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The Asset Management Industry

Portfolio investment consists of that which takes place by the purchase of marketable securities, both bonds and equity. Portfolio investment in emerging markets has increased dramatically in the past 15 years. Reasons for this are summarized in the following long sentence (Eichengreen and Mussa 1998, 5).

> These developments reflect technological change, which has reduced the cost of issuing and trading securitized financial instruments; privatization, which has created a population of profit-oriented companies in which it is attractive to invest; far-reaching deregulation of financial markets in key industrial countries in the 1980s and early 1990s, which played an important role in allowing developing countries to raise capital in the forms of bonds and equity; the growth of institutional investors like pension funds and mutual funds with an appetite for foreign securities; and macroeconomic and trade reform in developing countries, which has rendered emerging markets more attractive to investors seeking to diversify internationally.

This chapter contains a description of the ways in which the capital markets are organized. It identifies the problems that arise as a result of the organization of the asset management industry so as to provide a background for the subsequent discussion of reforms that might stabilize the flow of capital to emerging markets.

How Asset Management Is Organized

Perhaps the most important purpose of the financial system is to intermediate funds from savers or, more accurately, from wealth owners to borrowers. One thinks of wealth owners as primarily households, but

many types of organizations also have assets to invest for the long term (e.g., foundations and endowments) or to hold until needed (e.g., corporations and governmental units). Borrowers constitute corporations, public-sector entities, nonprofit organizations, and households. They may borrow by taking nonmarketable loans,[1] by issuing bonds[2] or short-term fixed interest debt, or, in the case of corporations, by issuing equities, which are ownership claims. These entitle their holders to share in the residual profits after all expenses, including those of servicing the corporation's debt, have been paid. Both bonds and equities are normally marketable, meaning they are traded on active markets at prices that fluctuate to equate supply and demand, that is, at prices that ensure that the outstanding stock of securities is willingly held. Both bonds and equities may also be issued privately (unregistered), but these are rarely traded.

Some securities are bought and held directly by wealth owners, but (at least in the United States and some of the other major industrial countries) the majority are held by financial intermediaries, or asset managers, who finance their purchases by issuing claims to the public. The most familiar of these intermediaries are banks, which issue claims fixed in nominal value and keep the bulk of their assets in direct nonmarketable loans but which also hold some marketable claims, either bonds or short-term assets like certificates of deposit (or, in some countries, also equities). Some of the other financial intermediaries, notably the savings and loans, are quite banklike in that they too issue liabilities fixed in nominal value and hold a large volume of nonmarketable claims with fixed nominal values. Indeed, they are sometimes classified together with banks as depositary institutions.

The main asset managers are (life) insurance companies, pension funds, mutual funds, hedge funds, and portfolio managers. All of these except defined-benefit pension plans and fixed-value insurance policies differ from banks in that the liabilities they issue in order to acquire the funds they manage are not fixed in nominal value. Most of the assets they acquire are marketable securities with prices that fluctuate on some market from day to day, although several of these asset managers may also place a part of their portfolios in private equity. Thus, an open-end mutual fund can be sold at the redemption value of the securities held by the fund on behalf of the purchaser. A defined-contribution pension fund promises to pay a pension equal to the annuity that can be bought by the sum (including accrued interest and capital gains) the contributor has accumu-

1. This is essentially the only option for households and nonprofit organizations although that statement needs to be qualified by noting that mortgages or credit card debt may be packaged by investment banks so as to form the backing for marketable securities.

2. Bonds are usually defined as relatively long-term, fixed-interest assets. Fixed interest nowadays does not mean exactly what it says because bonds may pay an interest rate that is periodically revised in accordance with some specified formula (such as the London Interbank Offered Rate, LIBOR, or the increase in some price index plus x percent).

lated. The investors in a hedge fund are entitled to withdraw their share of the fund's value on a defined date.

Asset managers may also manage funds that they receive from other financial intermediaries rather than directly from the public. These portfolio managers run what are usually referred to as boutiques. They form a key part of the system of financial intermediation but, presumably because they do not deal directly with the public, they receive little public notice. They have also received relatively little academic attention. Their role is to bring specialist knowledge to bear in selecting the particular securities to include in a portfolio; they normally limit their purchases to the area (geographic, sectoral, or both) in which they have declared an intention to invest and on which they claim specialist knowledge. Asset managers constitute the bulk of what is referred to as the buy side of the capital market.

A final element in the system of financial intermediation is the investment banks. Nowadays investment banks are allowed also to carry out commercial banking functions in a single institution and therefore tend to be financial supermarkets. An investment bank as it was organized before 1998 did some investing on its own account, some asset managing on behalf of its private clients (the polite euphemism for those who have more money than they know what to do with), trading, underwriting, packaging mortgages or credit card debt and issuing the marketable bonds that they back, mergers and acquisitions, and so on. Perhaps their most important role in intermediating funds from savers to investors was underwriting, that is, helping the ultimate borrowers issue marketable securities (bonds and equities) and placing these with the asset managers. Investment banks acting this way constitute the sell side of the capital market. They are also active on the buy side, investing both on behalf of their private clients and on their own account by their proprietary trading desks, which act pretty much like hedge funds in ferreting out market anomalies and good bets that they judge to offer the prospect of a high rate of return.

One additional distinction is worth noting. Most financial intermediaries, including banks and many asset managers, are organized as profit-making corporations, run for the benefit of their shareholders. A part of the industry, however, is run by trustees on behalf of the clients who make the investments. This part includes the endowments and foundations and also some life insurance companies and pension funds. (Until recently some investment banks were still organized as partnerships, but this is now uncommon.)

Problems

Creditors in the capital markets thus involve a wide array of actors. Some of these are hedge funds and the proprietary trading desks of banks, which may hold long- or short-term assets but in any event frequently do not hold them for very long; others are, or at least were, much more likely

to be patient holders. In particular, insurance companies and pension funds issue long-term liabilities with a market value related to the value of their portfolios of assets. Logic therefore says that they can afford to buy and hold long-term assets based on their appraisal of the long-run risk-return trade-off or else place funds with portfolio managers who invest on that basis. Having many such lenders in the capital markets is attractive to borrowers because it allows them to make real investments with an eye to the long term and ride out short-term difficulties by borrowing more rather than liquidating their investments. In particular, such lenders are attractive from the standpoint of emerging markets, which get a chance to borrow without the ever-present threat of a crisis prompted by attempts to run before everyone else has done so.

Unfortunately the asset management business suffers from pervasive principal-agent problems. The ultimate principals, the wealth owners, want a good combination of return and risk. Tastes will differ as regards willingness to bear risk, but everyone wants to be on the risk-return frontier, and individual investors can give some idea of how much risk (and what type of risk, e.g., regarding surprises in real or nominal returns) they are willing to bear.

For several reasons, the agents—the various types of financial intermediaries and fund managers—may find their interests conflicting with those of their principals. To begin with, the agents have a direct interest in being generously rewarded for their professional activities, with rewards that come out of the pockets of their principals to the extent that their remuneration is not necessary to induce their level of performance. Agents who are not particularly talented or industrious obviously have an interest in concealing that fact from their principals so that they get rewarded as though they were particularly meritorious. Furthermore, the agents may be able to profit by diverting investment into activities where their friends can earn rents, at the expense of the returns that the investors can expect to receive. Investment banks, for example, make money out of debt restructurings and may therefore discourage the creditor forbearance that might enable an illiquid debtor to overcome its difficulties in a way that is in the collective interest of the creditors. At times the abuses have been egregious: A particularly notorious example concerns the ways in which Kohlberg Kravis Roberts ripped off their clients during the years of excess in the late 1980s and early 1990s (documented by David Swensen 2000).

Attempts have been made to address these pervasive problems by fashioning appropriate incentive structures. Two are of key importance. The first is legal: The trustees and directors of many of these asset management organizations are defined as having fiduciary responsibilities.[3] That

3. Hedge funds do not have fiduciary responsibilities; they invest only sums deposited by those assumed to be able to look after themselves, like rich individuals, and are therefore completely unregulated apart from rules intended to prevent fraud.

is, they are placed under a legal obligation to act prudently to further the interests of those who place money with them, the principal, rather than to pursue their own financial interest. Regulations may then specify further what is and is not to be regarded as prudent; for example, regulations may restrain an insurance company from holding bonds below investment grade or from holding foreign bonds. The alternative approach is known as the prudent-man rule: A fiduciary is permitted to make an investment that is in itself risky if the expected return is judged high enough to justify the level of risk and if the overall portfolio achieves a sufficiently low level of risk.

It is difficult to be certain that a fiduciary is indeed fulfilling its responsibilities because of another pervasive problem that distinguishes the financial markets from the classic perfect market: asymmetric information. The asymmetric information problem will be especially acute if the fiduciary follows a prudent-man rule instead of abiding by a set of arbitrary ratios, which may not result in good investments but do at least provide an easily policed constraint on opportunistic behavior. A contrarian investment policy—seeking to profit from market fads by buying what is temporarily unpopular and selling what is currently popular—is particularly liable to result in losses when the agent's peers are doing well and, thus, to make the fiduciary inappropriately vulnerable to criticism for inadequate performance.

The other key incentive structure intended to respond to the potential gulf between the interests of principals and agents consists of the remuneration structure of the agents, which is intended to align their personal incentives with the welfare of their principals. The standard practice is to pay the agent a base salary that is augmented by the possibility of earning a substantial bonus for superior performance. The base salary is intended to secure a reasonable standard of living for a manager even for a performance that is only normal, and the bonus pays a part of the benefit that would accrue to the agent's principal if the returns are exceptional, thus providing the agent with an incentive to make an effort to achieve such exceptional returns. The bonus is normally based on the extent to which the portfolio that is managed achieves a higher return than the norm for the asset class in which the investment is made, as measured by the index for that asset class. Such indices (for example, the S&P 500 for the US stock market or the EMBI for emerging-market bonds) now exist for all the major asset classes and for many subclasses.[4] The normal practice is for

4. The traditional (as opposed to alternative) asset classes considered by Swensen (2000, 159) are long-term US Treasuries, US Treasuries, AAA industrial bonds, mortgage-backed securities, high-yield bonds, emerging-market debt, large-cap US stocks, developed-country foreign stocks, all-cap US stocks, emerging-market stocks, and small-cap US stocks. Swensen emphasizes that asset classes change over time, reflecting changes in the economy, and even at any one point in time a different classification would have been possible.

mutual funds to give quarterly bonuses based on comparison with the chosen index and for pension funds to give bonuses on an annual basis.

The problem with this solution is that the time frame over which bonuses are defined may not be long enough to permit a contrarian investment policy to bear fruit. If bonuses were paid annually and fads lasted only a few months, the bonus system might indeed give a manager the right incentives. But if bonuses are paid on an annual basis (or, worse, if they are paid every three months) while fads can last for years at a time, a totally responsible investment manager who makes long-term contrarian bets can forgo bonuses most of the time. Worse still, the manager may risk getting fired for falling significantly behind the index for a period shorter than a fad can last. The bonus system is an attempt to respond to the very real problem of making sure that managers act in the interest of their principals, but it can provide an incentive for managers to make sure that they do not depart far from the index, a pattern of behavior that can in turn amplify and prolong fads and undermine market efficiency by contributing to herd behavior.

This is presumably a major part of the explanation for the transformation in the financial system that is noted by Henry Kaufman (2000). He argues that in former times most financial institutions operated with a long time horizon, holding assets that they had bought for the long term. In recent years, however, the search to maximize short-run returns in every quarter, which used to be limited to hedge funds and the proprietary desks of the investment banks, has become generalized to the whole of the financial markets, leaving few contrarian or patient investors. This is clearly bad for the borrowers, but there is another issue as well.

Is Short-Termism Good for Creditors?

It is tautological that the long-run return to the lender will be maximized if the short-run return is maximized in every period. Nevertheless, it does not follow that the right way to maximize the long-run return is to seek to maximize the return in every short-run period. The reason is that this creates a danger of precluding a contrarian investment strategy (of buying something when its price falls, when it is most likely to be available at a bargain price). Some contrarian investors, like David Swensen (2000), who has managed the Yale portfolio, have done their principals proud. The principle he used was to decide on the basis of long-run criteria a target allocation of his portfolio among asset classes, which meant that a fall in the price of a class required him to buy more of those assets in order to hold constant the percentage of the portfolio held in that asset class. The contrarian investment strategy was thus built-in and, in practice, yielded richer returns than the constant chase to maximize short-run returns, with the danger of being carried along for too long on fads.

A particularly talented portfolio manager may be able to use personal skills to achieve superior returns, at least as long as the manager's principal is not afraid of risk. That is presumably the reason for the success of the hedge funds: Some people with superior skills may need a regular investment test and reward to motivate them to outperform their peers. But the typical quarterly performance–chaser almost by definition cannot outperform the market, in which case it is not clear why investors should prefer those actively managed funds to indexed funds that give similar returns and incur fewer transaction costs. An increasing number of investors seem to have concluded just that, to judge by the increasing popularity of indexed funds.

Hence, one might think that the way to make the capital markets more friendly to emerging-market borrowers would be to scrap or modify the link of the remuneration of asset managers to market performance. However strongly an asset manager may believe a security to be misvalued by the market, that manager simply cannot afford to follow personal convictions if the manager believes the crowd is going to perpetuate its error for any length of time. That is the way to risk not only a bonus but even the job. Professional prudence dictates not straying too far from the benchmark, that is, not defying the herd. Why not simply prohibit bonuses?

Doubtless the lawyers would have a field day devising ways around any such prohibition if it were to be imposed, but an even more basic reason is that the bonus responds to a very real problem—that of aligning the interests of principals and their agents. How about the possibility of modifying the bonus formula instead? During my research as background for this study, I talked to a number of firms, some of which were seeking alternatives because they recognized a problem with current practices. I talked to one company that was experimenting with alternative formulas by using three-year as well as one-year performance and a cap on the bonus if the manager beat the benchmark by more than 250 basis points, on the argument that this would discourage gambling behavior. A pension fund said that it specifically sought managers who did not make a practice of hugging the benchmark. One manager said that his organization did not make use of bonuses at all. Most firms can see a problem, but it is one they do not know how to deal with: Rejecting the use of the benchmark would mean they would have no way to evaluate managers at all.

Because the problem is that the bonus design provides an incentive to follow the herd in the short run without paying proper attention to the likely long-run consequences of where the herd is heading, a natural possibility would be to introduce longer-run performance into the design. Suppose, for example, that a manager were paid a quarterly or annual bonus only after a delay. To be specific, suppose that a manager were to be paid the bonus for performance in 2004 after five years, in 2009, only if subsequent events had not established that the investment strategy being

pursued was flawed. This would provide a very concrete incentive to assess the longer-term sustainability of the manager's strategy, and it would not be difficult to use tax policy to encourage all asset management organizations to revise their remuneration practices in this way. One could provide that bonuses paid more promptly or without appropriate conditionality would not count as an expense that the employer was entitled to deduct from revenue in calculating taxable profit.

Such an approach would be relatively easy if asset managers stayed in the same job for their whole careers; they would receive their year 2004 bonus in due course provided that the portfolios they were managing had not performed worse than some agreed standard in the succeeding five years.[5] This approach unfortunately runs into difficulties when a manager quits. One surely would not want to give an artificial incentive to accelerated turnover of managers by paying out the bonus unconditionally to any manager who quit the job. Could one notionally freeze the portfolio as it was on the leaving date and apply the agreed test to that hypothetical portfolio? Because managers change their portfolios all the time, that would hardly seem just. Would one look at the performance achieved by the manager's successor and assume that the departing manager's policy would have been the same? If that is a good assumption, one has to have doubts as to whether it was worth hiring or firing one or the other manager. Would one require the departing manager to continue managing a hypothetical portfolio for the succeeding five years to establish that the manager could have achieved the hurdle level of performance? That would be wasteful and appears quite unrealistic. In short, there seems no remotely satisfactory solution. But is that really sufficient reason to abandon the attempt to introduce a concern for longer-term results into the incentives facing asset managers?

An alternative approach would involve more radical change in the way the industry functions, with trustees taking a bigger part of the burden on themselves. Instead of hiring managers to make the critical decisions and seeking to blame those managers when things go wrong, trustees could themselves decide to buy and hold for the long term. Or they could decide that a certain proportion of their portfolios was going to be invested in an asset class like emerging-market bonds and then hire a manager to look after it for 5 or 10 years, with a bonus to be determined only at the end of that period on the basis of cumulative performance over the whole period. They might even experiment with assigning a portfolio to a manager for a 10-year period and then rely on the manager's sense of professional responsibility to act in the best long-term

5. One possible standard would be that the portfolio had never fallen more than a certain percentage, say 20 percent, below its value at the end of the reference year over the succeeding five years. Another might be that its value at the end of the five-year period was at least as great as its value on the reference date.

interest of the principals. After all, some people find that a professional challenge provides sufficient motivation for exceptional effort, without a need for monetary incentives.

One can hope that such practices as these will be adopted in some companies and may even spread. However, I was unable to persuade myself that they provide a basis for a program that could be instituted by public policy. In the next two chapters we turn to examine proposals that would more readily lend themselves to policy initiatives.