A friend with a pack of cards asks you if you are willing to bet $100 to win $100 (i.e., even money) that the next card she turns up is a heart. Is that a good decision to say yes? She shows you that the last two cards she turned up were hearts. Does that change your view? Perhaps buoyed by that morning’s horoscope (“be bold after nightfall…”), you take the bet and indeed a heart comes up so you win the $100. Was it a good decision now?

My letter this quarter is about the subject of partnership between asset owners and asset managers. This is certainly a hot topic with almost every manager seemingly offering a version of partnership, as owners increasingly seek it. I was inspired to pursue this topic by a series of discussions I have been having over the last three months with an ex-colleague of mine from consulting days who now oversees a very large asset owner. Maybe because of our common consulting roots, we have approached the subject with a healthy dose of realism/cynicism about what partnership really means.

Before we get to partnership, let me expand on my initial seemingly facile question, which is really about decision-making under uncertainty. Many, if not most, of the decisions that an owner faces fall into this camp. To make the decision on a sound basis, you need to assess the upside against the downside (return vs. risk), and the probabilities of both. The probabilities are crucial: many decisions we face are asymmetric, typically skewed to the downside, so calibrating the likelihood alongside the magnitude of both is essential to good decision-making.

In my example, we are operating with seemingly clear-cut information. So, since you win the same as you lose and, assuming a fair pack, you have only a one in four chance of winning, of course the correct decision is to decline the bet. But to address my final question, if you have a moment of madness, make the bet and win, did that make it a good decision? I would argue that since it’s the same decision as it was a priori, it would still be a bad decision to take the bet, even if on this particular turn of the cards you got lucky. If you keep taking decisions like this, you will soon be bankrupt! Therefore, unless your sole frame of reference is around what would have worked on this particular turn of the cards, we have to stick to the methodical probabilistic approach.

In the investment world, however, there are certain elements that make that judgment more difficult. The first is the human tendency to extrapolate from the past. Does anyone think that the fact that the last couple of cards were hearts make it more likely that the next one would be? Of course not, and indeed in a strict probability sense, it makes it less likely because there are only 13 hearts, so if two have shown up already, there are only 11 left. The investment analogue of this is the way our industry loves to herd, and how procyclical our activities are: money flocks to successful managers, sometimes taking them well out beyond their capacity to manage successfully; likewise, if the supply of good opportunities in an asset class doesn't change, the herding effect of increased allocations will diminish the expected return for all. The second element that compounds the problem is that, for many decisions, the bad outcomes are often “lumpy,” i.e., they are low probability but much worse than the upside if they come up. A simple example of that is repayment on an individual corporate credit risk, low probability of the company going bust, but much bigger
losses than the interest you collect if it does. But the same is true at a macro level: the environment can stay benign for many years until one year it collapses – think Tech Bubble or Global Financial Crisis (GFC).

I should make one other relevant point in my framing. Suppose I had started “A stranger with a pack of cards…” rather than “A friend…”: should that affect your answer? It absolutely should – how do you even know there are hearts at all? Why would you trust the stranger who has a pecuniary interest in the outcome to frame the bet fairly?

In my discussions with my ex-colleague, I separated the possible benefits of partnership under two headings: commercial benefits and access to intellectual capital. It seems to me that too much of the industry discussion on partnership sees it through the commercial lens. Of course, if an owner gives an asset manager more money, for example, they will expect to pay a lower fee, but I am not sure why this defines a partnership, as opposed to a normal commercial relationship. Likewise, some illiquid asset managers will frame the partnership in terms of early access to a “scarce” investment opportunity. I think it’s important to maintain a healthy skepticism about these, both because there will be compliance dictates behind the scene, and because the reality is the manager will be making its own commercial judgment about any prioritization.

It seems to me that the true value of partnership should lie around intellectual capital, and in particular I want to focus on help with decision-making. In a past role, I had responsibility for a very large OCIO client relationship including through the financial crisis, which in many ways echoed the partnership construct. There were no shortage of investment banks and managers calling on the client with very technical money-making schemes – this was the age of the CDO squared after all – and I have often felt that we added a huge amount of value to the client simply by helping them say no to these highly plausible ideas, which would of course have been ruinously expensive as well. My diagnosis was that two key elements came together: we had the technical expertise to see through the sales pitch to the risks behind it, and this was that relatively rare “lumpy” environment where these risks came home. These elements point the way to a better framework for thinking about partnership benefits.

As established earlier, a generalized decision-making process comprises for each decision:

- Definition of the opportunity vs. the risks, whether explicit or not.
- Estimation of the likelihood of those risks, allowing an overall evaluation to be made.

As with structured credit products in the GFC, it may be hard for the asset owner to have internal expertise to properly tease out all the risks of a particular decision, whereas of course the manager who is doing the selling has every incentive to bring out the upside – the manager is the analogue to the stranger rather than the friend. The more specialist the proposition, the more likely the skills required to analyze it properly are to be expensive and hence to sit inside an investment manager or bank. The partner asset manager can help level the playing field for the owner by lending its own skills as part of the partnership firstly to ensure that the risks are clear alongside the upside.

Secondly estimation of probabilities of those risks may not be easy, and the more the nature of the investment return stream is “lumpy,” the harder it is: after all, a 5% probability, a 1% probability and a 0.1% probability are all “highly unlikely,” and yet they may span a terrible investment to a decent one to a great one. The one thing we know with certainty, like my prior heart cards, is that extrapolating from the past is highly dangerous. This points to a second area where the partner asset manager can add real value, in helping to calibrate these risks, and again the more specialist the arena, the more likely that the manager’s perspective will be additive.
The final area within this framework where a partner asset manager can help an owner is more broadly in being willing to offer a different perspective and being part of the protection against groupthink. Our industry is sadly so prone to herding that this can be a very real risk. My interlocutor had just lost an advisor who had been fantastic at offering that different perspective to ensure a wider debate, and was finding it hard to replace. We both agreed that the partner asset manager is ideally placed to play that role. You don't have to be right, but rather to offer a thoughtful and different perspective. Of course, the more markets seem to be at extremes, the likelier that we are near a point where groupthink will be found out, as we are arguably are today, for example.

Before summarizing, I would add one subtle point around this notion of partnership through intellectual capital. The expertise that the owner is looking to access is likely to lie outside the narrow mandate(s) that may form the commercial element of the partnership, since the proposition that is being tested probably arises in a different asset class or specialism. So, the real added value of this form of partnership will likely lie either in access to a range of different specialist skills or to a broader macro or market perspective.

In summary, therefore, I believe that the true value of partnership from an asset manager lies more on the intellectual capital side of the line than the commercial, in either leveraging their specialist skills to help an owner better evaluate other propositions, or in terms of their ability to bring diversity of thought and avoid groupthink. In each case, it is likely to go broader than the specific mandates that the manager may run. Finally, it's important to recognize that the added value may be lumpy over time, which in turn reflects the nature of many risks that the owner faces. Much of the time, these risks may not matter at all, but particularly at extreme points – like now? – it may matter an awful lot. Just because hearts may have come up recently makes it a worse bet going forward – not a better one!

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