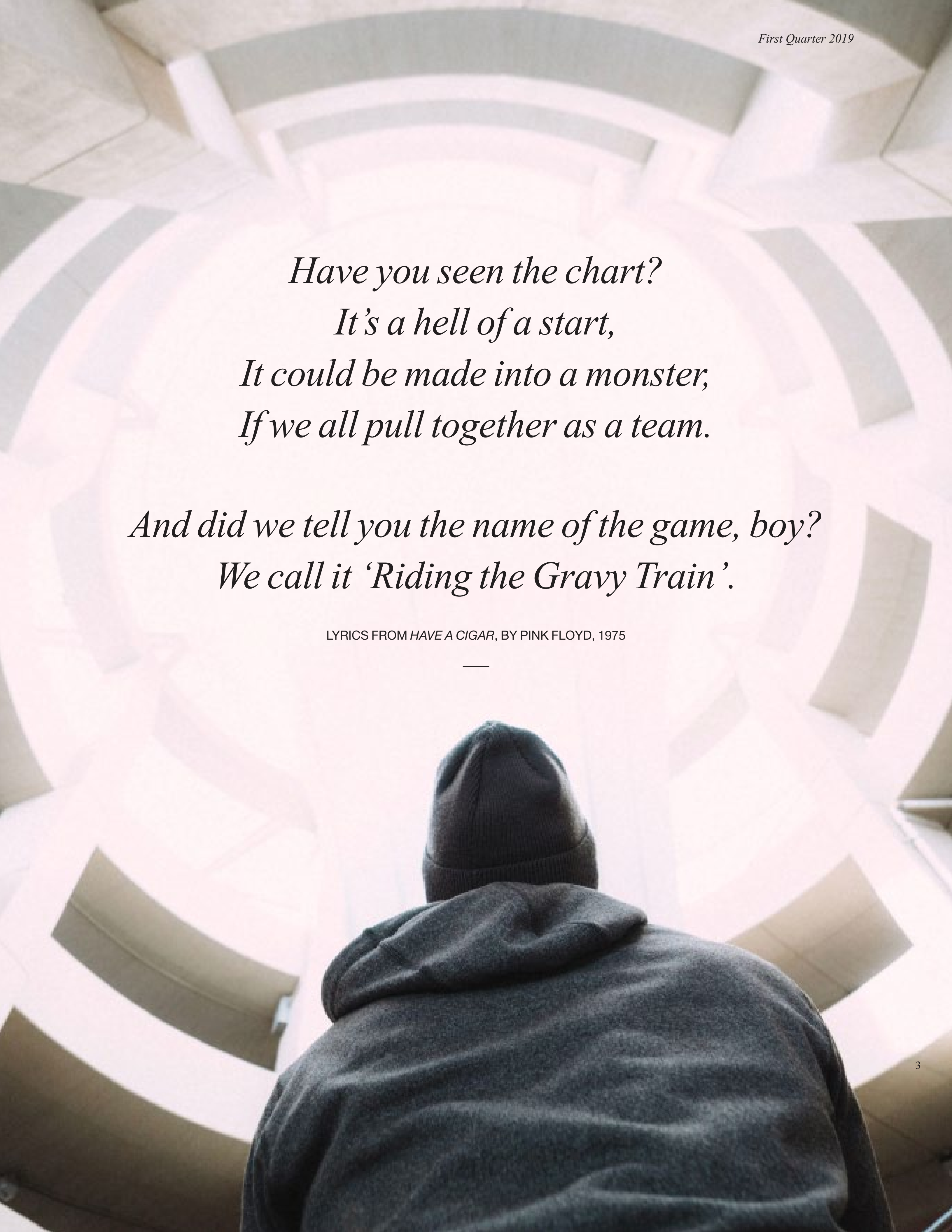


Have you seen the chart?
It's a hell of a start,
It could be made into a monster,
If we all pull together as a team.

And did we tell you the name of the game, boy?
We call it 'Riding the Gravy Train'.

LYRICS FROM *HAVE A CIGAR*, BY PINK FLOYD, 1975

RIDING THE GRAVY TRAIN

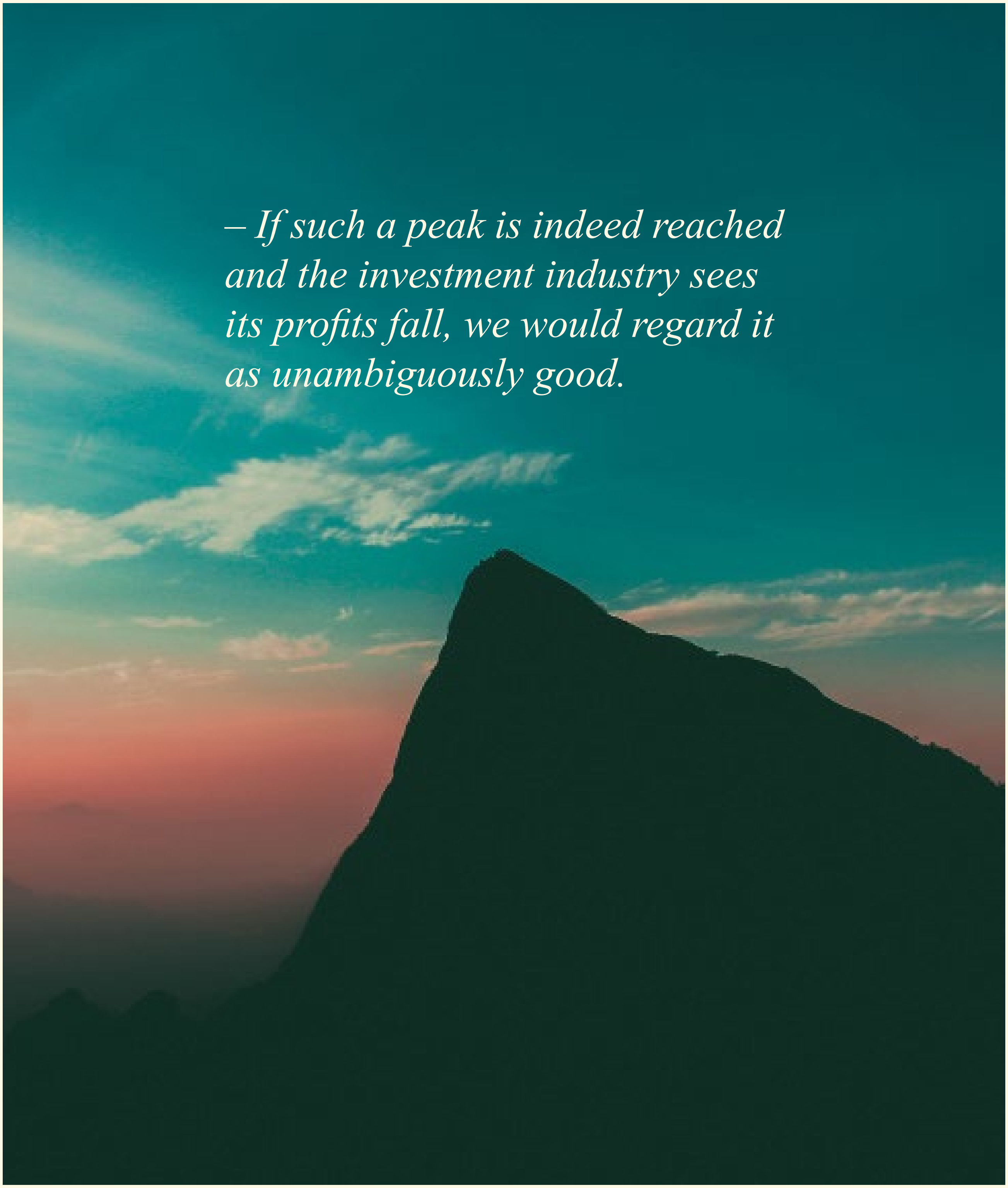
WHO GUARDS THE GUARDS?

BY TOM COUTTS

Readers may be familiar with the concept of Peak Oil, the point at which we reach the maximum rate of petroleum extraction globally. The concept is a simple one, even if identifying it in real time has proven more difficult.

It is our contention that the investment industry may be experiencing a peak of its own, in this case the point of the maximum rate at which it extracts value from its clients' assets. Let's call it Peak Gravy.

If such a peak is indeed reached and the investment industry sees its profits fall, we would regard it as unambiguously good. Such a comment may sound odd coming from a fund manager, but we have never held the wider investment industry in high regard. It seems to us that most funds' fees are too high, most so-called investors' time-horizons are too short, and most firms operate with their eyes focused inwardly on their own interests rather than outwardly on their clients'.


– If such a peak is indeed reached and the investment industry sees its profits fall, we would regard it as unambiguously good.

MASTERS OF THE UNIVERSE, OR DENTISTS?

The financial industry itself creates little of value. It is a facilitator, a lubricant for the economy, helping savers to earn a good return on their money and providing financing for investment opportunities, from the funding of a new car to the construction of a spaceship. Those of us who work within it should be humble about the role we play. That, generally speaking, such humility is lacking, has much to do with the impact of three cultural phenomena from the late 1980s that transformed perceptions of the financial world. The first was Gordon Gekko from the film *Wall Street*, all slicked-back hair, pin-striped suits and ‘greed is good’. The second was Tom Wolfe’s novel *Bonfire of the Vanities*, with its bond-trader protagonist Sherman McCoy: “On Wall Street he and a few others – how many? – three hundred, four hundred, five hundred? – had become precisely that … Masters of the Universe”. And the third was Michael Lewis’s memoir of his time at Salomon Brothers, *Liar’s Poker*, published in 1989. Lewis was astounded by the way his book was interpreted, writing in a 2008 article:

Author Michael Lewis (second left) playing liar’s poker with three men wearing visors as they scrutinize their dollar bills.

“I had no great agenda, apart from telling what I took to be a remarkable tale, but if you got a few drinks in me and then asked what effect I thought my book would have on the world, I might have said something like, ‘I hope that college students trying to figure out what to do with their lives will read it and decide that it’s silly to phony it up and abandon their passions to become financiers.’ I hoped that some bright kid at, say, Ohio State University who really wanted to become an oceanographer would read my book, spurn the offer from Morgan Stanley, and set out to sea.

“Somehow that message failed to come across. Six months after *Liar’s Poker* was published, I was knee-deep in letters from students at Ohio State who wanted to know if I had any other secrets to share about Wall Street. They’d read my book as a how-to manual.”

Michael Douglas in the Film 'Wall Street'.

© Röhnert / ullstein bild via Getty Images.

American writer Tom Wolfe (1928–2018) was best known for his novel Bonfire of the Vanities and in his journalistic work The Electric Kool-Aid Acid Test.

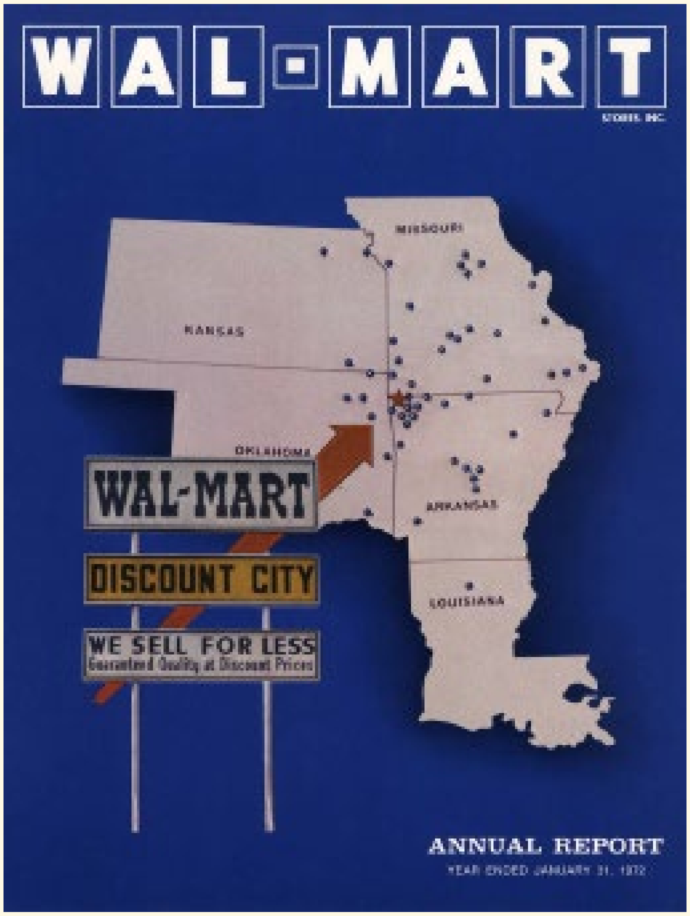
© Sophie Bassouls / Sygma / Sygma via Getty Images.

Rather than masters of the universe, financiers should aspire to the sort of role in society described by John Maynard Keynes in his 1930 article, *Economic Possibilities for our Grandchildren*: "But, chiefly, do not let us overestimate the importance of the economic problem, or sacrifice to its supposed necessities other matters of greater and more permanent significance. It should be a matter for specialists – like dentistry. If economists could manage to get themselves thought of as humble, competent people, on a level with dentists, that would be splendid!"

That investment managers haven't yet managed to reach the level of dentists has several causes. One is that investment strategies are to some degree seen as Veblen Goods – the higher the price, the better the quality – even though studies suggest this not to be the case. In addition, fees are typically struck relative to the level of assets under management. So while firms trying to win business will take risks, holding out promises of differentiation and genuinely active management in order to attract clients, once those clients have been won, the manager's emphasis shifts to protecting what they have in order to hold on to the assets for as long as possible. The simplest way to do this is to avoid taking risk by staying close to the index. While doing so may minimise the likelihood of poor relative returns, it also, of course, minimises the likelihood of good ones, condemning many clients to expensive mediocrity in their investment results.

"I was knee-deep in letters from students at Ohio State who wanted to know if I had any other secrets to share about Wall Street. They'd read my book as a how-to manual."

MICHAEL LEWIS, 2008.



Wal-Mart 1972 annual report cover.
© Walmart.

HOW HIGH SHOULD FEES BE?

It is a commonplace, and not only in the finance industry, that there should be a positive relationship between risk and reward. But perversely the current structure of investment management fees leaves the manager's reward guaranteed, at least for a period of time, and the client bearing the risk of an uncertain outcome.

The rule of thumb seems to be that asset managers should reasonably share around a quarter of the gross value added above the benchmark return. In the isolated case of an individual firm managing to add value over the long term that doesn't seem excessive. But there is a fallacy of composition here: an approach that appropriately rewards one successful investment firm means at the same time that the active management industry in aggregate delivers returns after fees that fall short of the benchmark return.

The industry should, in this author's view, evolve to a model based on a low base fee, sufficient to cover costs so that an asset management firm can continue to invest during the inevitable periods when its results are poor[1], combined with a sliding, and capped, performance fee. The base fee might, for instance, be 20 basis points, and the performance capture a fifth of the total above 1 per cent. Instead of the hedge fund industry's infamous 'two-and-twenty', we would end up with something closer to 'point-two-and-twenty', striking a far better balance between the interests of client and manager.

VALUE, NOT PRICE

The costs that clients pay matter hugely of course, but only in the context of total returns – as in so much else, we need to make a clear distinction between price and value. At present, the investment industry in aggregate does a poor job and does that job expensively; no wonder our clients' focus has shifted largely to price. Like the US grocery industry in the 1960s when Sam Walton started Wal-Mart, there are too many people charging too much. There is a large pool of investors that just wants simple products at a low price, and they should seek out the investment equivalent of Wal-Mart. And there is a part of the market that is willing to pay slightly more for a significantly better product. But that product needs to be genuinely better so that those clients really are getting value for money. To continue the analogy, at the moment we have the unsustainable position of too much Wal-Mart product being sold at Whole Foods prices. But by the same token, genuinely differentiated investment strategies that deliver long-term value for their clients should not be sold at discount-store prices.

1. As various studies have shown, even the most successful long-term investors are highly likely to underperform for fairly prolonged periods; one can only deviate from the benchmark return in a positive direction by accepting the inevitability of occasional deviations in a negative direction.


Wall
Street

WHAT SHOULD THE INVESTMENT MANAGEMENT INDUSTRY LOOK LIKE?

— It should be smaller. There are currently too many spoons in the bowl, too many managers extracting rent from the assets belonging to long-term savers. As in any other industry, firms offering me-too products or failing to add value for their clients should go out of business. The euthanasia of some of these particular rentiers is long overdue.

— There should be a decent proportion of assets allocated to passive managers, who offer a low-cost benchmark for the active industry to beat – they are the Wal-Mart of the investment industry. But passive must actually be low cost: there are tracker funds in the UK with annual management fees of 1 per cent! And we should be clear that the whole industry can't go this way: at one level passive investing isn't really investing at all, it's buying cheap market access.

— It should bear more of its own costs – and those costs should increase as it invests more in in-house corporate governance and investment research functions. Combined with lower fees this means it should become less profitable. The foot-dragging attempts by many asset managers to avoid paying for broker research themselves under MiFID II Regulations shone an unflattering, though wholly accurate, light on their approach to these things. And we noted with interest a recent piece of investment research from Morgan Stanley that pronounced: "To emerge a winner, Asset Managers must cut costs & enhance investment processes". Enhance investment processes? Of course, constantly. Cut costs? Not so much: companies that respond to customer pressure by cutting their costs rather than investing in their capabilities will, in our view, merely hasten their journey to irrelevance.

— It should encourage positive behaviour at the companies in which it invests. The investment industry has explicit costs, but it also has hidden ones from the corporate behaviours that it incentivises. And these hidden costs may be even more damaging to society. The most damaging of these behaviours are short-termism, a fear of uncertainty, and a narrow focus on shareholder value. By acting as if the next quarter is more important than the next decade, the investment industry discourages companies from investing for long-term value creation. By shrinking from uncertainty rather than embracing it, investors – and therefore companies – are far too unwilling to support the next big thing that might go right, worrying instead about the many things that may go wrong. And, by emphasising shareholder value ahead of the interests of all stakeholders, companies risk losing their social licence to operate. This is not how capitalism is supposed to work.

— It should show a greater awareness of its role in society and be more willing to engage with the interests of the end beneficiaries. We might even hope this leads to greater humility among financial industry participants.

— And a plea in the opposite direction: if our societies are to continue on the path of shifting the responsibility for savings onto individuals, those individuals must be educated about the decisions they are taking. There is an assumption that because information is freely available the investing public can take well-informed decisions – and perhaps if that were true the problems we have described would solve themselves as customers voted with their feet. But at the moment we have a deluge of information that serves only to confuse, not enlighten. Perhaps simple, clear investor education should be our next endeavour.

QUIS CUSTODIET IPSOS CUSTODES?

One of the central tasks that falls to investors is overseeing the governance of the companies in which they invest. As long-term investors this is a key part of our role, and one that requires close co-ordination between the experts on our Governance and Sustainability team, who have written extensively on the topic, and our investors.

Logic dictates that alongside the greater emphasis on the way listed companies are governed we need to ask, 'Who guards the guards?', and scrutinise the governance, culture and motivations of investment firms themselves. As a private partnership we are not subject to the oversight of the market, though we would argue that the long-term nature of our ownership structure (110 years and counting…) instils a discipline far superior to that of the stock market: as Charlie Munger noted, "a partnership must be extra careful in its behavior".

But notwithstanding the organisation and culture of our own firm, whose merits our clients, regulators, employees and owners assess for themselves every day and in every interaction with us. The point stands that investors sit in judgement on companies while their own affairs continue largely unquestioned. Such self-policing is rarely good for customers, a point that was starkly made in 2015 when two investment firms threatened to resign from the Investment Association, a UK trade-body for the industry, because its then head was pursuing an agenda that, in their eyes, put too much emphasis on customers' interests. This seems to us a myopic and adversarial view of the investor's task, and completely the wrong way round: it is crystal clear to us that – as in any industry – putting clients' interests first is, in the long run, the best way to advance your own interests. The relationship between an investment manager and their client should be symbiotic; that it is often viewed as parasitic can be no surprise if this is the way that some firms behave.

– Logic dictates that alongside the greater emphasis on the way listed companies are governed we need to ask, ‘Who guards the guards?’...

SMALLER, CHEAPER, BETTER

Nobody owes us a living. Like any professional undertaking in any realm of our society, we stand or fall by the quality of the job we do for our clients. But for too long the investment industry has seemed to take its inspiration from the slogan of the Olympic Games: Faster, Higher, Stronger. Faster trading, higher fees, a stronger position relative to its clients. We can't help thinking that it should be targeting the exact opposite: Slower, Lower, Weaker. Slower levels of portfolio activity, lower fees, and a weaker position compared to its clients and society. That's hardly a rousing slogan, admittedly, but it is an optimistic one, as it would mean the surviving investment firms were doing a better, more valuable, job.

Investors who are serious about actually investing need to differentiate themselves from the mass of index-plus managers charging high fees and caring nothing about the social utility of what they do, or the long-term health of the companies they support. If they do this, those that provide good long-term returns to their clients net of all fees should thrive. And, of course, ours is also an optimistic message for clients, who should get better investment returns after fees, and more gravy for their ultimate beneficiaries.

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