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Will TPA sink the asset management industry's 'Customers' Yachts' business model?

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"Long ago, Sir Isaac Newton gave us three laws of motion, which were the work of genius. But Sir Isaac's talents didn't extend to investing: he lost a bundle in the South Sea Bubble, explaining later, 'I can calculate the movement of the stars, but not the madness of men.' If he had not been traumatized by this loss, Sir Isaac might well have gone on to discover the Fourth Law of Motion: *for investors as a whole, returns decrease as motion increases.*"

WARREN BUFFETT

"Again and again, however, we have seen that what is hot in the investment world today, generally turns cold, deathly cold, in the none too distant future."

CAPITAL ACCOUNT, FOREWORD

As readers will know, this writer is often prone to criticise the fund management industry – in particular the "product proliferation and fee enrichment" business model that is practised by most firms. Against an industry backdrop of a rise in low-fee indexation and ever-shorter-term performance measurement periods, active management's answer to relative underperformance seems to have been to promote "product specialisation". Rather than diversified, global mandates with "all-weather" benchmarks, instead concentrated portfolios with niche geographic, sector and/or market cap investment mandates run by "star managers" became the imperative. Paradoxically, as managers converge around narrower, more specialised and "high conviction" investment products, it seems that they can charge higher fees! But the knock-on effects to the end investor don't stop there. As specialisation proliferates, so too do the consultants, manager selectors, oversight committees and internal staff required to monitor it all.

It's hard to find good help these days

This over-specialisation of investment products, together with limited investee names in each portfolio, results in the need for increased oversight and therefore higher staff numbers at institutional asset allocators. It was Mr Munger (RIP Charlie) who popularised the notion of the "croupiers' take" in which he likened Wall Street fees, management expenses and related transactional frictions to a casino house advantage that mathematically reduced collective investor returns below market averages.[1] And in the Berkshire 2005 annual report, Buffett introduced readers to the Gotrocks Family and their ever-expanding collection of "helpers" (ibid., p18).

Initially broker helpers, the list has expanded to include money manager helpers, consultant helpers and even hyper helpers (read: hedge funds and private equity), the latter group with fees that are off the scale by traditional fee standards. According to NACUBO, large endowments increased their average manager roster from approximately 18 managers in 1994 to 108 managers in 2019.[2] Institutional portfolios likely employ an even larger number of managers today as allocations to private and alternative investments have grown further. This proliferation of external helpers has been accompanied by a proliferation of internal overseers tasked with selecting, monitoring and evaluating them. In short, in addition to the age-old risk of active managers underperforming the benchmark, we must now add the risks of over-specialisation, portfolio concentration (with its associated hubris), and widespread over-charging (in our opinion).

The ultimate cause of this proliferation and chaos is the faulty premise that money management is purely a third-party profit-maximising commercial activity where asset gathering trumps fiduciary duty. To fall into this trap is to conflate the nature of the activity itself (a fiduciary activity which demands professionalism, great trust and patience) with the attractive financial returns it has historically generated. Of course, when considered through this commercial lens, anything goes if it increases the

[1] C.T. Munger, 'Investment Practices of Leading Charitable Foundations' (Speech to the Foundation Financial Officers Group, Los Angeles, CA, 14 October 1998).
[2] Richard M Ennis, 'Failure of the Standard Model of Institutional Investment' (Working Draft, October 2020)

croupiers' take. Indeed, an increase in the croupiers' take IS the business model of most fund management organisations!

It seems obvious to us that these trends misalign asset manager and allocator incentives and are therefore unsustainable. While this has become the widely accepted norm for investors ranging from the largest sovereign funds to the smallest family wealth offices, this state of affairs is emphatically *not* in the interests of institutional investors. As Fred Schwed Jr famously wrote, "where are the customers' yachts"?

A better way?

When we founded Hosking Partners, we set out to structure our firm and investment approach to be different. Our global, unconstrained, diversified approach, executed by a team of generalist multi-counsellors, with a low base and long-term performance fee structure is designed to support our 8-10 year investment horizon and align our interests with clients. A far cry from the prevailing highly concentrated, star-manager, consensus-driven quality narrative, this has historically not been the easiest commercial "pitch".

However, our capital cycle investment framework allows us to invest across a broad spectrum of opportunities that specialists, constrained by narrower mandates, often overlook. Our portfolio spans memory semiconductors (held for over a decade), precious metal miners, activist Japanese mid-caps, exotic emerging and frontier market plays (such as Sri Lanka!) and long-forgotten idiosyncratic "value traps" where value is finally being unlocked. And all the time, the investment team is looking for more similarly exciting investments. This portfolio is well diversified with little of the stock selection risk that may characterise a highly concentrated portfolio, and it has delivered meaningful alpha in the last few years. We have been lucky to have the support of long-term, like-minded, patient investors who added during periods of challenging performance during our first decade, a period which may now with hindsight be viewed as an anomaly with the competing forces of zero cost of capital and an influx of Chinese capacity into global markets. As we return to a more normal

cost of capital environment, we believe we can continue to deliver an extended period of strong returns, and new similarly minded, long-term investors are beginning to join us.

A possible industry solution

As our generalist approach appears to become more anomalous in a sea of specialisation, we believe one solution to the industry's "customers' yachts problem" may be found in the Total Portfolio Approach (TPA). At its core, TPA evaluates the total portfolio rather than individual specialised silos. At CalPERS, for example, a simple 75/25 reference portfolio will replace a collection of asset-class benchmarks.

We suspect this approach will expose the true cost of complexity and highlight the fee leakage and organisational overhead inherent in the over-specialised paradigm. More interesting than headline results will be the diagnosis that follows. The attribution of the net result relative to the benchmark will be interesting. For example, did staff identify the appropriate number/blend of specialist funds? Were the practitioners in each asset class above average? Were the mix weightings appropriate? Viewed through a total portfolio lens, these questions become difficult to avoid.

If the result of all this complexity is net negative, as we suspect, then over time one should expect fewer helpers with larger portfolios and more degrees of manager freedom, necessary in order to find (and invest in) the most compelling opportunities. Of course, larger mandates will encourage lower fees as funds cash in on their advantage of scale. The new paradigm may come to resemble more closely the balanced fund as in days of old. In this way the wheels of investment fashion will continue to turn! After all it is an axiom that what gets measured gets managed. It is long past the time that the “product proliferation and fee enrichment model” was held to account.

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