PRICE**VALUE**PARTNERS

Failure, guaranteed

"Advertising is a valuable economic factor because it is the cheapest way of selling goods, especially if the goods are worthless."

- Sinclair Lewis.

There are at least three serious impediments that prevent fund managers from doing their job – to make the best possible return for their clients – properly.

The first, and the most critical, is that the main commercial driver of fund management organisations is to generate fee income. Under conventional *ad valorem* fee structures, the more assets fund managers manage, the more they earn. Awkwardly for the industry, a growing library of evidence suggests that the larger fund managers become, the less likelihood they have of delivering superior investment returns. Above a certain level of assets, size is likely to correlate inversely with performance. This is unfortunate for the retail investors who are most easily won over by the power and marketing heft of well-funded brands.

Louis Lowenstein's book *The Investor's Dilemma* serves to remind us of the dangers of size:

> There is a profound conflict of interest built into the industry's structure, one that grows out of the fact that (mutual fund) management companies are independently owned, separate from the funds themselves, and managers profit by maximizing the funds under management because their fees are based on assets, not performance.

As Bloomberg's Chet Currier has observed, *asset bloat*, as investor capital comes tumbling in on the back of a manager's hot track record, has a tendency to make superior performance mean-reverting. Fund researchers Morningstar point out that:

> The worst effect of the asset bloat phenomenon is simple. The more money a fund has in it, the less nimble it becomes. If a fund's asset base increases too much, its character necessarily changes.

Which is something Fidelity, for example, have experienced before, in the form of the Magellan Fund, one of the world's highest-profile actively-managed funds. When storied manager Peter Lynch left Magellan in May 1990 after 13 years with the group, the fund had grown to $13 billion in assets. By the time Morris Smith left in July 1992, the fund was up to $20 billion. On Jeffrey Vinik's departure in June 1996, assets were up to $50 billion. By the end of the century, Magellan assets had grown to over $100 billion (the fund was closed to new investors in September 1997 and peaked at almost $110 billion in August 2000), only to see them fall back to $52 billion on manager Robert Stansky's departure in 2005, through a combination of investment losses and investor outflows. Stansky is even believed to have helped coin the phrase *closet indexer*.

The journalist Dan Gross has pointed out the downside of managing vast pools of capital – which is essentially the law of large numbers that others, including Warren Buffett, have highlighted. Once you get beyond a certain size, any individual investment is just too small to move the needle of the aggregate portfolio. It's also difficult to trade nimbly, and the manager is inevitably constrained to mega-cap stocks. (Which in some cases are now trading at all-time highs.)

The second impediment to generating superior performance is that most fund managers fail to beat their benchmark. Investors who are content to receive the returns of an established market benchmark – the FTSE 100, or the S&P 500, for example – would be better off owning low-cost index-tracking funds instead. Worse still, most investment benchmarks are irrelevant for the investors they are supposed to serve – or actively injurious to their interests.

The third impediment to performance is that professional fund managers and financial institutions have grown to the point that they have *become the market*. This is what is referred to as the principal-agent problem. In a piece of research that questions the City's sustainability, Legg Mason's Michael Mauboussin asks a simple-sounding question: whether financial institutions matter to asset pricing. In traditional economics they don't, which is just one more reason why traditional economics is a waste of time.

Franklin Allen, we are told, gave a presidential address to the American Finance Association in 2001 in which he identified a strange dichotomy. In corporate finance, agency theory – and the role of economic agents has been extensively explored over a period of 75 years. In asset pricing theory, however, agents are almost completely absent. As in traditional economics, the role of institutions within the financial markets has been *assumed away* to make the equations easier. As Mauboussin points out:

> Several market observers, including Jack Bogle [founder of the Vanguard Group], Charley Ellis [founder of Greenwich Associates], and David Swensen [Chief Investment Officer of the Yale University Endowment] have been vocal in pointing out that the agents – professional money managers – have incentives to behaviour that is not in the interest of investors.

Mauboussin asks why financial institutions and related agency costs have played so little role in asset pricing theory. One answer, he reveals, is that for a long time there ***was*** no principal-agent problem:

> As recently as 1980, individuals owned almost three-quarters of all stocks. Only recently have principals delegated a majority of assets to agents – financial institutions such as pension funds and mutual funds – but principals dominated agents as asset pricing theory developed in the 1950s and 1960s. For instance, in 1950 individuals directly controlled over 90% of corporate equities. Agency theory wasn't in the models because agents weren't in the picture.

Agency theory matters because agents control the market. They control the market in absolute monetary terms, but also in marketing, research and newsflow. They control the chatter about the marketplace, too.

Agency risk is the risk that you, the end investor, may not be well served by an economic agent – your fund manager, for example – who has little or no personal skin in the game. An economic agent isn't focused on outperforming, just on keeping his job. Faced with the career risk that comes with straying far from the herd peer group, an economic agent will prefer to sit right in the middle of that herd instead. Those in the middle of the herd rarely get fired for generating a herd-like return.

One response to agency risk is to adopt exclusively passive investment products, such as exchange traded funds (ETFs). But this doesn't solve the agency risk problem: economic agents also administer those funds. Giving them money in a passive form enables them to control the market further. And favouring a passive approach does not remove decision-making – it merely transfers it to the sponsor of the fund, along with their preferred process for replicating the market return.

And it still leaves the problem for the private investor of asset allocation – deciding how to allocate your assets between stocks, bonds, property, cash and anything else. Unless one slavishly follows a rigid rebalancing approach across multiple asset classes that permits no variation or subjective assessment of value, the informed investor still needs to take active asset allocation decisions. These decisions are extraordinarily difficult in an environment of explicit financial repression, puny or negative interest rates, and the artificial manipulation of prices in stock and bond markets. And now, Quantitative Tightening on top.

Almost all large investment institutions allocate their clients' capital in accordance with indices. During the last week there were a number of key index-related developments. General Electric was finally ejected from the Dow Jones Industrial Average, an overhyped throwback to the early 20th Century, in which the performance of 30 stocks chosen by a committee is tiresomely reported by the world's clueless financial media (which is admittedly tautology). The index-provider MSCI also decided to promote Saudi Arabia and Argentina (?) from 'frontier' to 'emerging market' status, thus proving that index-providers are more than capable of acting independently of both ethical concerns and common sense. This promotion is, however, more than just technically important, because it enables billions of dollars to flow into these countries from index-tracking managers forbidden from investing in frontier economies but permitted to invest in emerging ones. (Another market likely to benefit from this promotion in the years to come is Vietnam, which, unlike its formerly frontier peers, is objectively cheap and going like a train to boot.) Finally, index provider Russell decided to rearrange the composition of its own small and large-cap indices.

Going passive may save on fees, but it also comes with the inherent problem today of buying markets that in many cases are close to their all-time highs. It is perfectly possible to be penny-wise and pound-foolish. As Michael Douglas pointed out in the film *Wall Street*, a fool and his money are lucky enough to get together in the first place. As to the problems highlighted above (asset size being an anchor to performance, and index-tracking being a guaranteed way to lose money in a bear market), the ways to resolve them are entirely straightforward. Favour boutique managers with skin in the game over asset gathering factories, and favour entirely unconstrained managers over primitive index-trackers.

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Tim Price is co-manager of the VT Price Value Portfolio and author of 'Investing through the Looking Glass: a rational guide to irrational financial markets'. You can access a full archive of these weekly investment commentaries here.

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