Governance, incentives and decision rights at investment managers

Many investment managers here in Japan have signed up to the Stewardship Code and engage with investee firms on their governance in line with the Corporate Governance Code. However, some might point to governance at the investment managers themselves. What would you say ?

Yes, I would agree that investment managers could do some house cleaning before pointing to others. Internal governance at the captive investment managers of banking and insurance groups, the norm in Japan, features prominently in our work at Casey Quirk.

Good governance with respect to decision rights – starting with portfolio management and including broader hiring and firing – is the hallmark of a successful investment organisation. Governance can be a real challenge for the fund management industry generally, in terms of the independence of the investment management unit, and decision rights with respect to the portfolio and to senior appointments.

Another example is how investment managers decide service providers including custody and best execution. Few investment managers in Japan publish a clear policy on selection processes for custody, administration, best execution or IT providers, who are often group companies. Nor is the cost of each line item transparent. These have a direct impact on the returns fund investors experience. In many countries like the US and Australia, affiliated custody, administration and best execution providers must compete as third parties, and in some countries use of group firms is prohibited.

Perhaps I could say something about voting here as well. A number of Japanese investment managers have spoken to me about being afraid of being called out by foreign investors on the opaqueness of their ESG policy (or lack thereof) on issues like compensation, M&A and other corporate actions, and special dividends/share buybacks. In other countries, investment managers follow the guidance of a reputable third party advisor, or do not vote to prevent conflicts of interest. Best practice is to have a stated policy on how voting is decided, and an independent committee with clear representation of people who are looking at the companies as shareholders, including the portfolio managers, rather than banking/insurance/securities clients.

Many investment managers in Japan are subsidiaries of large financial groups, and relatively few independent investment managers exist. Governance could be defined as the alignment in goals of management, employees, investors/clients and shareholders of the investment firm, to allow sound risk-taking in both investment management and management of the firm. However, this can be difficult to achieve when an investment firm is not independent but has a parent to which it reports, including regarding optimal allocation of resources.

In our experience the best firms overall (as measured via growth, innovation, client loyalty, industry leadership, talent development and retention, operating margins, long-term investment performance) are independent firms where senior management are major owners of the business, and so they are keenly focused on (i) keeping their clients happy via steady returns and constant product/service innovation and (ii) keeping their investment teams stable and engaged. These CEOs have no aspiration for a higher job at the bank or insurance owner (since there is no owner), and there is no complacency from relying on the parent for flows.

In our work with captives we recommend as much as possible to replicate this "partner-like" mindset by paying senior management as if they were partners/owners in their investment management business: via a combination of deferred profit-share (investment management profit controlled by them, not by the bank/insurance/securities firm) plus pseudo-equity at the investment management company level, ring-fenced from the parent's earnings. Therefore senior management is paid to think about current profits as well as longer-term investments in new capabilities. Management needs to have the ability to make these decisions unencumbered from the top. The most spectacular successes to be captives used precisely this combination of arrangements.

There are frustrations in Japan with regards to decision rights and incentives. There is a corporate culture of risk aversion where for senior portfolio managers for example, there is more downside to being wrong than there is upside to being right. This is a function of the incentive structure. If truly variable pay were more substantial in Japan, with big bonuses when portfolio managers knocked it out of the ball park, we might see a change in that behaviour. I have expressed the view to many executives that a problem around risk taking also permeates business front office and senior management, who are not challenged to push the business, and who will not be fired for underperformance, as long as the situation is not catastrophic.

I can understand that the right incentive structure and the right governance structure including decision rights, will come together to produce a better outcome. Will the right incentive structure allow the assertion of those decision rights ?

Yes, but there may be limits.

Deloitte and Casey Quirk have worked in the past to convince a Japanese financial institution to introduce a pseudo-equity scheme. Phantom shares would be used to top-up compensation of senior management, who run the business and manage P&Ls which drive valuation.

At captive investment managers within financial groups, the investment management unit can hire sales people to help the top line, but do not have control over costs, and this is where decision rights come in. For example, they may not be able to use a non-affiliated custodian, or be overruled if they proposed switching from an antiquated proprietary IT platform to a state of the art third-party one.

We benchmarked the internal investment management business of one Japanese financial institution against global best practice, and brought up the issue of CEO empowerment. Senior management at the financial institution actually said to me that executives are rotated every three years and they want them to be administrators. They said they understood it meant they could never manage high quality investment teams internally, and their investment management unit could only be a utility.

You need a company within a company, with a separate brand name, run independently, able to recruit good people, and not forced to go along with bad trading systems or product ideas.

Decision rights are also important with respect to product. Product channels are powerful in Japan, and there can be pressure to create clones of competitor funds, even if the investment style is very different from your core capability. Thus captive investment managers, even if they are paid on performance, can be forced to do things they fundamentally disagree with and believe will lose money.

We've touched on the fact that base salary represents a larger proportion of remuneration at many Japanese investment managers compared to global managers. Performance fee arrangements (between investment managers and asset owners/retail funds) are also relatively rare compared to globally. Do you think it would help better align incentives if asset owners/retail funds extended performance fee arrangements ?

Performance fees continue to be a popular structure with many institutional investors globally. In general institutions have tended to pressure their managers to shift the fee mix away from fixed management fees and towards performance fees. Additional performance fee parameters which buyers focus include (i) the measurement period and aligning it to the investment strategy's horizon, (ii) using a relevant hurdle or benchmark, and (iii) incorporating claw-backs.

I'm not sure performance fees would make a large difference for retail buyers, as they don't really look at how managers are paid. You would need to explain to the investor that you would pay less because you only pay if we outperform.

My questions have mostly been about good governance and good incentive structures. What do you think the impact is of bad governance and bad incentive structures on the health and competitiveness of the asset management industry as a whole ?

There have been two almost insurmountable challenges in Japan.

There is a returns challenge for Japan asset classes, as they have seriously underperformed for two decades, which has been a major headwind for the industry.

The second is a policy challenge. Policy makers have only recently started to channel national savings into funds as household assets are mostly in bank savings in Japan. Other countries have been able to grow larger, competitive industries, for example with superannuation in Australia.