Response to Green Paper COM(2011) 164 “The EU corporate governance framework”

Submitted by Martin White, July 2011

I am pleased to have the opportunity to respond to the Commission’s Green Paper (GP).

This response concentrates on what I understand to be the main objectives, drawn from the GP’s first three pages, namely

A) To have well run, sustainable companies.

B) To discourage harmful short-termism and excessive risk taking, and replace them with a more durable philosophy and culture within companies.

C) To consider the role of shareholders and their agents in achieving these two desirable outcomes.

I am grateful that under the paragraph headed “objective of the consultation” on the consultation’s web page, the final sentence invites respondents to flag items the commission has not considered so far. I have taken advantage of this invitation, and this submission therefore contains material not explicitly asked for in the GP’s 25 numbered questions, but all completely relevant to the objectives A, B and C above.

I have no problem with the analysis contained in the GP, but feel that many of the suggestions contained within the 25 questions are unlikely to make much difference. I have therefore concentrated on where I have constructive suggestions to make and not on the 25 questions.

What is short-termism?

“Short-termism” itself is not defined in the GP, but for the purpose of this discussion I will set out some of the ideas it conveys to me, which will indicate why I agree that it is a problem:

- Getting rich quick
- Buying something “because it is rising” in the explicit or implicit expectation of selling it to another “mug” in the future.
- General selfishness and disregard for other stakeholders
- Taking advantage of “options” against other stakeholders, whether against shareholders through the use of share options, whether against customers, suppliers employees, taxpayers through the legal mechanism of limited liability

- The opposite of stewardship, patience and prudence
- The absence of honest and intelligent long term thinking
- A focus on market values of assets rather than underlying values, and a consequent unhealthy preoccupation with non-permanent capital gains and losses, as opposed to the more healthy attitude of ownership of sustainable, albeit uncertain, indefinite income streams
- "Academic" research which treats a rise in share prices in response to a stimulus as evidence of the stimulus itself being wealth-creating
- The inability, from which almost everyone suffers to some degree, to keep emotions under control and to put head over heart in economic decisions.
- The ability to close the mind to fundamental problems, because they are not close enough to gain attention over immediate concerns. A good example is where a family, company – or even a country – operates at a loss and is lent too much money by foolish lenders, foolish lenders who either delude themselves that they will ultimately be repaid by the borrower, or without proper analysis presume that others will be forced to pick up the loss.
- Insufficient awareness of counterparty risk, and an uninformed approach to risk and uncertainty more generally.
- A tendency to indulge in wishful thinking rather than cold, objective analysis.
- Short termism is a therefore a mixture of lack of concern for others, coupled with a failure to think ahead. It is a recipe for wealth destruction and damaging social consequences, rather than wealth creation and the development of people.
- Individuals who understand this and who are minded to think long term and keep their emotions under control can profit greatly from it whilst society as a whole is damaging itself. But it is an uncomfortable reason for personal success and some successful long term thinkers are keen to share their insights for the benefit of society.
- Short termism is as much a consequence of lack of awareness and education as it is consciously evil. A good example is the existence of accounting standards which, no doubt without evil intent, were changed to prevent proper recognition of asset weakness by lenders, hiding losses and permitting further losses to accrue.
- All this sounds very negative, but it is still with optimism that I have written this submission.

Cultural change

An important part of what is needed is cultural change from "get rich quick" to "get rich slowly". It is an objective which is difficult to approach directly. Instead progress is needed on a large number of fronts.

In this submission, I have attempted to ask some fundamental questions about short-termism and the circumstances that give rise to it. I conclude that there are many parties that play a part in maintaining the status quo. I ask why it is so entrenched. I discuss how companies should be run, and consider the impact of the complicated ownership structure which diverts control from the underlying owners.

I believe that the problem of short-termism cannot be solved without wider changes in society, and make reference to the problem which individuals face as savers and investors, including their unwitting contribution to the problem of short-termism. Part of the solution in my view is the education and empowerment of individuals.

The plight of individuals as customers of the financial system is not good. It is encouraging that the GP focuses on the behaviour of shareholders and their agents, as is the mention of work such as Paul Woolley's paper "Why are financial markets so inefficient and exploitative?" (reference 48 of the GP)[1].

Many company managers are excellent

Whilst many financial institutions have behaved especially badly and cynically[2], it would be unfair to assume that all company managers would indulge in short-termism and harmful risk taking if left to their own devices. My personal experience as an investor in a few smaller companies whose managers welcome discussion with individual shareholders is completely different from this. The short-termism originates outside companies in many cases, although the accepted wisdom that has built up over the years, especially the falsehood that share options properly align the interests of managers and owners, can have a corrupting influence within companies as well.

No mention of individual shareholders?

Although the wording is potentially misleading, I agree with the GP's assertion (page 3) "there is evidence that the majority of shareholders are passive[3] and are often only focused on short term profits". Unfortunately, the use of the term "shareholders" here conceals the enormity of the problem. There is an agency failure. The "shareholders" to whom the GP refers are not the true underlying owners in most cases, but stewards for those underlying owners. Stewards whose interests diverge from the GP's admirable long term sustainability objectives. There is no mention at all of the existence of individual persons as shareholders, which is unfortunate. A reader of the GP might conclude that they did not exist, and would almost certainly conclude that even if they did exist, they did not matter. Yet individual shareholders, where they do exist, are true owners and should be encouraged.

Accounting has played a part

Another aspect which the GP does not address is the importance of realistic and not imprudent financial reporting. Whilst the accounting rules might strictly be out of scope, I feel they are so important that they deserve a mention in a discussion on governance. The culture within companies should be such that boards want to give a realistic picture to the world, whatever the accounting rules might be at the time. The accounting establishment, in its fear of litigation, appears to have engineered the removal of prudence and the true and fair test as key principles of financial reporting and replaced them with compliance with rules in spite (in the UK – I cannot speak about other countries) of company law requirements to protect creditors and companies from over-distribution of profits. Prudence, and accountability for professional judgment on the truth and fairness of financial reports need to be imposed again, and from outside the profession if necessary.

More thinking is needed before adopting regulatory measures

My view is that the problem of short-termism deserves a wider range of enquiry than is covered by the GP[4]. Fortunately much thinking has already been done by investors following the ideas of Ben Graham, who realised that companies should be studied in their own right, rather than as a share price.

Outline of arguments in remainder of this submission

- Yes, short-termism is a problem, and a much deeper problem than the GP analysis suggests, with so many parties contributing to it.

  Here I consider what short-termism means and how different parties contribute to it

- Why is short-termism so entrenched, and why will a few regulations not fix it?

  I discuss the contribution of human nature, current received wisdom, and the many interests there are in preserving the status quo.

- So how should companies be run? – What values should govern the responsible and sustainable company?

  I look at a hypothetical "ideal" company, in the sense of having an intelligent long term perspective, with a simple ownership structure, and consider what happens when we introduce changes to that structure and to the behaviour of the owners. I set out the concept of three "hurdles"; wealth creation in companies, wealth appropriation by senior managers, and wealth extraction through intermediation.

- Why education and empowerment of individuals are needed for sustainable change in the culture of short-termism – and the beneficial consequences for retirement provision.

- Promoting the interests of the underlying owners

I end with an attachment discussing a long term partnership contract between investor and fund manager.

DISCUSSION

1 **Yes, short-termism is a problem, and a much deeper problem than the GP analysis suggests, with so many contributors to this situation.**

1.1 The Green Paper identifies a number of parties as having a role in short termism, through their influence on the governance of companies. Boards of companies and the larger shareholders who themselves are managing money on a fiduciary basis are the main focus of the paper, but there is also mention of the relationship between institutional investors and those to whom they give asset management mandates and the potential for that relationship to build in long term rather than short term incentives.

1.2 But there are many more parties involved, and potentially involved, in our analysis of why and how short-termism persists, and what to do to change the situation. I now list those that occur to me as currently contributing to the problem, discussing in some cases their current contributions:

- The academic establishment and the “market for excuses”. Rather than studying how wealth is created within companies, and what theories would best help shareholders dictate appropriate principles and values for company boards to follow, academic effort has been focused on how investors can outdo each other. Studying share price movements, with the explicit objective of outperforming other investors, is in part studying the vagaries of investor behaviour, which itself can exhibit what George Soros calls “reflexivity”, with thoughts themselves influencing outcomes. Really successful long term investors concentrate on understanding the underlying companies, rather than on the potential future behaviour of other investors[5].
- Financial advisers to individuals and also to bodies such as pension funds frequently encourage switching investment managers based on recent performance “zyx have been underperforming lately, you had better move money to other managers”. Advice to pension trustees has improved recently however, with increasing recognition that such switching behaviour is a recipe to “buy high, sell low” and that a more patient approach is needed. As a result the proportion of company pension fund equity investment which is in low cost passive arrangements has risen.
- The education system combined with financial services marketing messages; permitting a lack of financial education in the fundamentals, which should include an understanding of the wealth creation process, of the nature of financial uncertainties, the agency conflicts, and the power of compound interest when applied to investment returns, expenses and inflation, as well as the “no free lunch” principle – if it looks too good to be true, then it isn’t true.
- Governments, for their acquiescence or complicity in the disenfranchisement of individuals as shareholders in companies. Shares held in nominee form should not be in pooled (i.e. anonymous) form, but instead regulations should require them to be designated with the company registrars, identifying the underlying investor as well as the nominee. This would enable companies to communicate directly with all investors without involving the nominee in certain communications (such as voting or annual reports or invitations to AGMs), and modern technology

would make this perfectly practical. It would also have the very considerable benefit of assuring the underlying investors that the holdings did actually exist, and help manage fidelity risk.

- Governments (or regulators) who would put obstacles in the way of disintermediation, and of free availability of comparative expense information, all in the name of investor protection.
- Governments, whose tax treatment of debt interest makes many companies inclined to favour raising funds as debt rather than as equity. This permits more geared performance of the equity (good and bad) than otherwise, it makes each company and the overall system less resilient to shocks than otherwise, and when added to a (frequently ill-judged) "return on equity" target and the presence of share options we have a powerful and toxic medicine for excessive risk-taking. The toxic medicine can kill the patient, with all the human and other costs when companies fail.
- Retail fund management organisations whose business model is based on funds under management and on an outperformance "story" rather than on true value created for their clients. With this model, with clients who do not sufficiently understand the impact of annual charges, and who choose, or are advised, to switch from "recently underperforming" to "recently outperforming" funds, the fund managers are terrified of short term underperformance. This may be a particularly powerful single driver of short-termism. These fund managers will also tend towards high turnover levels in the underlying investments, thus incurring trading costs for their clients which further detract from returns.
- A class of fund managers, hedge funds, have as their main marketing message that they will outsmart other investors. Their style is sometimes very short-term and aggressive, the embodiment of making a quick buck at the expense of the other mug. Their ability to "borrow" shares and acquire votes in companies without having a normal economic interest in them is clearly a matter for concern.
- Remuneration consultants, remuneration committees, and the general wisdom about "incentivising" senior management can together have a very damaging effect. The problem starts with a deemed right for senior management to have a chance to become very rich quite quickly. This is achieved by participation in "good" outcomes in some pre-defined way, with share options a very common way of achieving this. There are many problems with this. It effectively transfers, on average, material wealth from shareholders to executives; the reason it does this is that the shareholders keep all the downside but have to share part of the upside. It causes managers to focus on the share price, which is extremely damaging and a perfect recipe for short-termism.

1.3 In contrast to a business model which depends in large part on the lack of understanding of their clients, there are fund managers who are mutually owned, who genuinely compete on price to the client, who do not pay commission to introducers, and who offer a simple product free of counterparty risk, such as tracker funds and non-synthetic exchange traded funds (ETFs). Where there is a passive strategy, with is no pretence at "outperformance" or "added value", the underlying assets are held for long periods, trading costs are minimised, as of course are staff costs. Whilst retail customers are rarely told the benefits of such services, and have difficulty in accessing them without paying something to financial advisers, these services are increasingly used by investing institutions such as pension funds, whose advisers are able to point out the long term advantages of low cost, passive strategies. Large, low cost, passive fund managers sometimes have a stewardship mentality and take their contribution to corporate governance seriously, but the active management industry will try to denigrate their contribution as "mindless investing" and in some way antisocial[6].

1.5 One reads generally of the pressures placed on companies by their shareholders to deliver certain short term results, or to engage in high growth strategies, and I am aware of some specific instances. One which has been well published is the pressure on HSBC (which to their credit they resisted, happily), by certain hedge funds before the sub-prime crisis broke, to "gear up and go for growth". The GP expands on this problem at some length.

1.6 As the GP says, institutional investors do not necessarily feel they have a duty to act as engaged owners. See "Capitalism without owners will fail, a policymakers guide to reform (2002)" by Monks and Sykes[7]. More recently, Lord Myners, a minister in the last UK Government, referred to the problem of "ownerless corporations"

2 Why is short-termism so entrenched, and why will a few regulations not fix it?

2.1 In case readers give up at this point, it is important to restate my optimism. I believe that the Commission could achieve a great deal, over time, but this optimism is totally dependent upon there **being an understanding how great is the potential prize, and a determination to achieve it.** I believe the problem needs to be attacked on very many fronts, but the size of the challenge must be understood first.

2.2 Short-termism is currently heavily entrenched for a number of reasons including the following.

2.3 A powerful motivation for a powerful industry to maintain the status quo, especially its ability to extract wealth from investors. Keeping retail investors and savers ill-educated and ill-informed as to the impact of costs and fighting a rear-guard action against cheap passive funds is a viable business strategy. The UK's Retail Distribution Review (RDR) should start to turn the tide in the UK if it is implemented, however.

2.4 Human nature, of individual savers and investors, does not help, unfortunately. We tend to look for quick and simple solutions, and it is not in everyone's nature to plan ahead or to ask questions when aged 25 such as "what will I live on when I'm 70, given there's a real possibility I could last until 100?" This means we are prey to over-simplistic "get rich quick" ideas without objectively evaluating the possibilities. Thus we are naturally prone to many of the "short-termism" problems set out in para 1.3 above.[8]

2.5 Received wisdom, such as what are appropriate ways of incentivising senior managers, is very difficult to change. First an alternative wisdom has to be developed, and then all the people who have a stake in the old wisdom, especially academics who have taught it all their lives, and consultants who are selected by the people on whose remuneration they advise, have to be overcome.

2.6 For the right incentives to begin to emerge, we would have to see the aim “get rich slowly” as being part of the value set within companies, with “get rich quickly” a thing of the past. This might mean that the mix of personality types at the top of companies ought to change a little. Such changes would happen slowly, if at all.

2.7 The financial regulatory bodies have “stability of the financial industry” as an objective which trumps the interests of the ordinary saver, investor, shareholder, etc. There need to be distinct bodies whose function is to advance the latter without restraint from other objectives. It requires a clear political decision to introduce this – and there could even be opposition from existing regulators who are comfortable with the relationship they have with the financial services industry especially if regulatory experience is helpful in obtaining employment in the industry.

2.8 With a very few exceptions, those individuals who have an understanding of the issues relating to financial education and empowerment will have no personal incentive to put in the effort to make a difference. There is no personal profit in it, just a charitable motivation. Such people can be found within the private investor community, and also within retirees, especially from the financial services industry. But they have to be harnessed and encouraged to share the ideas, something which “investor protection” regulations can make difficult.

2.9 The share register of companies are dominated by institutional investors or their fund managers who, given current relationships, have little incentive to engage within the companies in which they invest. However, individual shareholders do have that incentive, and the power of ideas is frequently greater than the power of votes, but in the UK at least there is currently no support within Government for the suggestion of making use of individual shareholders in corporate governance.

2.10 Institutional investors and fund managers will be reluctant to upset a corporate remuneration culture in the companies in which they invest, if they themselves benefit from such a culture in their own companies.

2.11 Making changes to education is difficult and slow, and it is difficult to reach people after school age.

2.12 There is a deep mistrust of the financial services industry. There have been so many scandals that people have difficulty knowing who to trust, and negative emotions prevent people from taking decisions at all. This means that widespread positive engagement in the wealth creation process can not take place easily. Change will be unlikely to come from a grass roots movement unless it is associated with some sort of consumer champion organisation which is evangelical in its approach, reaching out to everyone, not just to its existing members.

2.13 So the current relationships between many retail investors in “funds” and the managers of those funds, combines with the understanding and behaviour of those retail investors to lead both the retail investors and the fund managers to take short term views.. It does not take every fund investor to be prepared to switch between manager to cause the problem – there just have to be enough of them for the fund manager to be afraid of short term underperformance.

2.14 It can be seen that some of the blocks above could be addressed by courageous regulatory change. But we do need some new ideas to put instead of the accepted wisdom, and I discuss some of these, and their sources later in this submission, starting with an alternative to short-termism in companies themselves.

3 So how should companies be run? – What values should govern the responsible and sustainable company?

3.1 A good place to start is to ask what happens when there are no "outside" shareholders. Whilst the problem of survival bias makes it difficult to draw sound conclusions, some of the very best long-term performing companies appear to have a long-standing founder or family control.

3.2 The owner-managed or long established family company already has enough incentive to think long term. The underlying financial objective will be to maximise long term spendable wealth (after inflation and all taxes) whilst minimising the risk of failure or loss of control. But whilst that is the long term objective and requires a culture of stewardship, it is not an operating objective; it is a consequence of an enterprising approach which is at the same time severely tempered by prudence. The way the company operates will be to do all the good things which the green paper is looking for – to focus on developing and maintaining an "edge" in that part of the economy in which it trades, and doing this requires all the human factors to come together in a patient and persistent way that benefits customers, suppliers and employees. An intelligently run company does not need to have "stakeholder" responsibilities imposed on it; instead it is by providing value to stakeholders that shareholder wealth is ultimately created and maintained.

3.3 Maintaining, and developing, the competitive advantage or edge requires an open culture and a deep humility at board level, so that there is no self-delusion or unjustified over-confidence and the whole organisation is welcoming of challenge to ideas and aware of the need to be constantly learning. This, of course, is not consistent with greedy, dictatorial, impatient and defensive senior managers who have played their part in the banking crisis. Nor is it consistent with preoccupation with the company's share price; indeed, being quoted has disadvantages as well as advantages for a company wishing to pursue a sustainable long term strategy, and understanding and mitigating these disadvantages should be one of the aims of the current consultation.

3.4 Will the managers of this company necessarily be paid huge sums? If it is family controlled, the last thing they will want to do is give up equity. So no share options. They will pay enough to get the people they need who are happy to work there. And, as a company which has clear and healthy values, especially respect for and development of its people, it will be a more satisfying place to work than many. If it is desired to give long term incentives to senior managers, then providing part of the shares were traded on public markets the company might subsidise the purchase of some shares by those managers in the open market, on the condition that they were retained until at least a few years after the managers left the company. That would give an incentive to do the right thing, namely to build the company's capability and competitive advantage for the future.

3.4 Should a company be run differently if owned (in full or in part) by "outsiders"? I would answer no, obviously not. It is in the shareholders' collective interest that the company is run in the way set out above, and any actions that the shareholders as a body take should actively encourage that long term approach.

3.5 We have just painted a picture of an ideal company. My personal view is that it is with such a set of long term objectives in mind that remuneration structures for all companies should be designed, and I try to bear this ideal in mind when selecting companies to invest in myself. Providing its shares can be bought at a reasonable price, the intelligent long term investor in such a company should be happy owning part of it even if the stock market were to close down for ten years. The combination of stable shareholding and the company's traditions, capabilities and culture should create value in the years ahead. Wealth is **created** in the company.

3.6 But it is from this point that we can start to derive the essential lessons about what can go wrong.

3.7 Disaster No 1: What if the ownership of the company changes sufficiently that the tight control on remuneration that prevents gifting parts of the company to the executives is lost. Share options are granted. Some of the wealth created has now been **appropriated** by the management, and the existing shareholders suffer dilution. But it's worse than that. Once one lot of share options have been paid out and a new management team comes, another lot of share options is granted. Another dose of dilution and wealth appropriated by the management. And so on. (Far better, rather than keep giving away chunks of equity to decide that a proportion of the profits should be set aside for employees more widely, with a degree of deferral before they are paid out, depending on the volatility of the business. As well as costing the shareholders less in the long run, this would make for a healthier culture and help maintain a longer term focus, as there would be less focus on the share price.)

3.8 It can be seen that if Disaster No1 strikes, the shareholders lose in two ways. Not only is some of their wealth **appropriated** by the management, but less will be created in the first place, because the management do not have the original, build-the-team-for-the-long-term mentality any more; they are just focused on the share price. But not only do the shareholders lose, so do the employees, as the culture deteriorates.

3.9 Disaster No 2. This one can strike even if Disaster No 1 does not. Best illustrated by the story of the Gotrocks family, as set out by Warren Buffett in his 2005 and 2006 letters to the shareholders of Berkshire Hathaway inc.[9] They start out owning all of American businesses and doing nothing except spending some of the income and reinvesting the rest. Then along come some "helpers" who advise each of them to make more money by trading with each other. And then some more helpers who advise which helpers to choose, and so on. Ultimately, a large proportion of the wealth created in the businesses has been **extracted** by the financial services industry.

3.10 But once again, Disaster 2 is worse than that. The dysfunctional financial markets and their participants (or the Gotrocks' "helpers") put pressure on the companies to perform in the short term, with little concern about the long term, so less wealth is now created in the first place.

3.10 So that's the problem simply put, and where we are today albeit stylised and exaggerated. Wealth is **created** in companies, and the better governed the more is created. But if the governance is not good enough, too much gets **appropriated** by the management. And then, finally, if the owners are stupid enough, a (surprisingly large) part of what remains is **extracted** by the financial services industry. I call the process of creation + appropriation plus extraction the **three hurdles** that face the underlying savers and investors.

3.11 In the Gotrocks, a healthy situation is turned into an unhealthy one by a mixture of stupidity, gullibility and greed, with the "helpers" definitely not in "stewardship" mode.

3.12 We can see that attempts by individual shareholders, by trading in the shares, to increase their wealth beyond their share of what the company creates are obviously futile in aggregate, incur frictional costs, and rely on exploiting a buy high, sell low behaviour of other shareholders. But turnover in stock markets has risen, not fallen, as they have become more "sophisticated" and levels of intermediation have risen, not fallen as they have in most walks of life. The underlying savers and investors whose wealth is ultimately an ownership stake in companies are typically either unaware of the wealth destruction they are suffering, whilst those who are aware of it have limited ability to change the situation. Really effective investment education would need to point out the fundamental truths of the problem: (i) wealth creation by companies and how to encourage it; (ii) (excessive) wealth appropriation by company managers and how to prevent it, and (iii) wealth extraction by financial intermediaries including fund managers. But there is little incentive for the financial press to deliver education of this nature; their advertisers may wish to sell products and services which are not in the best interests of their customers

3.13 (Here I will use the UK situation for illustration, but similar pressures have applied in other countries as well.) Over the decades the ownership pattern of companies has changed. Once the share registers were dominated by individual private investors, insurance companies, and company pension funds, largely making their own investment decisions. Over time, the task of making investment decisions was increasingly delegated to specialist fund managers. It is striking that in almost all of the current set of post-2008 public policy discussion documents, of which the Green Paper is one, there is virtually no reference to the position and role of individual savers and investors who are the ultimate beneficiaries to whom all financial services owe a duty.[10]

4 Why education and empowerment of individuals are needed for sustainable change in the culture of short-termism – and the beneficial consequences for retirement provision, among other things

4.1 Short-termism in companies would be less prevalent if there were more widespread appreciation of the intelligent owner perspective. People would be able to distinguish between behaviour and incentives that encouraged long term building and maintenance of competitive capability, and the resulting wealth creation. But there is no chance of this happening until ordinary citizens, or enough of them, learn to think of themselves as owners, and the understanding needed is taught within the educational system.

4.2 Anyone who invests even indirectly in industry is an owner, providing there is an equity component. But for most people, the world of wealth creation and the ownership chain is not something they think about. On the contrary, there is a deep mistrust of the system and all the parties within it, for reasons that will be well known. To quote from Paul Woolley's paper[11] :-

> "The second key consequence of asymmetric information is the ability of financial intermediaries to capture "*rents*", or excess profits. Rent extraction has become one of the defining features of finance and goes a long way to explaining the sector's extraordinary growth in recent years, as well as its fragility and potential for crisis."

For individuals, the problem starts with commission bias.

4.3 If you talk to an individual who is not in an employer-sponsored defined benefit pension arrangement about retirement saving, you will be likely to hear "I don't know who to trust". And with good reason. Faced with this situation, the likely consequence is to do nothing.

4.4 Financial education within the curriculum should be able to teach the basics – especially the lessons from section 3 above. But for there to be any real benefit, people need the capability to act on their knowledge. Unless the "I don't know who to trust" problem is resolved, financial education will make little difference to people's lives.

4.5 To achieve this there has to be some body, or ideally more than one, that people can trust to obtain essential financial information needed to make decisions.

4.6 Faced with a market failure of the scale that exists within our overall ownership chain, it has to be for regulators / legislators between them to tackle the problem. Consumer interest and education bodies need to be set up, or encouraged, to make the essential information available. The most important information needed is price – how to understand the impact of charges, and how to avoid or minimise them where possible. This information is extremely difficult to obtain and, having obtained it, there can be legal problems in sharing it. Reducing these problems would help a great deal.

4.7 Associated bodies, or appropriate academic research, can also be used to develop ideas for more appropriate contractual arrangements at every level in the chain. Once again, there is a regulatory / legislative role to make this happen.

4.8 Empowerment for individuals in this context means having both the understanding and the detailed knowledge about the options available – and then to act as intelligent buyers of products and services. This will drive down the price of standard financial products – from which all consumers will benefit. If, for example, by shopping around and being demanding, consumers can reduce annual expenses on managed funds by just 0.5% per annum, this would very materially increase funds available at retirement. And by going to the very cheapest approach, a passive fund paying no commission, the savings could be even greater. The essential lesson is to keep to the absolute minimum any charge or expense which is levied as a percentage of funds under investment. Fixed price stockbroking services can now be obtained quite easily.

4.9 Ideally, one would like to see more people owning shares directly. This should be the cheapest route of all, and there are great benefits for society if individuals are encouraged to take an interest in companies in this way. However, holding individual shares is a lifestyle decision, it requires considerable work to do effectively, and very few investors are likely to outperform the passive indices. It only makes sense if carried out carefully and, most importantly, if it can be viewed as an enjoyable pastime.

4.10 It should be possible for individuals to access simple and extremely cheap fund management services without needing to pay a rent to a financial adviser – and legislation / regulation should ensure this is possible.

4.11 In a new world in which savers and investors learned to be cost-conscious and made much more use of the cheapest routes, the financial sector would undoubtedly shrink, and we could expect some consolidation to occur.

4.11 Whilst it is clear that active fund managers as a whole cannot outperform the market, and that they must seriously underperform once fees and expenses are taken into account – and therefore that the intelligent choice for most people is to use a cheap and passive route – I do not believe that outperformance is impossible for individual managers. In fact, to the extent that the market as a whole is too short term in its outlook, that presents an opportunity to outperform. But it needs the right contractual relationship.

4.12 The GP refers to incentive structures for asset managers. In the Attachment “Active management partnership” I set out what I regard as an intelligent contract for a patient investor to enter into. Unfortunately I have not yet discovered a fund manager prepared to offer this contract. In one sense, it was written to demonstrate a sort of “reduction ad absurdum” for active fund management. But it also demonstrates the kind of relationship that is needed between fund manager and investor to engender trust between them and to keep the eye of both on long term wealth maximisation, with very little concern for the vagaries of the market in the interim.

5 Promoting the interests of the underlying owners

5.1 I believe there is a need for an independent body with a powerful voice to be set up solely to promote the interests of financial service consumers and individual shareholders, including to empower individuals to make their own financial decisions and avoid the intermediary process as much as possible.

5.2 Remembering the "three hurdles" concepts in part 3 above, the body would be able to commission and encourage research in relation to the governance requirements and principles to be adopted by boards and supported by shareholders. The body's objectives would specifically include the encouragement of long term wealth creation within companies. Thus it would not exclude initiatives such as the "Shareholder Committee" idea referred to in notes at the end of this document.

5.2 This body would not have any representatives of the financial services industry in a formal position – it would be dominated by consumer interest groups and not be under any form of political control, though it could take advice from wherever it wished.

5.3 The body could make good use of volunteer resources, especially within the retired community and consumer interest community, and should be cheap to run.

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

(taken from the UK Shareholders Association's "Private Investor" magazine, January 2009)

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?

Martin White

NOTES

[1] Paul Woolley, a former fund manager, hits the spot exactly when he argues in his paper that "Principal/agent problems do a good job of explaining how the global finance sector has become so bloated, profitable and prone to crisis. Remedial action involves the principals changing the way they contract with, and instruct agents."

[2] See the story from Charles T Munger, *A Parody Describing the Contributions of Wantmore, Tweakmore, Totalscum, Countwrong, and Oblivious to the Tragic "Great Recession" in Boneheadia and the Thoughts of Some People Relating to This Disaster* http://www.slate.com/id/2298582/

[3] "Active" managers are frequently passive, in the sense used in the GP. Thus the word "passive" can have two meanings. The GP's usage is where investors do not bother (or, one should add, are not able) to engage with the company. The most common use of the word "passive" in investment circles refers to funds where there is no claim to add value through stock selection.

[4] It should be noted that the economist John Kay has been asked by the UK Government to conduct an independent review of the effect of UK equity markets on the competitiveness of UK business, with the review to report in 2012. To view the terms of reference go to http://www.bis.gov.uk/assets/biscore/business-law/docs/k/11-1015-kay-review-terms-of-reference.pdf

[5] See for example *The Great Investors* by Glen Arnold (FT Prentice Hall), covering Benjamin Graham, John Templeton, Warren Buffett, Peter Lynch, Anthony Bolton, Charles Munger, George Soros, Philip Fisher. Arnold lists their common themes: be a business analyst rather than a security analyst, do your homework, control your emotion, be consistent in approach, keep it simple, constantly learn from mistakes, self-reliance, and reasonable risk taking.

[6] The book *Smarter Investing, Simpler decisions for better results* by Tim Hale (2009), FT Prentice Hall, is used as recommended reading by the UK Institute of Financial Planning. Chapter 15, Standing Firm on Index Funds, starts as follows. "In an industry dominated by managers trying to beat the markets for a living and advisers who rely on the fees and commissions that active investment products provide, you should not be too surprised if you come across resistance to accepting the validity of the index fund and its rightful place as the default vehicle at the core of a portfolio. A number of arguments are used to dissuade investors from using index funds. Have the confidence to know that you are right and stand your ground." He then discusses 6 common put-downs used by such active managers or advisers, and explains the key points to bear in mind to resist them: "The common arguments that you will face are easy to refute. Remember that just because they may be able to find isolated cases to support their arguments, you are playing a game of probabilities, which always lie in favour of using index funds unless an active manager can really demonstrate their superior and sustainable skills."

[7] See http://www.ragm.com/library/Capitalism-Without-Owners-Will-Fail and http://www.cua.uam.mx/biblio/ueas10-I/ueaarticulostodos/Capitalismwithoutowners.pdf

[8] See the talk "On the psychology of human misjudgement" by Charles T Munger, given in 1995 at Harvard university. http://files.arunbansal.com/pdf/Mungerspeech_june_95.pdf

[9] See http://www.berkshirehathaway.com/letters/2005ltr.pdf and http://www.berkshirehathaway.com/letters/2006ltr.pdf search in each case for “Gotrocks”

[10] The booklet *Responsible investing, for the individual and for society*, Published by the UK Shareholders Association at http://www.uksa.org.uk/ri2010.pdf, suggests that individual shareholders could make a meaningful contribution to governance through “shareholder committees” and sets out on page 21 the key features of a proposal that was set out in a private member’s bill in 17 March 2009 by William Cash, MP.

[11] “Why are financial markets so inefficient and exploitative – and a suggested remedy”