Lashing the engine

A fund management firm may have billions to invest, but if it cannot retain its key fund managers, the losers are not only the firm, but also the investors and shareholders. ANDREW BAKER looks at the key issues surrounding fund manager retention.

Lashing the engine started with the observation that many fund management firms do not seem to be able to retain their key investment professionals – those individuals able to deliver sustained outperformance – over the long term (or sometimes even the short term). There is a general acceptance that key investment professionals are relatively rare, have a strong bargaining position, and from time to time use that strength to maximise their financial outcomes.

We were ultimately interested in identifying factors which encourage key professionals to both voluntarily limit their bargaining power and stay with their firm. In doing so, we followed a series of steps in building our understanding of:

- The nature of the knowledge used by key professionals, its potential as a source of competitive advantage for firms, and its role as the foundation of bargaining power;
- The extent to which key professionals gain access to the profits of the firm, ie earn “rents”, their potential to extract more, and how remuneration structures reflect this;
- What bargaining factors make key professionals so strong;
- How key professionals think about boutique formation;
- Identification of the key job/organisational design and cultural factors for key professional retention;
- Measurement of levels of satisfaction with the key factors and identification of correlations.

WHAT’S THE BOTTOM LINE?

So what really matters to key investment professionals? We gave our sample a list of 14 major job/organisational design factors and 14 major cultural factors and asked them to rank their top five and score their satisfaction with their top five on a 1-5 scale.

The results demonstrated that there is a single and overwhelming no.1 job/organisational design factor for key professionals – challenge of the job. In fact, when expanded to a top five analysis (Figure 2), there are really only two other particularly important factors: levels of remuneration and relationship with team/co-workers.

A lot of factors important in general management populations were infrequently selected. For example, the relationship with the team is much more important than the relationship with the key professional’s superior. Leadership opportunities, performance review and variety are all relatively unimportant for key professionals.

In stark contrast, there are no dominating cultural retention factors (Figure 3) at all – a lot of factors matter. Important factors (Figure 4) include...
recognition, informality, trust, the ability of employees to speak and be heard, and openness to change.

**KEY INVESTMENT PROFESSIONALS ARE DIFFERENT**

The primary reason why general managers say they stay in a role is personal growth and development, while the primary predictor of whether they actually stay is their relationship with their immediate superior. Even a great company cannot expect a superior retention experience unless it has good people managers. By comparison, money consistently ranks as a middle-ranking factor.

A relatively recent McKinsey survey, (Hedberg et al, 2001) looking at the overall asset management industry, identified the following factors as important to employees in choosing to join or stay at a company:

1. Feedback
2. Mentoring
3. Compensation
4. Pay differentials
5. On-the-job training

As the figures demonstrate, the above general manager and industry factors are basically nowhere in the key professional’s world. Key professionals are a different population, and they therefore need different retention strategies applied to them.

**MANY ARE SATISFIED … BUT FAR FROM ALL**

So, given we have identified what most key professionals think is important, how satisfied do they tend to be with the important factors?

Looking at the important design factors (Figure 5), key professionals are not only very motivated by the challenge of their job; most are also very satisfied. The team relationship is also generally associated with high levels of satisfaction. But despite key professionals being a well-paid group in an absolute sense, satisfaction with levels of remuneration is not especially high.

However, the only real problem area is equity participation, because it is: (a) surprisingly, not very common and (b)
where present it is often very difficult to value. Equity participation needs a lot of work.

Other areas for improvement include: development/growth opportunities; involvement with business decisions and relationships with superiors. But these are not gaping holes, and sources of dissatisfaction seem to be isolated.

**THE KEY ROLE OF CULTURE**

At first glance, the picture for the top cultural factors (Figure 6) looks at least as good as it does for the top job/organisational design factors. Both informality and trust are associated with high levels of satisfaction.

But closer analysis revealed this to be a deceptive view of culture as a whole. A lot of factors matter in culture, and average scores concealed large variations. Satisfaction with culture tends to be polarised, especially in second-tier factors.

In first-tier factors, employees can speak and be heard, and openness to change, were extremely divergent, with quite high and low satisfaction. There are low satisfaction problems with neutrality/lack of favouritism, treated as a partner by top management, and to a lesser extent willingness to take risks.

On top of this, satisfaction with important cultural factors is correlated in a way that is not the case for design factors. Respondents reporting a “1” (i.e. very low satisfaction) score for an important cultural factor had a very high tendency (probability approaching 90%) to have 4-5 of their top five cultural factors scored in the 1-3 range.

As a result there was a significant proportion – approximately one third – of respondents reporting alarmingly low levels of satisfaction with most or all of their top cultural factors.

A very low cultural satisfaction score for any major factor usually signals low satisfaction with the culture as a whole and may therefore suggest the existence of a general problem.

While the relative importance of design and cultural factors in a key professional’s decision to stay or leave was not considered, it seems likely that a low satisfaction score with a major cultural factor may be a useful indicator...
of looming retention problems. One of the respondents who fell into this category resigned within the period of the research. Clearly one incident is statistically meaningless, but it does support the flagging of culture as critical for retention.

It makes sense that culture is important. It’s one of the relatively few characteristics of a firm that are truly difficult to replicate, and if employees associate positively with cultural values, they may derive an additional “psychic” remuneration from them which would be lost if they depart.

Cultural can also be a solution to information problems. Within professional groups an intra-group form of control known as clan control can develop. It provides a set of unwritten rules which can be applied when clan members have to make decisions with incomplete information.

Clan control means that members of the clan may decline to take advantage of information gaps when they exist – something of great value to an asset management firm when you consider the knowledge and awareness gaps which often persist between general management and the investment professionals. Firms with bad cultures forgo this potential advantage.

Knowledge-based resources can therefore potentially create a sustainable competitive advantage in a manner which is difficult to obtain via physical or financial assets. The asset management industry appears to be a strong candidate to achieve this.

All of the respondents to our study were operating investment processes which were either qualitative or had a significant qualitative component.

The knowledge used to produce decisions tends towards tacitness rather than being the hard and fast outcomes of a formula-based process. In particular, tacitness often revolves around the correct interpretation of information, when several interpretations might be available. This is something which cannot be supplanted by IT. It is a positive factor for a firm’s competitive advantage, but it was the only one of significance.

The bad news for asset management firms starts with the generality of investment related knowledge. It can usually be applied across many different firms including direct competitors. This results in relatively weak protection of knowledge, mainly arising from the identity of key professionals to depart and take it with them.

MANAGING THE POWER OF KEY PROFESSIONALS
A firm seeking superior shareholder returns needs a sustainable competitive advantage, and this means access to resources which are valuable, rare, and hard to imitate. Knowledge is an attractive resource because:

- It may be tacit, making it resistant to copying or transmission;
- It may be firm specific; it cannot be applied anywhere else;
- It may emerge as a result of team or social interactions, which are difficult to replicate;
- Outcomes may have unclear causation, making it difficult for competitors to work out how the outcome was achieved;
- It may be protected by patent, secrecy, or otherwise difficult for competitors to obtain via observation or hiring.

The pre-eminence of the individual over the team in developing investment knowledge created an interesting paradox given the finding elsewhere in the research program that the key professional’s relationship with the team is a both a key retention factor and a major source of satisfaction.

If the team is not very important for the knowledge creation behind investment decisions, yet is very important to the key professional’s satisfaction and decision to stay or leave the firm, what then is the role of the investment team?

It is tempting to relegate the importance of teams to a subsidiary or supporting role to the individual key professional. It is especially tempting to cast considerable scepticism on the efforts of some asset management firms to promote their funds as “team managed” to the extent that this is seen as a counter to the star culture and its bargaining power. This looks contrary to reality and ultimately pointless given that it is not difficult to see through the team to identify the key individuals.

It appears, therefore, that the job of a key professional itself does not strictly involve or require a significant team element, and that even where a group is involved, it seems to function more as a group of individuals rather than a team. Therefore, if the key professional does not appear to have a critical need for a team to do the job, it may be that the importance of the team is at least as much a social role as a functional role.

Given that the benefits of investment
teams seem to be limited in a functional sense, it seems appropriate that the often seen customer and asset consultant preference for investment teams over individuals be revisited. This preference, usually based on the hope that the business risk associated with key professionals can be diversified away simply through the use of teams, looks superficial and unlikely to be effective unless an asset manager can construct a team which includes other key professionals. Given that these people are not common, this strategy will often not be available.

Rather than trying to wish investment teams into something that they do not appear to be, it might be more useful for customers and external stakeholders to recognise the role of investment teams as a social network which is of significant importance to the key professional.

Teams are not a solution to the bargaining power of key professionals. Rather, solutions lie in a range of measures which management can take, the combination of which is far more effective in limiting the bargaining power of their key professionals than the use of teams.

This does not fundamentally challenge the validity of investment teams in asset management, but it does challenge the traditional perceptions of their function.

**BARGAINING POWER**

Key investment professionals are relatively rare and valuable. Inherently we would expect them to have a strong bargaining position.

But how strong? What factors make them strong? Do asset management firms inadvertently behave in certain ways which weaken their own bargaining position? (Figure 7)

In fact it is possible to measure the bargaining power of professionals along a number of dimensions:

- The ability to bargain collectively;
- Access to financial and operational information of the firm;
- The risk of major customer loss if the key professional leaves;
- Length of time to replace a key professional;
- The task difficulty facing a replacement;
- The exit costs faced by a key professional;
- The unity, or lack, of the management team on the opposite side of the bargaining table;
- The extent of management understanding of and involvement in the knowledge development process.

We asked our respondents to score their situation along all these factors in order to build up a picture of their overall bargaining position, and were able to perform a rudimentary attribution among factors.

We found that most factors make a significant contribution; in fact the only weakness is that key professionals can rarely negotiate as a group. With a few notable exceptions, bargaining is an individual activity.

But that's minor given that key professionals score strongly along most other factors. They often have extensive access to profitability and operational information, and the risk of customer loss following the departure of a key professional is high.

The departure of a key professional is a blow to an asset management firm because not only are they likely to lose clients, it also takes a significant amount of time to replace a key professional – over six months on average. This is then followed by another non-trivial period of time during which the replacement incurs initial task learning or redesign costs. The loss of effectiveness following the departure of a key professional can easily extend to a year or more.

These are factors that management cannot do much about. But when we look at factors where management does have significant influence, there is evidence that some asset management firms are making bargaining harder for themselves than it need be.

Key professionals often face only low to moderate exit costs, which was unexpected. This is partly because the incidence and size of equity participation was much lower than expected, and where present, it is often hard to put any value on, and partly because key professionals often have sufficient bargaining power to get their new employer to compensate them for exit costs.

Management is often seen to create problems for themselves rather than acting in a manner which reduces the bargaining power of the key professionals – such as presenting a united front. A material number of respondents agreed that “Management consists of warring factions”.

While there are some strong united management teams, disunity is quite common.

There is also something of a disconnect when it comes to managing knowledge, which after all, is at the heart of asset management businesses.

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**FIGURE 7 BARGAINING POWER**

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<td>Bargain in concert with others</td>
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Management understanding of investment knowledge is only moderate, and development is often delegated to the key professionals, rather than management overseeing this process. This is puzzling. Even though management may not be investment specialists (although they often are), given that knowledge is a key resource, we might expect that management would be actively involved in managing it.

A strong bargaining position translates into an ability to capture profits, something of considerable concern to shareholders (where they are different to the key professionals).

Profit appropriation is difficult to observe directly so it was addressed by asking key professionals whether they would work for less in their current job, and if so, where the “floor” would be relative to current remuneration. This floor can be defined as the level of remuneration required to bring them into production; any excess above this can then be defined as profit appropriation – rent generation.

Results showed that about half the respondents would work for a third less on average. This suggests that shareholders are paying key professionals a premium of some 50% as a result of their bargaining power.

It should be pointed out that this is not necessarily a bad result for shareholders. Profit sharing and equity participation have long been seen as both important retention tools and solutions for aligning the interests of shareholders and their employees.

Smart shareholders with their general managers will set out to design a profit sharing scheme that recognises the bargaining power of their key professionals, but still preserves a satisfactory – preferably superior – return for shareholders.

What is particularly concerning is the implication from the data that non-key professionals might also be appropriating profits. Non-key investment professionals tend to add little value for the firm’s investors, or even subtract it, and can therefore be a significant drag on shareholder returns. The prospect that underperformers are also gaining large remuneration premiums is somewhat unpalatable, certainly for shareholders, but increasingly also for the public.

Not only are key professionals obtaining rent, they believe that they could obtain more. Over 70% believe that they could increase their remuneration if they bargained harder, by an average of 42%.

Respondents described the structure of their variable remuneration in terms of percentage of base – absolute amounts were not requested. (Figure 8)

The average total variable remuneration was 179% of base and the median 150%, but data points ranged from relatively small amounts to 450% or higher.

Profit appropriation is mainly collected as performance bonuses. This structure differed to expectations. The average equity component was relatively small, and while the other equity related component, profit share, was larger, it was not used very frequently. When equity was present, it was often in the form of options or other equity linked remuneration which was either seen as impossible to value or currently worthless. “Other” components were infrequent but significant where they occurred.

Remuneration policy can be made to work harder. At present it is often ineffective as a retention tool given that key professionals rarely face high effective exit costs.

Remuneration policy often is not structured with effective alignment of interests in mind. Equity linked components in particular need to be reviewed where they exist as often little value is attributed to them. Equity is important to key professionals, but it needs to be understandable and measurable.

Remuneration policy also needs distinguish between true key professionals, where rent sharing may be appropriate, and non-key professionals where rent sharing is not appropriate, but may still be occurring to the considerable expense of shareholders.

### LASHING THE ENGINE

So what practical steps can senior managers take to retain their key professionals? These rare and unusual individuals represent a significant management challenge (if not nightmare) – they are different to other staff, are largely impervious to financial incentives, sensitive to the culture, tempted by boutiques and armed with strong bargaining power.

However, a few measures can make a lot of difference:

- **Establish who is really key and who is not;**
- **Get a grip on which factors matter and which don’t (see earlier discussion).** In organisational design what matters is mainly challenge, remuneration, and the team. In culture, everything matters.
- **Culture is key, so be tough in assessing yours, as about one third of large firms have bad cultures.**

![FIGURE 8 REMUNERATION AS PERCENTAGE OF BASE](chart)
Key professionals tend to be happy or very unhappy with culture – there is not much in between. Key professionals leave bad cultures; good cultures not only keep them but bring a range of other benefits.

• Stop doing the stupid things. Management in-fighting and detachment from knowledge development prevent a united front and increase information gaps.

• Review the goals of remuneration policy. It’s probably ineffective as a key professional retention tool at present. It needs to distinguish between who is really key and who is not, or shareholders are simply giving away profits. Remuneration also needs to create alignment between shareholders and key professionals whether this involves equity or not. Some of these measures can be done quickly; others, like fixing a bad culture, are no short or easy thing. Active investment management exists to produce alpha, and the evidence suggests that only a small number of individuals – the true key professionals – can do it consistently. Active firms have little proportion if they cannot retain their key professionals, but they need to do so in a manner which leaves sufficient return for their shareholders.

Top managers need to create conditions which make key professionals want to stay, and at an acceptable cost. Creating such conditions is a major challenge, yet aspects such as culture are very difficult to replicate and therefore offer competitive advantage. This, ultimately, is what allows you to lash the key professional engine tightly to the firm.

NOTES


Lashing the engine – the boutique alternative

Since Kerr Nielson left BT in 1994 to create one of Australia’s most successful investment boutiques, what seemed like a brave move at the time has been followed by a wave of new boutique investment management firms. Anecdotally, there is strong awareness of the impressive investment performance produced by some boutique firms, and increasing acceptance by small and large investors alike. Names such as Perennial, PM, Select, HFA, and Paradice Cooper were barely known three years ago, but are increasingly seen as mainstream investment choices.

And it is not just anecdotal. The largest investment managers in Australia have been losing market share for the past couple of years. Despite the consolidation in the Australian industry, it is presently becoming less concentrated, not more, as investment fragments among a larger number of small managers (Table 1).

If anything, the trend has been accelerating among the very largest managers.

Why has there been such a shift of talented investment professionals from large firms to boutiques? What motivates them?

In fact it turns out that once investment professionals have made the jump to a boutique, on average they are notably more satisfied than those who stay behind with the larger firms.

Generally, boutiques are associated with high levels of satisfaction and key professionals working in boutiques are significantly more satisfied in terms of key design and cultural retention factors than their counterparts in larger firms. This was significant at a 95% confidence level (Figure 9).

So boutiques do seem to be happier places. This does not mean that larger firms cannot be good places to work. Several notable examples have strong records in key professional retention and recorded strong satisfaction scores. The problem is that respondents indicate that around one-third of large firms have very low satisfaction scores, especially when it comes to organisational culture. Large firms are particularly prone to dysfunctional cultures.

However, if large firms can get their culture right, there are other positives which they can offer relative to boutiques. Large firms offer advantages that some key professionals value, such as more resources, marketing and business infrastructure. They also offer a bigger, more diverse and sometimes more dynamic social environment, which is very important to some people.

Most key professionals weigh up the boutique decision. And if it was just about money, there seems little doubt they would exit en masse. Almost all key professionals believe that exiting to form a boutique would result in an increase in their earnings, part of which

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FUND MANAGEMENT
would be due to clients following them to their new firm.

But it is not just about money. Boutiques are clearly not for everyone. Categories of factors favourable for exiting to a boutique include:

- Freedom from undesirable tasks seen as associated with larger firms – bureaucracy and administration in particular;
- Specific current firm issues – dissatisfaction, lack of fun, lack of trust, or lack of fair recognition;
- The ability to build equity value and the more direct link between performance and reward;
- Freedom to work in a preferred manner – freedom of action, independence, and the ability to control one’s destiny;
- Characteristics of a boutique seen as more desirable – superior work environment, high satisfaction, better culture, more dynamism, better ethics, more flexibility;
- Attractive market timing at present – there are good people around who could act in concert, capital is available and success is seen as relatively likely;
- Attractive personal timing – may be particularly attractive for individuals at certain points in their career.

Each of these categories was roughly equally important, so while financial considerations are there, they are just one of a number of important benefits. There are also categories of factors adverse to key professionals forming a boutique (of which the first two groups were easily the most important). These include:

- High risk of new ventures – potential to fail, vulnerability to competition, potential damage to personal reputations;
- New ventures may increase workload – hassle of setting up, more administration, IT issues and increased regulatory load;
- Current positive factors which might be lost – loyalty, enjoyment of current team;
- Challenge of new venture formation – the time required to find backers and the need to have committed partners;
- General positive factors of large firms which would be absent – support systems and marketing and sales infrastructure, and ease of access to companies and research.

What primarily holds back key professionals from forming boutiques, therefore, is personal risk aversion and the enormous workload that goes with setting up a new venture of any type. There is no question that large firms face a real threat from existing and prospective boutiques for the loyalties of their key investment professionals. This is compounded by specific disadvantages that significant numbers of large firms feature.

Large firms find it more difficult to offer the same type of performance – reward link and alignment, either because equity is not available, or because the equity is part of a much larger firm in which others may well overwhelm a key professional’s contribution. Large firms also appear to suffer from bad cultures much more frequently than boutiques.

As many Australian firms have experienced, the consequences of losing key professionals can be severe, with buy ratings placed on review and even mass investor exodus. Large firms need to think about the measures they can take to reduce this.

Some key professionals are risk averse and will never move to a boutique. Some are entrepreneurially minded and will never stay. But many of the potential entrepreneurs will stay if large firms can offer a combination of benefits that boutiques cannot replicate, particularly the feel and satisfaction associated with a boutique together with the more extensive resources and other advantages of a larger firm.