The *Ambachtsheer* Letter

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DOES INSTITUTIONAL INVESTING HAVE A FUTURE?

"How can we allow people of varying abilities and financial sophistication to express preferences for investments without making them vulnerable to salespeople selling 'snake oil'?"

From the book "Animal Spirits" by
George Akerlof and Robert Shiller

A Keynote Speech in Tokyo

We just delivered a keynote speech in Tokyo that addresses the question posed above: "does institutional investing have a future?" Not to keep you in suspense, our answer was "Of course it has". But there was an important caveat. A significant proportion of institutional investment services on offer today cannot not meet the 'value for clients/ beneficiaries' test. Below, we set out the argument for this view, provide evidence supporting its validity, use logic and empirical evidence to lay out a 'better way', and ask how that 'better way' could be realized.

The argument for the 'no value for most of the customers' reality follows logically from the two key facts:

1. Markets for investment management services are 'asymmetrical'. Most sellers know more about what they are selling than most buyers know about what they are buying.
2. Sellers take advantage of this situation by not competing on price, but on less tangible factors such as 'hope', 'quality', and building strong distribution channels.

Nobel Prize-wining economist George Akerlof pointed out many years ago that in markets with these characteristics, customers will pay too much for too little. Conversely, sellers will be paid too much relative to the economic value of the product or service they provide.

The Cost of Active Investing

How much do the customers in fact pay for institutional investment services? Prof. Ken French answered this question in his 2008 Presidential Address to the American Finance Association. Focusing specifically on the US stock market, he estimated the annual investment costs (management fees and trading costs) paid by investors over the 1991-2006 period. As a specific example, the total cost of investing in US stocks in 2006 amounted to 77 basis points, or $115 billion dollars. Of that $115 billion, French estimated that the total cost would have been about $15 billion (10 bps) if the entire pool had been passively managed, leaving the remaining $100 billion (67 bps) as the incremental cost of active management to investors in that year.

The question Prof. French's work allows us to pose is this: 'what *value* did that incremental $100 billion in active fees and trading costs create for participants in pension, mutual, and hedge funds in 2006?' The correct economic answer is 'price discovery'. In other words, with zero active management, stock prices would have no economic basis. Thus the economics-based question becomes: how much money should be spent on active fees and trading costs in order to maintain 'fair value' pricing in the US stock market? The economics-based answer of course is: 'up to the point where an incremental dollar spent does not