Thinking Beyond the Hiring and Firing of Asset Managers: A New Framework Truly Aligning Asset Owners With Asset Managers

Patrick J. Wierckx
MN

Research has shown that the way asset owners deal with their asset managers often leads to adverse outcomes for themselves and their asset managers. This paper introduces an innovative framework which plays a key role in achieving a stronger alignment between an asset owner and their asset manager. The framework has been designed to offer a strong theoretical foundation to determine the asset owner's optimal set of investment strategies across multiple asset classes. Based on this framework, the paper offers an asset owner a coherent set of alignment strategies which contribute to a better alignment with the asset owner's investment objectives.

Keywords: investment strategy, asset owner, external manager's selection, asset manager, pension funds

INTRODUCTION

Goyal and Wahal (2008) showed that the typical asset owner's hiring and firing of asset managers is ineffective. Not only did the newly appointed asset managers generate a lower return than the terminated asset managers, but the study also revealed that the relative return of the terminated asset managers improved after their termination.

While it may seem to make sense to terminate an underperforming asset manager, multiple studies have shown that even the most successful asset managers face periods in which they underperform their respective benchmarks followed by periods in which they significantly outperform their benchmarks. For example, Baird (2009) revealed that 89% of the best performing mutual funds at some point underperformed their benchmarks over a three-year period. Cornell et al. (2017) argued that the role of the asset manager's past performance in the asset owner's process of hiring and firing asset managers was too dominant and destroyed value for the asset owner. *But how are asset owners able to assess whether underperformance is due to the asset manager's structural inability to outperform or due to a temporary setback?*

Jenkinson et al. (2016) indicated that traditional selection criteria were not valuable in selecting successful asset managers. Furthermore, Cornell et al. (2017) suggested that asset owners should look for other factors than past performance in their assessment. It is therefore key *to rethink the way asset owners currently assess their asset managers*.

Recent research presented some factors[1] that may be indicative of the asset manager's future performance such as active share (Cremers & Petajisto, 2009), a high level of fund ownership (Khonrana et al., 2007) and the level of portfolio concentration (Brown et al., 2020). Arguably, these factors do not strongly relate to the asset manager's core competence, i.e., their capability to generate positive

performance. To put it differently, these factors will not *generate* any positive performance by themselves. Consequently, these factors are likely to have a limited (practical) value to an asset owner who has to decide whether to keep or fire an underperforming asset manager. Additionally, asset owners tend to employ a *generic* set of criteria to evaluate their asset managers. This paper aims to directly address the asset owner's challenges by considering the asset manager's *specific* capability to outperform. Furthermore, it aims to improve the asset owner's complete hiring, monitoring, and firing process in a *differentiated*, transparent, and structured manner.

Current research on the hiring and firing of asset managers is largely quantitative, backward-looking, and predominantly equity focused, while this paper introduces a *qualitative, forward-looking, and asset class independent* framework to the existing body of research. Importantly, the framework also facilitates the drive towards more alignment between asset owners and their asset managers. Asset owners who employ this framework should expect significant advantages. *Not only should asset owners expect to see a reduction in fee-levels and transition costs, but asset owners should also expect to see a major improvement in the effectiveness with which the asset owners' specific goals can be achieved.*

THE COMPETITIVE ADVANTAGE-BASED FRAMEWORK

Competitive Advantage-Based Investment Strategies

In order to achieve a stronger alignment between an asset owner and their asset managers, asset owners should rethink their current asset manager's selection process.

The asset manager's selection process should focus on the asset manager's ability to achieve future positive excess returns (alpha) and its specific fit with the asset owner's goals and constraints. To facilitate the evaluation of the asset manager's ability to achieve positive alpha, it is imperative for the asset owner to fully understand the investment strategy's fundamental drivers.

At this point, it might be helpful to draw a parallel between a corporate strategy and an investment strategy. A corporate strategy primarily focuses on the way a firm deals with its competitive environment to stay or to become profitable. An investment strategy should be seen from a similar perspective. Therefore, *an investment strategy should specifically address the way the asset manager deals with the asset class's competitive nature to structurally achieve a positive alpha.*

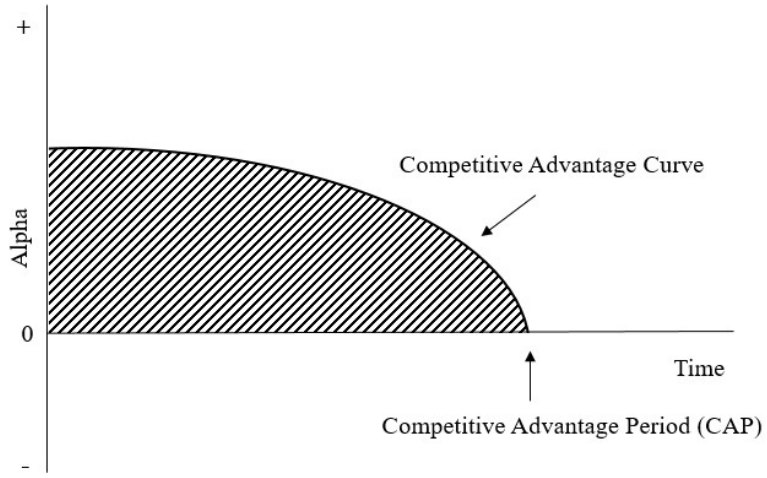
Porter (1980) discusses the central role of the firm's competitive advantages in setting the firm's corporate strategy. In a similar manner, the asset manager's investment strategy should be based on the asset manager's competitive advantages and *should determine the asset manager's ability and probability of structurally achieving positive alpha*. If an investment strategy does not possess a competitive advantage, its alpha will be nothing more than a random outcome. Generally, such an investment strategy is not a suitable alternative for asset owners. In other words, *only competitive advantage based (CAB)-investment strategies*[1] *have the ability to outperform a certain market.*

Finally, it should be noted that an investment strategy based on competitive advantages does not guarantee positive alpha. More formally: the asset manager's competitive advantages *should be viewed as a necessary condition, but not a sufficient condition, for structurally generating positive alpha.*

The Competitive Advantage Period

While competitive advantages are one of the most powerful drivers of a successful investment strategy, it is important to note that the competitive advantage's power is subject to erosion. Due to the competitive nature of the environment, most successful competitive advantages are increasingly likely to be copied by others, which reduces the competitive advantage's unique power (see Figure 1).

FIGURE 1
THE COMPETITIVE ADVANTAGE CURVE



The *competitive advantage curve*[3] describes the evolution of the competitive advantage's maximum power over time. The point in time where the competitive advantage power will be fully depleted, or where the competitive advantage curve crosses the y-axis, determines the investment strategy's *competitive advantage period* (CAP). The CAP is an important concept in the framework and equals the period during which the investment strategy's competitive advantage is able to generate positive alpha[4]. Finally, it is important to note that the area below the competitive advantage curve equals the cumulative alpha which could be *maximally* generated from a competitive advantage and is primarily determined by the CAP.

The next paragraph discusses three types of competitive advantages, whereby each type has a different CAP.

Drivers of the Competitive Advantage Period

The specific nature of a competitive advantage predominantly determines the CAP. Fuller (1998) distinguishes three categories of competitive advantages: informational competitive advantages, analytical competitive advantages, and behavioral competitive advantages.

Informational Competitive Advantages

Informational competitive advantages are derived from a market participant's possession and exploitation of a certain piece of valuable information. To be valuable, the information should be (largely) unknown to other market-participants and should have a meaningful impact on the security's price.

Generally, an informational competitive advantage's CAP has a short duration, since, over time, it is increasingly likely that other market participants also obtain this valuable piece of information. Furthermore, it is important to note that the value of the information is often time dependent. For example, information about the next quarterly sales figures could be very valuable. However, right after a firm releases these quarterly sales figures, this information will quickly become worthless as it is absorbed by the market.

Informational competitive advantages became relatively scarce due to regulation and other legal measures preventing market participants from taking advantage of valuable non-public information (e.g., the Regulation Fair Disclosure and the Sarbanes-Oxley Act). Furthermore, major improvements in the communications infrastructure (e.g., e-mail and internet) further reduced the number of informational competitive advantages.

Analytical Competitive Advantages

Analytical competitive advantages may be achieved by analyzing and combining publicly available information in such a way that it creates valuable knowledge.

Due to several entry barriers, it is less likely that this type of competitive advantages is copied by other market-participants. For example, a competitive advantage derived from the asset manager's valuable deep industry knowledge is protected from competing market-participants who lack this depth of industry knowledge. Consequently, the analytical competitive advantage's CAP tends to have a higher duration than an informational competitive advantage's CAP.

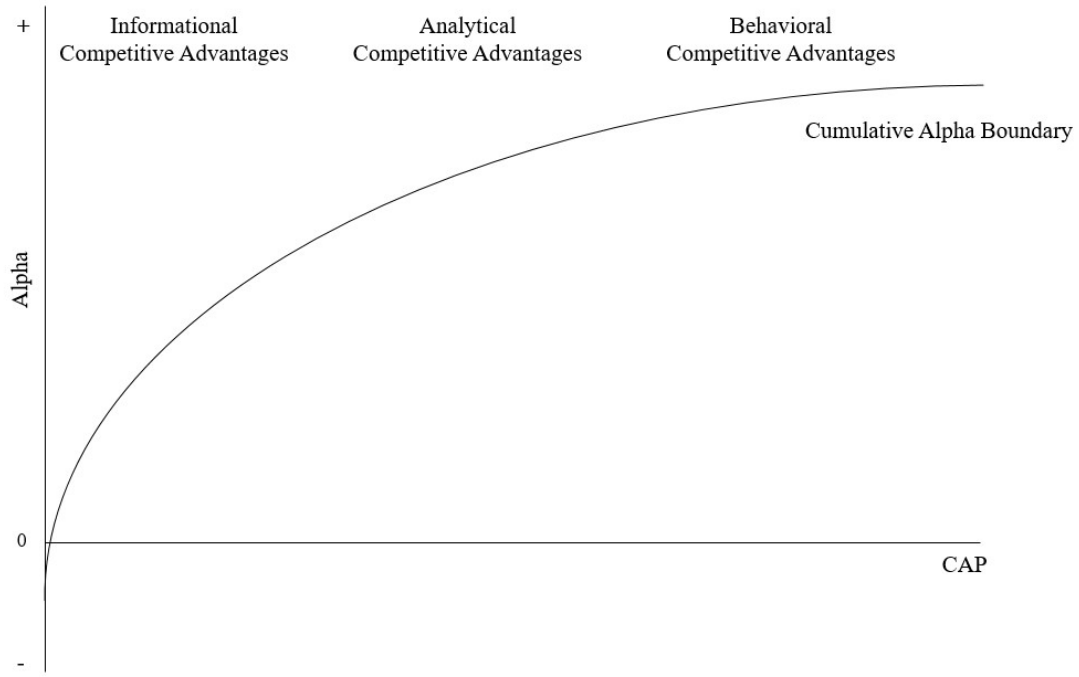
Behavioral Competitive Advantages

Behavioral competitive advantages are the last category of competitive advantages. Research has demonstrated that market-participants often are using mental-short cuts (or heuristics) to process information and evaluate investment decisions (e.g., Kahneman & Tversky, 1979). These heuristics may cause behavioral biases which could create a competitive advantage for a market participant who is able to exploit these biases. Since these behavioral biases tend to be persistent, the behavioral competitive advantage' CAP generally has a high duration.

The Cumulative Alpha Boundary

In the previous paragraph, the three types of competitive advantages and their associated CAP's were discussed. Figure 2 plots the *cumulative alpha boundary*[5] which describes the positive relationship between the competitive advantage's CAP and the maximum achievable alpha (i.e., the area under the competitive advantage curve in Figure 1).

FIGURE 2
CUMULATIVE ALPHA BOUNDARY



Often, investment strategies do not employ one single competitive advantage, but rather they tend to use a combination of competitive advantages. Here, the relative importance of the individual competitive advantages will determine the investment strategy's CAP and the maximum achievable alpha. For example, investment strategies which are predominantly based on informational competitive advantages will tend to

have a shorter CAP and a lower maximum achievable alpha compared to an investment strategy which employs more behavioral competitive advantages in its investment process.

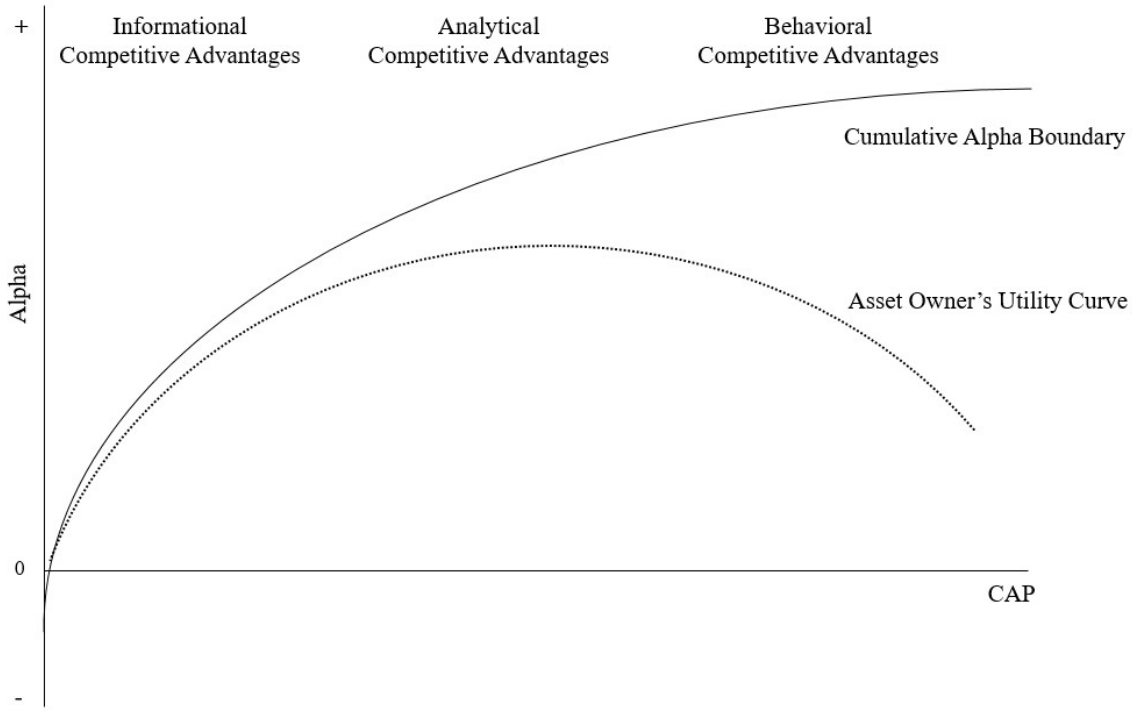
While active investment strategies are the paper's primary focus, in some cases a passive investment strategy[6] may be the asset owner's best alternative. Given that the primary objective of passive strategies is to mimic the return of an index, these strategies do not employ any of the competitive advantages which were discussed in paragraph 1.3. With the absence of these competitive advantages, passive investment strategies' do not have a CAP. Furthermore, the passive investment strategy's maximum achievable alpha tends to be slightly negative due to the negative impact of transaction costs and management fees. Consequently, passive investment strategies are located on the far-left hand side of the cumulative alpha boundary.

The Asset Owner's Utility Curve

Based on the shape of the cumulative alpha curve (see Figure 2), one may be inclined to conclude that, under all circumstances, an investment strategy based on behavioral competitive advantages is the asset owner's preferred alternative. After all, the cumulative alpha curve reaches its maximum at a point which equals the behavioral competitive advantages' CAP. In practice, however, a behavioral competitive advantage based-investment strategy does not always appear to be the asset owner's most suitable investment strategy. The primary reason for this relates to the principal-agent relationship between the asset owner and the asset manager, where the asset manager (the agent) decides which securities to buy or sell on behalf of an asset owner (the principal) (e.g., Jensen, 1976; Cornell et al., 2005).

In this principal-agent relationship, the asset owner will be eager to understand whether the asset manager is performing in line with the asset owner's expectations. Moreover, the asset owner would like to make this judgement as soon as possible as the asset owner does not wish to retain an investment strategy which does not fully contribute to the asset owner's goals. Therefore, time as a factor should be integrated into the framework to specifically account for its positive effect on the cumulative alpha potential, but also for its negative effect as longer duration competitive advantages are less likely to be aligned with the asset owner's time preference. Furthermore, a longer timeframe increases the likelihood that the asset owner's risk tolerance may change during this period, which may lead to the investment strategy's premature, and often costly, termination. Figure 3 plots the *asset owner's utility curve*, which adjusts the cumulative alpha boundary to address the asset owner's time preference.

FIGURE 3
ASSET OWNER'S UTILITY CURVE

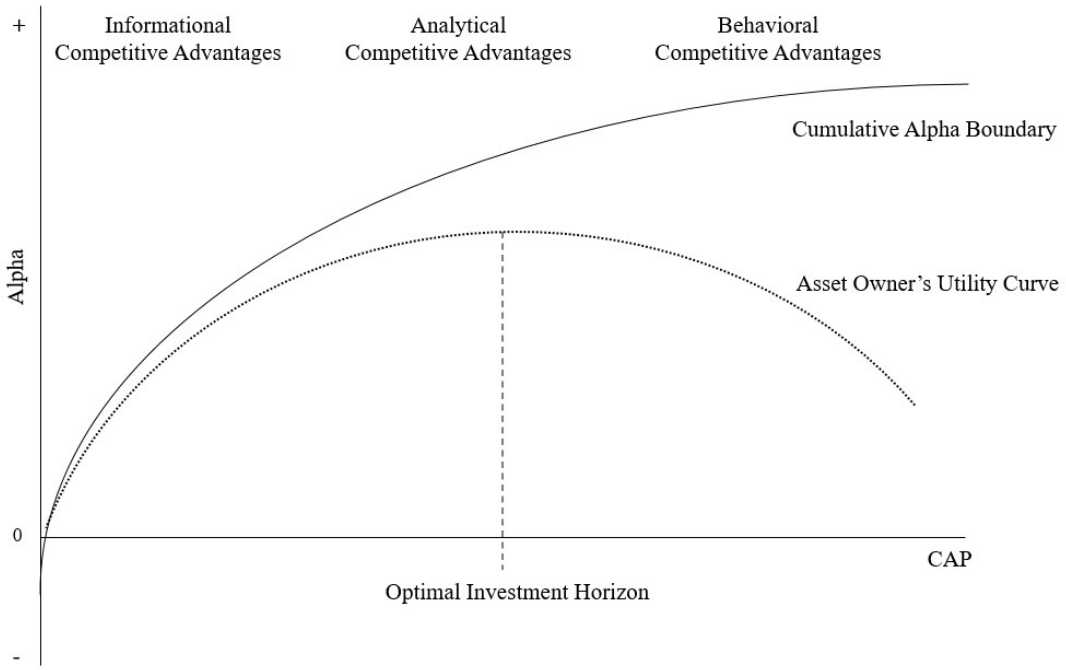


THE NEW PARADIGM: A PARTNERSHIP APPROACH BASED ON THE COMPETITIVE ADVANTAGES FRAMEWORK

Aligning the Asset Owner's Optimal Investment Horizon to the Asset Manager's Investment Horizon

The asset owner's utility curve, discussed in paragraph 1.5, has an important role in the CAB-framework as it determines the asset owner's *optimal investment horizon*. The point at which the asset owner's utility curve reaches its maximum is equal to the asset owner's optimal investment horizon and reflects the optimal trade-off between the competitive advantage's maximum cumulative alpha potential and the asset owner's degree of time-preference (see Figure 4).

FIGURE 4
ASSET OWNER'S OPTIMAL INVESTMENT HORIZON



The asset owner's optimal investment horizon should be equal to the asset manager's investment horizon as a mismatch between the two horizons may result in undesirable outcomes. A situation where the asset owner's investment horizon is shorter than the asset manager's investment horizon may result in a situation where the asset manager's competitive advantages may not have been fully utilized. This will likely underestimate the asset manager's true quality and may cause a premature, and often costly, termination of the asset owner's relationship with their asset manager. Alternatively, when the asset owner's investment horizon is longer than the asset manager's investment horizon, the asset owner's alpha potential will not be fully captured.

Furthermore, as the asset owner's optimal investment horizon should equal the asset manager's investment horizon, it is important to note that the *asset owner's* optimal investment horizon also determines the range of the *asset manager's* suitable competitive advantages.

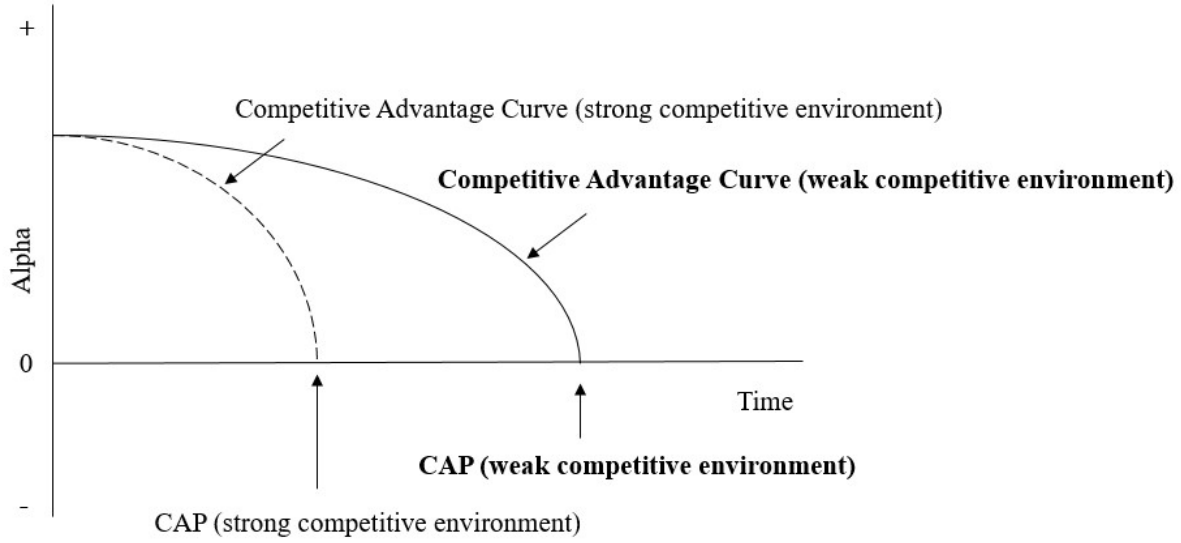
Asset Class Alignment

As discussed earlier, the shape of the asset owner's utility curve is based on the cumulative alpha which can be extracted from the intersection of the asset manager's competitive advantage and the asset owner's time preference. In addition to the shape of the utility curve, the asset owner's optimal investment strategy is also determined by the asset class's level of price efficiency and the asset class's duration.

The Asset Class's Level of Price Efficiency

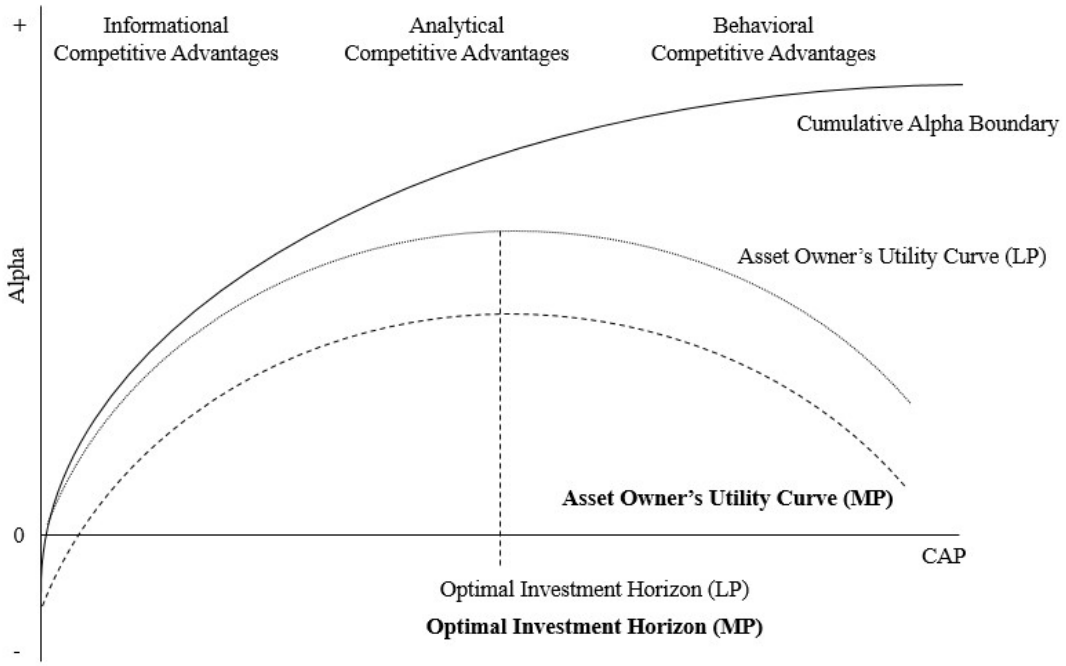
The competitive advantage's value is affected by the asset class's competitive intensity. Strong competition is likely to result in an earlier decline of the competitive advantage's power as competitive forces make it increasingly likely that the existing competitive advantages are reproduced by others. Hence, in a strong competitive environment, the CAP has a relatively short duration, and the competitive advantage can only generate limited cumulative alpha. Conversely, in a weak competitive environment, the CAP has a relatively high duration, and consequently the competitive advantage's cumulative alpha is higher (see Figure 5).

FIGURE 5
COMPETITIVE INTENSITY AND THE CAP



While corporate strategists employ the term competitive intensity, financial economists tend to describe the asset class's competitive intensity as the *asset class's degree of price efficiency*. Price efficiency can be interpreted as the extent to which all market participants incorporate all the available information (Fama, 1970). According to the Efficient Market Hypothesis (Fama, 1970), it is impossible to structurally generate positive alpha from an asset class which exhibits full price efficiency. Since no competitive advantage would exist in such a case, the CAP would be zero and the asset owner's optimal investment strategy would obviously be a passive investment strategy. In practice however, most asset classes are not considered to be fully price efficient. Some asset classes are regarded to be highly price efficient (e.g., US large cap equities), whilst other asset classes are considered less price efficient (e.g., emerging markets equities) (Baird, 2016). The CAB-framework can be used to illustrate the impact of an asset class's level of price efficiency on the asset owner's optimal investment strategy (see Figure 6).

FIGURE 6
ASSET CLASS'S PRICE EFFICIENCY AND THE OPTIMAL INVESTMENT HORIZON



(MP = More price efficient asset class, LP = Less price efficient asset class)

A more price efficient asset class results in a lower cumulative alpha boundary and a lower asset owner's utility curve compared to a less price efficient asset class (see Figure 6). It is important to note that a change in the level of price efficiency causes a *parallel shift* of both curves. Consequently, the *asset class's level of price efficiency will not affect the asset owner's optimal investment horizon.* Furthermore, the asset owner's optimal investment strategy would also be unaffected by the level of price efficiency, except for one special circumstance. In a situation where an asset class's level of price efficiency causes the asset owner's utility curve's maximum to be fully positioned below zero, an investment strategy would result in a *dis*utility to the asset owner. In such a case, the optimal alternative for the asset owner is to select a passive investment approach as this would limit the level of disutility.

The Asset Class's Duration

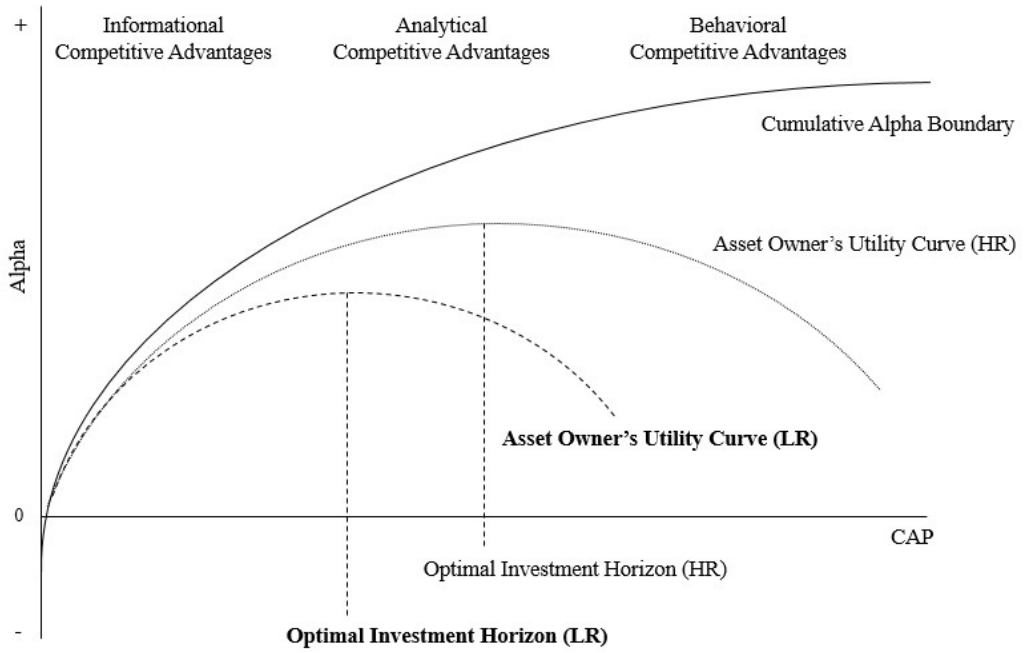
Apart from the fact that asset classes may vary in their level of price efficiency, asset-classes may also differ in their duration[7]. The asset class's duration may affect the asset owner's optimal investment strategy. Generally, equities are considered to have an infinite duration, whereas bonds often have a finite maturity. Since the competitive advantage's value would obviously need to be captured before a security reaches its maturity, *the competitive advantage's CAP should not exceed the asset-class's duration.*

This has major policy consequences. First, behavioral competitive advantages may be less optimal in short-duration asset classes. This is because the asset class's duration is likely to be shorter than the CAP associated with behavioral advantages. For shorter-duration asset classes, informational and/or analytical competitive advantages may be more appropriate, as their CAP is shorter. Second, a longer-duration asset class has a broader range of potentially suitable competitive advantages. Especially for asset classes which exhibit an infinite duration, such as equities, all three competitive advantages may be suitable as there is no limit to the competitive advantage's CAP.

Alignment of Asset Owner's Level of Risk Tolerance

The optimal investment horizon will be determined by the point at which the asset owner's utility curve reaches its maximum. A steeper utility curve will shorten the optimal investment horizon, and vice versa. The utility's curve's steepness will primarily depend on the asset owner's degree of risk tolerance. An asset owner with a lower level of risk tolerance has a steeper utility curve and a correspondingly shorter optimal investment horizon (see Figure 7). Conversely, an asset owner with a higher level of risk tolerance will have a flatter utility curve and hence a longer optimal investment horizon.

FIGURE 7
LEVEL OF RISK TOLERANCE AND THE OPTIMAL INVESTMENT HORIZON



The asset owner's level of risk tolerance is mainly determined by two factors. First, the asset owner's ability to take risk will be (partly) set by the asset owner's financial situation. Generally, an asset owner who faces a poor financial situation has a lower tolerance for risk as the asset owner will be less able to withstand any investment losses, and vice versa. As a rule: *the asset owner's financial situation will generally have a positive relationship with the asset owner's optimal investment horizon*.

Second, asset owners often have to comply with certain regulations and laws, which may influence the asset owner's willingness and/or ability to take risk.

Alignment of Competitive Advantages

The asset owner's optimal CAB-investment strategy will be predominantly determined by three factors: the asset class's level of price efficiency, the asset owner's level of risk tolerance and finally the investment strategy's typical management fee.

Table 1 provides an overview of optimal CAB-investment strategies based on the asset class's degree of price efficiency, the asset owner's level of risk tolerance, and the fact that passive investment strategies are generally significantly cheaper than active investment strategies. This policy matrix may assist an asset owner in determining their optimal asset class's investment strategy.

TABLE 1
POLICY MATRIX: OPTIMAL CAB-INVESTMENT STRATEGIES

		Asset class's degree of price-efficiency		
		Low	Middle	High
Asset owner's level of risk tolerance	Low	I/ P	P	P
	Middle	A	A/P	P
	High	B	B	B/P

(P = Passive Investment Strategy, I = Informational Investment Strategy, A = Analytical Investment Strategy, B = Behavioral Investment Strategy)

Please note that the policy matrix uses both an endogenous, asset owner-related factor (i.e., the level of risk tolerance), and an exogeneous, non-asset owner-related factor (i.e., the asset class's degree of price efficiency). This means that, *within the same asset class, market participants may have different optimal investment strategies, as their levels of risk tolerance may vary.*

IMPLEMENTING THE PARTNERSHIP APPROACH

This paragraph offers multiple recommendations to achieve a stronger alignment throughout the entire relationship, from the pre-selection phase to the potential co-development of investment solutions. *In order to achieve a stronger alignment between the asset owner and the asset manager, it is critically important to broaden the scope to focus on the overall value both parties can bring to each other*

Achieving Lower Fee Levels

Currently, most fee-negotiations could be described as zero-sum negotiations, whereby the asset owner's gain (i.e., lower fees) will be equal to the asset manager's loss (i.e. lower revenues) and vice versa. Such type of negotiations bear resemblance to most transactional product sales and do not tend to reflect the start of a cooperative and durable partnership. The CAB-framework, and more specifically the asset owner's optimal investment horizon, plays a crucial role to prevent such zero-sum negotiations, by creating a stronger alignment at the start of the relationship. Interestingly, it may also result in lower fees for the asset owner.

The asset owner's optimal evaluation period equals the timespan which optimizes the trade-off between the asset manager's competitive advantage's alpha potential and the asset owner's time preference. Furthermore, *an asset manager whose investment horizon is equal to the asset owner's optimal evaluation period is considered to be optimal*, as the asset owner can take full advantage of the asset manager's competitive advantage. Importantly, the asset owner should refrain themself from terminating the asset manager's IMA during this period as the asset owner's assessment of their asset manager should only take place after the expiration of the asset manager's investment horizon. Therefore, the asset owner's *minimum evaluation period* should be at least equal to the asset manager's investment horizon.

Given that asset owners generally tend to switch asset managers prematurely (Goyal & Wahal, 2008), the minimum evaluation period provides the asset manager with significantly more certainty around their prospective fees. Assuming the same net present value of prospective fees, an asset manager may be willing to charge the asset owner a lower (annual) fee level, as the period during which the asset owner have to pay fees is expected to be longer under the minimum evaluation period. In order to drive a stronger alignment, *asset managers are therefore recommended to offer loyalty-based pricing,* whereby the asset owner who is committed to staying a longer time with the asset manager, would be offered a lower fee and vice versa.

Alignment of the Investment Management Agreement

An IMA is an important legal contract between an asset owner and their asset manager and therefore shapes both parties' behavior. With the aim to change the current transactional relationship to a partnership model, it is important to align the IMA with the following two recommendations.

First, it is *recommended that the IMA specifies the asset owner's minimum evaluation period and the asset manager's investment horizon.* The formal inclusion of the asset owner's minimum evaluation period increases the asset manager's confidence that the asset owner will not terminate the IMA before the expiration of the minimum evaluation period. Additionally, the formal inclusion of the asset manager's investment horizon assists the asset owner's monitoring process, as the asset owner may be better able to assess whether the asset manager's portfolio activities are consistent with the asset manager's specific competitive advantages and their corresponding investment horizon. Furthermore, it may reduce the asset manager's incentive to shorten the investment horizon when the asset manager experiences a period of negative alpha as the inconsistency of such portfolio activities become more transparent.

Second, it is *recommended to include specific break clauses in the IMA under which the asset owner can legally terminate the IMA before the minimum evaluation period's expiration*. Here, the asset owner and the asset manager should adopt a conservative, critical stance to the inclusion of such break clauses as too many, or too broadly defined, break clauses may result in significantly lowering the value of the minimum evaluation period. Furthermore, since the asset manager's performance tends to be one of the most popular reasons to terminate an IMA, it is important to stress that it is *not* recommended to relate any break clause to the asset manager's performance as this may offset many of the alignment strategies altogether. It is therefore recommended to *relate and limit the scope of these break clauses to the asset manager's specific competitive advantages*.

Improving the Selection and Monitoring Process: A Competitive Advantages Based Selection and Monitoring Process

In the previous paragraph, it was recommended not to include a performance related break-clause in the IMA. Then, how should the asset owner respond when their asset manager generates a significant negative performance during the minimum evaluation period and the asset owner is not allowed to terminate the IMA due to performance reasons?

Performance numbers are among the few quantitative, timely, and easily available outputs of an investment manager's investment process. Given these characteristics, most asset owners exhibit a tendency to focus on (short-term) performance numbers as they are eager to assess their asset manager as soon as possible. It is important to note that these (short-term) performance numbers tend to be treated by asset owners as a proxy for the asset manager's capacity to structurally generate alpha. *This tendency to over-rely on short-term performances may reflect the insufficient level of trust at the outset of the relationship.* It is therefore important to strengthen the level of trust during the asset owner's selection process, based on the following recommendations:

First, it is important that the asset owner formally determines their minimum evaluation period. In setting their minimum evaluation period, the asset owner must take into account the fact that their financial situation may vary through time which consequently may change their risk tolerance during the minimum evaluation period. Furthermore, since the asset owner still has a limited level of experience with their potential asset manager at the start of the relationship, it is recommended that the asset owner should adopt a conservative approach in setting their minimum evaluation period. The policy matrix discussed in paragraph 2.4, the minimum evaluation period, and the asset class's level of price efficiency should determine the asset owner's optimal competitive advantages. This outcome will significantly limit the set to asset managers who employ these competitive advantages early in the selection process and make the selection process much more effective.

Second, most selection processes tend to utilize *backward-looking* data, such as historical performances, which have not proven to be a successful indicator of the asset manager's capacity to generate positive prospective alpha (e.g., Lakonishok et al., 1992; Cornell et al., 2017). Conversely, to enable a *forward-looking* judgement of the asset manager's capacity to generate positive alpha, it is recommended that *the asset owner develops an excellent understanding of the asset manager's competitive advantage and the asset manager's organizational commitment to maintain and/or strengthen its competitive advantage*. Provided that the asset owner is not be able to terminate the IMA easily before the minimum evaluation period's expiration, the asset owner should ensure that the due diligence process

results in a sufficient level of trust or confidence in the asset manager's capability to generate positive alpha in the future.

Third, the asset manager needs to specifically describe their competitive advantages and determine their corresponding investment horizon. Formalizing their competitive advantage and their investment horizon would require a critical and detailed analysis of what truly drives their alpha generation capability. This transparency results in a significantly more effective due diligence phase as it limits the due diligence to only those asset managers whose investment horizon fits the asset owner's investment horizon.

Finally, *the asset owner's monitoring process should be a continuous forward-looking assessment of the asset manager's competitive advantage's strength and the asset manager's organizational commitment to maintain and/or strengthen their competitive advantage.* To facilitate a consistent judgement, the monitoring phase should employ at the minimum the same criteria as those used during the due diligence phase. Additionally, the asset owner needs to specifically judge whether the asset manager's portfolio activities are consistent with the asset manager's competitive advantage. This continuous forward-looking assessment will predominantly determine the level of trust between the asset owner and the asset manager.

It is important to stress that the asset manager's performance should only play a limited role in the asset owner's monitoring's phase, especially if the relationship's timespan has not yet reached the length of the asset manager's investment horizon. It may be hard for asset owners to ignore readily available short-term performances numbers, as this may be perceived to go against human nature. Nevertheless, de-emphasizing the importance of performance numbers will be key to truly achieving a long-term partnership relationship. The asset manager's short-term performance should be limited to offering a starting point to better understand whether the asset manager's behavior is consistent with the asset manager's competitive advantage especially during periods of negative alpha.

Improving the Allocation Process: A Competitive Advantages Based Allocation Process

At the start of the relationship between the asset owner and their asset manager, the asset owner's experience with their asset manager in 'real life' is still limited and the asset owner's trust in their asset manager is predominantly based on the in-depth analysis of the asset manager's competitive advantage during the due diligence phase. During the lifetime of the partnership, the asset owner gains more valuable insights into the asset manager's capacity to structurally generate positive alpha, which may result in a change in the asset owner's trust in their asset manager. In a situation whereby the asset owner's level of trust in their asset manager declines, it is important that the asset owner strongly refrains from lowering their allocation to the asset manager before the minimum evaluation period has expired. *The asset owner should therefore allocate conservatively to their asset manager, especially at the start of the partnership.* Furthermore, the minimum evaluation period's duration affects the size of the initial allocation to the asset manager, whereby, for example, a longer minimum evaluation period should result in a smaller initial allocation.

The asset owner's allocation process should also consider the asset owner's tendency to change their asset class mix through time, as this may impact the existing allocations to (some of) their asset managers within that asset class. In a partnership approach, it is important that the asset owner should refrain from reducing the allocation to their asset manager. It is therefore *recommended that the asset owner allocates a proportion of the asset class's investments to a dedicated flexible portfolio which specifically deals with any changes in that asset class's allocation*. While the majority of the asset class's investments may employ an active investment strategy, a passive investment strategy is generally considered to be the optimal investment strategy for the asset owner's flexible portfolio. This is due to several reasons. First, it will be complex to determine the flexible portfolio's specific investment horizon, as the frequency of in- and outflows within an asset class are often irregular. Second, passive investment strategies tend to offer more liquidity, as they generally invest in a broad portfolio of securities, which significantly lowers the asset owner's total transaction costs. Finally, a passive investment strategy's management fee tends to be significantly lower than an active investment strategy's management fee.

Achieving Customized Solutions Through Co-Development

The CAB-framework incentivizes asset owners and asset managers to think about their individual investment horizons as these timespans plays an important role in creating alignment between both parties. When both investment horizons are aligned, it creates opportunities for both parties to co-develop a highly customized investment strategy.

A co-developed customized investment strategy may benefit an asset owner, since it may lead to a much stronger alignment with their financial and non-financial (e.g., ESG-related) objectives. A co-developed customized investment strategy may also offer an asset manager multiple benefits. First, the inclusion of the asset owner's minimum evaluation period in the IMA, should result in a higher likelihood that an asset manager's development efforts to co-develop a customized investment strategy will be (financially) sufficiently rewarded. Second, an asset manager managing a well-differentiated, co-developed investment strategy is less prone to being replaced by competing asset managers offering less-customized investment strategies. Third, an asset manager gains important insights about the asset owner during the co-development phase, which may result in valuable inputs to develop and align the investment strategy further. It is important to note that these insights are valuable from a competitive standpoint as well, since competing asset managers do not tend to have the same level of insights. Fourth, an asset owner who co-developed an investment strategy, is more likely to view it as their 'own' investment strategy, making them less likely to terminate the strategy compared to a non-co-developed investment strategy. Finally, the asset manager who co-developed an investment strategy with the asset owner is more likely to become the asset owner's trusted partner. When the asset owner is looking for a solution, the asset owner is more likely to look at their existing asset manager for that solution.

CONCLUSION

The purpose of the paper is to introduce the CAB-framework, which is a differentiated and transparent method to significantly improve the effectiveness of an asset owner's complete hiring and firing process. Furthermore, the paper discusses multiple strategies to achieve a stronger alignment between the asset owner and their asset manager, which allows for a lower fee level, a lower asset manager turnover, and a better fit with the asset owner's objectives. On a larger scale, stronger alignment between the asset owner and their asset manager may also benefit society as it reduces society's frictional costs of hiring and firing asset managers. Asset owners and asset managers should therefore be urged to adopt the CAB-framework to accomplish a true partnership whereby both parties view each other as an aligned and trusted partner.

ACKNOWLEDGEMENTS

The author gratefully acknowledges helpful comments and suggestions from Hein Brans, Jonathan Cukierwar, Gerco Goote, Mark van der Kaaij and Mario Oosterkamp.

ENDNOTES

1. For an overview of these factors, see for example Cornell (2017).
2. CAB-investment strategies are defined as investment strategies which are based on the security's *fundamental* value drivers. Momentum investment strategies or investment strategies based on technical analysis generally are not considered a CAB-investment strategy, since both are predominantly based on (historical) price developments and, as such, do not relate to a security's fundamental value driver.
3. Figure 1 is included for illustrative purposes, as different shapes of the competitive advantage curve may exist. For example, Mauboussin and Johnson (1997) assume a constant decline in the difference between ROIC and WACC. It is important to note that the shape of the competitive advantage curve has no implications to the validity of the outcomes discussed in this paper.
4. This is similar to the use of the CAP in the corporate finance literature, where CAP is defined as the period during which the company's ROIC is greater than the company's WACC (Mauboussin & Johnson, 1997).

5. The cumulative alpha boundary measures the cumulative alpha potential, which is a function of the likelihood of finding an investment opportunity and the extent of the opportunity's payoff. The curve is upward sloping, due to several reasons. First, the cumulative alpha boundary is inversely related to the asset manager's utility curve. Generally, an asset manager prefers to employ shorter duration competitive advantages as it leads to an earlier payoff and is perceived to increase the asset manager's chances of survival. This preference subsequently results in stronger competition for shorter-term investment opportunities and, hence, lowers the overall effectiveness of shorter-term competitive advantages and vice versa. Second, regulatory measures and developments in technology tends to lower the probability of finding an investment opportunity and tends to lower the extent of the investment opportunity's payoff. Generally, this has a stronger impact on shorter-duration competitive advantages than longer-duration competitive advantages.
6. In this paper, passive investment strategies are defined as full replication passive strategies.
7. For simplicity purposes, duration is defined as the period until a security matures and does not necessarily equal the security's Macaulay duration.

REFERENCES

Baird's Advisory Services Research. (2009). *The Truth about Top-Performing Money Managers - Why investors should expect – and accept – periods of poor relative performance*. Retrieved from https://content.rwbaird.com/RWB/Content/PDF/Insights/Whitepapers/Truth-About-Top-Performing-Money-Managers.pdf

Baird's Asset Managers Research. (2016). *Active vs. Passive Money Management Exploring the costs and benefits of two alternative investment approaches*. Retrieved from https://content.rwbaird.com/RWB/Content/PDF/Insights/Whitepapers/active-vs-passive-money-management.pdf

Brown, K.C., Tiu, D., & Yoeli, U. (2020). The Decision to Concentrate: Active Management, Manager Skill, and Portfolio Size. *The Journal of Portfolio Management Fund Manager Selection*, *46*, 41-62.

Cornell, B., & Roll, R. (2005). A delegated agent asset-pricing model. *Financial Analysts Journal*, *61*, 57–69.

Cornell, B., Hsu, J., & Nanigian, D. (2017). Does Past Performance Matter in Investment Manager Selection? *The Journal of Portfolio Management*, *43*, 33-43.

Cremers, M., & Petajisto, A. (2009). How Active Is Your Fund Manager? A New Measure That Predicts Performance. *Review of Financial Studies*, *22*, 3329-3365.

Fama, E.F. (1970). Efficient Capital Markets: A Review of Theory and Empirical Work. *Journal of Finance*, *25*, 383–417.

Fuller, R.J. (1998). Behavioral Finance and the Sources of Alpha. *Journal of Pension Plan Investing*, *2*.

Goyal A., & Wahal S. (2008). The Selection and Termination of Investment Management Firms by Asset owners. *Journal of Finance*, *42*, 1805-1847.

Jensen, M.C., & Meckling, W.H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, *3*, 305–360.

Jenkinson, T., Jones H., & Martinez, J.V. (2016). Picking Winners? Investment Consultants' Recommendations of Fund Managers. *Journal of Finance*, *71*.

Kahneman, D., & Tversky, A. (1979). Prospect Theory: An Analysis of Decision Making Under Risk. *Econometrica*, *47*, 263-291.

Khorana, A., Servaes, H., & Wedge, L. (2007). Portfolio Manager Ownership and Fund Performance. *Journal of Financial Economics*, *85*, 179-204.

Lakonishok, J., Shleifer A., & Vishny, R. (1992). The structure and performance of the money management industry. *Brookings Papers: Microeconomics*, pp. 339–379.

Mauboussin, M., & Johnson, P. (1997). Competitive Advantage Period: The Neglected Value Driver. *Financial Management*, *2*, 67-74.

Porter, M.E. (1980). *Competitive Strategy – Techniques for Analyzing Industries and Competitors*. New York, NY: The Free Press.

APPENDIX

TABLE 2
MAIN DIFFERENCES CURRENT PARADIGM VERSUS NEW PARADIGM

	CURRENT PARADIGM	NEW PARADIGM
Approach	Transactional	Partnership
Investment management fee		Lower
Transition management fee		Lower
Co-development /Customization	Low	Higher
Alignment asset owner	Low	Higher
Alignment asset manager	Low	Higher
Investment horizon	Often not defined	Explicitly defined
Performance Evaluation Period		
Established	Ad-hoc during relationship.	Before start relationship.
Parties involved	Asset owner	Asset owner and asset manager.
Differentiated	No	Yes
Part of IMA	No	Yes
Formalized	No	Yes
Selection / Monitoring Phase		
Importance performance	Medium – high. Performance as proxy or confirmation of the asset manager's quality.	Limited. Should only be used from the perspective of the asset manager's competitive advantage.
Criteria	People, Process, Portfolio, Performance and Planet.	Focused on all aspects of the competitive advantage.
Differentiation	Non-differentiated	Differentiated based on type of competitive advantage(s).
Termination of IMA	Non-conditional	Conditional