In all aspects of life I have always felt it is incredibly important to look at incentives when considering how people will behave. It sounds like an obvious statement but in reality it is something that is very often overlooked, particularly in the wealth management industry.

Take, for example, the manager of a large UK Equity fund. In order to become a lead manager at one of the bigger asset management houses there is no doubt that he, or she, must have demonstrated a talent for stock picking and strong performance over a number of years. Earlier in their career, a manager's performance is everything to them: their future success (and potential earnings) are very closely linked to it. As time passes, a successful manager typically attracts more and more assets into their fund. Fees are charged as a percentage of assets under management, so if you think about it, there comes a point where the manager is more incentivised to just keep growing the size of the fund (collecting an ever growing management fee) and trying to avoid any significant underperformance which would likely cause an outflow of assets. In this scenario they are incentivised to stay close to the benchmark so as to avoid underperforming it, rather than using their true talent and taking the kinds of higher conviction positions that drove the performance in the first place. What you end up with can be a ‘closet tracker’ – and rightly, investors are led to ask why they are paying for active management if the fund is essentially hugging an index? It makes more sense to buy a much cheaper tracker fund such as an Exchange Traded Fund (ETF).

At Lincoln, we strongly believe in active management, however only where performance is genuinely targeted. So, how do you identify the right active managers? Part of the answer is to look at incentives. One characteristic we look for when starting due diligence on a manager is a significant level of a manager’s personal wealth invested in their own fund. For instance, one of our funds has assets under management of around $1 billion, and roughly a quarter of this is the management team’s own wealth. Clearly the ongoing fees are significant, but much more meaningful for the team’s prosperity is that the fund continues to perform strongly. Another feature of such funds is that they invariably cap their maximum size to avoid diluting performance which often occurs when a fund gets very large, particularly if investing in less liquid markets.

We also have the flexibility to invest in a manager that may have been successful in a larger firm but has left to set up on their own fund. In this instance his or her incentive is clearly very strong, but because the track record of the new fund will be short, most firms will not consider it. That is not to say we will only invest in smaller funds or those where there is owner management, and we do use ETFs in more liquid markets or tactically. However, looking for ‘skin in the game’ is a fundamental part of our investment philosophy.

A number of wealth management firms will agree with the above sentiments when considering investments to add to their clients portfolios, but it has always struck me as odd that the same doesn’t apply to the adviser themselves. Throughout my career I have often been asked by clients whether I would invest in a particular idea. In most cases the private banker or adviser does not commit their own money into the investments they are recommending. One of the things that attracted me to Lincoln, and I think really sets us apart, is that we invest all of our personal investable assets into our discretionary and advisory portfolios. As a result, clients know that we are completely focussed on seeking performance in all aspects of our investment process. When markets and portfolios fall, as they inevitably will during certain periods, the team at Lincoln feel the pain alongside our clients. Ultimately, we believe the Lincoln approach will drive better returns over the long term - unusually, for our industry, we have the courage of our convictions and are happy to invest alongside our clients to demonstrate this.

This is just one of the ways our model has been designed to align ourselves with our clients, but it is, I believe, a very powerful one.

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