The Contested Role of Investment Consultants: Ambiguity, Contract, and Innovation in Financial Institutions

Gordon L Clark and Ashby H B Monk+, Smith School of Enterprise and the Environment, University of Oxford, Hinshelwood Road, Oxford OX1 3QY, UK and Department of Banking and Finance, Monash University, Caulfield VIC 3142, Australia; +Global Projects Center, Faculty of Civil and Environmental Engineering, Stanford University, Palo Alto, CA 94305-4121, USA.

Contact. gordon.clark@smithschool.ox.ac.uk

Abstract. The global financial crisis and its aftermath put into sharp relief the structure and performance of the global financial services industry. Questions have been raised as to what intermediaries individually and collectively add to the production of investment returns and social welfare in general. In this paper, we look at the roles and responsibilities of investment consultants in relation to asset owners of various types, including pension funds, sovereign wealth funds, endowments, and family offices. Focusing upon the relationship between investment consultants and clients, it is suggested that this relationship is characterised by ambiguity; there is a lack of clarity as to the precise roles and responsibilities of both parties. This argument is developed by reference to a set of three prototypical pension funds, distinguished by asset size—a proxy for capabilities and resources. It is argued that ambiguity can be of benefit to both parties. But ambiguity can impose costs upon clients, unable or unwilling to remake their relationships with intermediaries. Our paper highlights instances of innovation, and the ways in which these relationships have been redrawn so as to respond to the challenges of operating in global financial markets.

Keywords. Asset owners, consultants, contract, finance, innovation, intermediation

JEL codes. D02, D21, G23

Acknowledgements. The authors are pleased to acknowledge the support of Stanford University and members of the research consortium on insourcing and outsourcing by financial institutions coordinated by the Global Projects group in the Faculty of Civil and Environmental Engineering. Research on the governance and management of investment institutions has been supported by the British Academy, the Leverhulme Trust, the Rotman International Centre for Pension Management, and Towers Watson. The authors wish to thank Keith Ambachtsheer, Ray Levitt, and Roger Urwin for their continuing interest in our research programme. Helpful advice and corrections on previous drafts were provided by George Bolton, Alice Chautard, Cody McCoy, Sarah McGill, and Dariusz Wójcik. None of the above should be held responsible for the views and opinions expressed herein.

Introduction

Pension funds collect contributions from savers and place those assets with service providers, often delegating the management (though not fiduciary responsibility) for producing investment returns (paraphrasing Diamond 1984). In most cases, these organisations depend upon a network of intermediaries linked in sequence so as to frame and implement their investment strategy. In many cases, asset owners seek out and make contracts with multifunctional financial service organisations, avoiding, as much as possible, the costs and consequences of going to the market for each separate but related financial service. Even multifunctional financial service companies combine insourcing with outsourcing, subcontracting to specialist service providers those activities that can't be produced internally in an effective manner (Clark and Monk 2013). In this context, intermediation has at least three dimensions: between savers and financial institutions like pension funds; between financial institutions and service providers; and between service providers.

Planning the production of financial returns typically involves entities that advise pension funds on the selection of organisations that provide investment-related services (Goyal and Wahal 2008). This is another dimension of intermediation, which describes the way in which the demand for financial services (buy-side) is intermediated just as the production of financial services (sell-side) is intermediated. Put more specifically, it is standard practice for asset owners such as endowments, foundations, pension funds, and sovereign wealth funds to rely upon intermediaries, including actuaries and investment consultants, to determine the nature and scope of the financial services needed to realise their investment objectives. It is standard practice for these types of intermediaries, which we define as 'consultants', to search the marketplace (local and global) for relevant service providers, rank-ordering them in terms of performance and reliability, and conducting 'beauty parades' where shortlisted providers pitch their virtues to clients (Shleifer 1985).

In this paper, we focus upon the role of consultants who advise clients on investment strategy and implementation.[1] There is a significant literature on the global consulting industry and management consultants (McKenna 2006). Here, though, there is less research although there are strong opinions. For some critics, investment consultants are gatekeepers, standing between asset owners and the global financial services industry, thereby limiting access on a preferential basis to the ultimate decision-making (Coffee 2006). Going further, Youngdahl (2013) contends that investment

[1]/. Investment consultants are people and, normally, employees of organisations that sell services. Globally, the investment advisory business is dominated by Mercer and Towers Watson. Their significance varies, however, by jurisdiction and market segment. For example, Cambridge Associates is important in North America and UK and Europe for charities, foundations, and family offices. In some countries, public sector pension funds have steered business away from the major investment consultants to smaller companies.

consultants have undue influence over clients, often exploiting their privileged position to gain long-term contracts, high fees, and even kickbacks. Knight and Dixon (2011) contend that investment consultants have stifled innovation since they have little incentive to go beyond industry norms and conventions.[2] Moreover, doubts have been raised about the value of investment consultants, and the money management industry in general, as revealed by the performance of recommended investment managers and products (Gennaioli et al. 2015; Jenkinson et al. 2015).

Investment consultants do more than sell "solutions to problems specified by the client" even if "consultants are represented as independent, objective advisers with superior know-how" (Glückler and Armbrüster 2003, 277). Investment consultants are essential to the investment performance of small and medium-sized asset owners, and even to that of some large investment institutions. Investment consultants tend to have long-term relationships with these organisations, providing crucial services including skills and expertise either not available within these organisations or, if available, insufficient in relation to financial risk and uncertainty. Contract is one of the threads holding these relationships together. Many funds are limited in their power to bargain the terms and conditions of service agreements. And yet, investment consultants often prefer equitable relationships rather than exploiting their market positions, thereby seeking to maintain market share via standardised contracts (see Choi and Triantis 2013, 55 on the ways in which bargaining power in contract negotiation is mediated by market strategy).

In this paper, we provide an analytical account of the various roles of investment consultants, how and why their roles vary by the size (assets under management) of clients, and ways in which consultants can foster or stand in the way of innovation. The paper begins with a discussion of the theory of intermediation, based upon landmark papers in the field including Allen (1990), Allen and Santamero (1998), and Diamond (1984), as well as Gorton and Winton's (2003) survey of the field as it relates to banking and finance. This is augmented by reference to the management science literature on organisational capabilities and resources (Helfat and Peteraf 2009). There are useful synergies between these fields which deepen our understanding of the role of consultants in general and the role and responsibilities of investment consultants in particular. The third section of the

[2]/. By 'norms' we mean industry-wide expectations as to the nature and scope of investment consultants' services and by 'conventions' we mean the social practices of the industry (matching Brennan et al. 2013, 17, 20-21, 100-102). Norms claim legitimacy by virtue of shared expectations whereas the later record what's done in the industry rather than what should be done (compare Storper 2000). Norms and conventions like standardized contracts are created "when markets are thick—in the sense that many actors face similar changes in their dealings and stand to benefit from concerted responses to them" (Gilson et al. 2013).

paper focuses on what investment consultants do, playing off of our previous discussion of what senior managers do in asset owners and asset management companies (Clark and Monk 2015).

This is followed by a stylised representation of the contractual relationships between asset owners and consultants, distinguishing between small, medium-sized, and large asset owners. We bring to light the subtleties of these relationships given the capabilities and resources of differently sized institutions. Going beyond functionalist conceptions of intermediation, we suggest that ambiguity is characteristic of these relationships. We argue that ambiguity can be desired by both parties because the production of investment rate of return is subject to market risk and uncertainty. Ambiguity in these relationships provides a space in which to adjust investment strategy and its implementation to unexpected changes in market conditions. This account of the virtues of ambiguity is informed by Hachigian (2015), and recent research on the importance of reflexivity in modern economies (Bathelt and Glückler 2011). In the fifth section we observe that the benefits of ambiguity must be judged against its possible costs, particularly where industry norms and conventions entrench advisory relationships to the detriment of innovation.

Throughout, our argument is analytical in that we do not refer to, or identify, specific organisations, financial centres, or service providers and intermediaries. This should not be taken as implying the specifics do not matter. The details do matter, especially in the regulation of commercial relationships, the nature and interpretation of fiduciary duty, and the accountability of the financial services industry at home and abroad (McCormick 2010). Nonetheless, these issues are held in abeyance so as to provide a fresh way of looking at intermediation and the role of consultants in the investment management industry.

Theory of Intermediation

For many analysts, the rationale for intermediation is best understood via the theory of transaction costs. In his treatise on the theory of the firm, Spulber (2009, 2-3) argued that firms exist because consumers cannot get what they want from separate suppliers in a cost-efficient manner. This argument has its origin with Coase (1937) who argued that the size of any firm is a function of that which can be done efficiently within its boundaries, as opposed to outsourcing to organisations that provide intermediate goods and services. In this section, we consider two versions of this argument: one found in financial theory and the other found in management science. We show that these arguments converge on a number of counts.

Financial intermediation

In the finance literature, the issue of intermediation is conceptualised in terms of the existence and functions of banks (or bank-like institutions) (Mayer and Vives 1995). Diamond (1984) began by asking why savers do not lend to investors directly: why are banks needed to manage the relationship between savers and investors? Diamond provided a set of interlocking answers. First, given that there are many savers, searching for investors and then overseeing or monitoring their actions can be, in the aggregate, very expensive. Second, there are likely to be free riders who shirk responsibility for their share of the costs of search and monitoring. Third, monitoring is an expensive business, with a premium on information—savers may be poorly placed to collect the needed information to make effective decisions.[3] In effect, it is assumed that banks provide two functions. They gather together and coordinate the interests of savers, utilising their skills and expertise to realise investment objectives. Banks also monitor the performance of entrepreneurs, expending scarce resources on that function up to the point where further monitoring is not repaid by better performance.

This model has been developed in many ways (see for example Gorton and Winton [2003] who looked at the related research on the various functions of banks). Much like banks, institutional investors like pension funds and insurance companies collect together dispersed savers, coordinate their interests in terms of desired investment returns, and then go about the business of investing the stock of assets in relevant and available opportunities according to target rates of return. Having realised investment gains or losses, these are then returned to savers. Whether this is done within an organisation or through its relationships with intermediaries that are better able or more efficient in realising investment objectives would seem unproblematic. Coase (1937) provided a rationale for insourcing versus outsourcing by focusing upon the transaction costs of one mode of organisation versus another, and the extent to which controlling a single entity is a better option than coordinating a set of external providers (Clark and Monk 2013).

Capabilities and resources

The theory of intermediation presupposes that financial organisations are flexible in that the switching costs between modes of organisation are not a constraint on the choice of modes. In management science, transaction costs are also significant—witness the importance attributed to

[3]/. Investors need more than a certain quantity of information—to be effective, investors also need information distinguished by quality and value. Caplin and Martin (2011, 2899) show that individuals typically satisfice rather than optimize when searching for information. As a consequence 'decisions are made without full examination of all available options indicating 'the best available options may be missed'. In response, investors may outsource this function to those with the requisite expertise and judgement.

Williamson’s (1975) theory of markets and hierarchies. Here, the issue is whether an organisation or set of organisations facing a changing environment have the internal capabilities and resources necessary to respond in an effective manner. In our analysis, capabilities are defined as the decision-making protocols by which organisations frame and implement strategies consistent with their goals and objectives. Resources are defined as the tangible and intangible assets of an organisation. Human capital is a key (intangible) asset in the global financial services industry (Faulconbridge 2006, 2009; Clark and Monk 2013).

There is some debate about the distinction to be drawn between the terms ‘capabilities’ and ‘resources’. Amin and Cohendet (2004) don’t use these terms but refer to an organization’s competencies: how it processes and distributes information and knowledge given the premium on coordination. Elsewhere, we suggest that coordination is a significant issue for many financial organisations, especially where senior managers are reliant upon task- and domain-specific expertise (Clark and Monk 2015). Helfat and Peteraf (2009) would merge the two terms, especially in a changing environment. Even so, we believe there is merit in maintaining the difference even if investment consultants can be seen as ‘resources’ as well as ‘capabilities’ in certain situations. As resources, intermediaries like investment consultants add information and knowledge not otherwise available within the sponsoring organisation. As capabilities, investment consultants provide skills and expertise so as to underwrite the investment decision-making process (Clark and Urwin 2008).

By this logic, intermediation adds to an existing organisation’s (or set of organisations’) capabilities and resources. This can be important because these capabilities and resources are either not available to the relevant organisation by virtue of its size and position in the market or are so task-specific and expensive that few managers can justify holding them internal to the organization. At the same time, intermediaries can bring to financial organisations information and knowledge of the competitive environment and related organisations that few organisations would be able to gather themselves. As such, the management literature on intermediation ends up in a similar place with the finance literature in that both suggest holding costs and search costs provide a rationale for intermediation.

Ambiguity and organisational form

The theory of intermediation gives priority to functions rather than organisational form (see Merton and Bodie 2005, 13). As such, we run the risk of functional essentialism in that this logic tends to ignore organisations’ histories and geographies and the ways in which both shape the conception and delivery of certain functions. This is not just an issue of degree—the extent to which there is a match between an organisation's capabilities and resources and functional performance in realising their objectives. In some settings, and in some types of organisations, capabilities and resources may be so inadequate as to compromise the realisation of their missions. Furthermore, a close match between functions and organisational form may be self-defeating. To the extent that organisational structure lags behind functionalist imperatives due to management entrenchment and rent-seeking behaviour, for instance, organisational form can be a constraint on the nature and pace of innovation.

In any event, functionalism is hardly an adequate representation of the evolution of organisations, whether financial or otherwise. As Roe (2006) observed, organisations are normally created for a variety of reasons, some of which cohere and some of which conflict with one another. So, for example, the express purpose of a pension fund is to reap the benefits of scale and scope in the provision of retirement income not available to individuals acting on their own account. But few pension funds stand alone: their activities and interests are subject to their sponsors' separate and collective interests as well as the balance that must be struck between different generations of workers (savers) who participate in such organisations. Functionalist conceptions of organisations decry the costs associated with embedded claims and counterclaims for priority. Nonetheless, these types of organisations exist because they are coalitions of interests, notwithstanding ambiguity as to their proper purpose and functions.

Vagueness as to the purpose of an organisation may be the price paid for its existence. Lack of clarity is one meaning of ambiguity (see Heath and Tversky 1991; compare Ellsberg 1961, 660). Ambiguous goals and objectives can have adverse consequences for decision-makers and their performance in financial markets (Epstein and Schneider 2008). It is often the case that ambiguity is characteristic of the decision-space of an organisation, where issues and possible solutions are left unstructured so as to facilitate negotiation and agreement. In this paper, we suggest that ambiguity as to the roles and responsibilities of consultants with respect to their client organisations can be beneficial to both parties and desired as such (*contra* Fox and Tversky 1995). There need not be one 'right' organisational form if uncertainty is characteristic of the environment (Hachigian 2015).[4]

[4]/. Organisational flexibility may be desirable given the nature of financial markets—always evolving in ways that are neither entirely predictable nor necessarily consistent with inherited management practices and commitments (Lo 2012). Regime shifts are rarely immediately obvious but demand an adaptive capacity that can bridge short-term responsiveness with long-term adaptation. Few financial organisations are as adaptive as necessarily implied by Lo's characterisation of financial markets.

What Do Advisers Do?

In what follows, we provide a schematic framework of what investment consultants do in three different types of pension funds: small funds, medium-sized funds, and large funds (in terms of assets under management, as specified below). We believe the schematic framework is also applicable to endowments and foundations, family offices, and sovereign wealth funds, though it is not our intention to empirically demonstrate the relevance of the framework to these financial organisations. Size matters because it is, in part, a proxy for organisational capabilities and resources (Clark and Urwin 2008). Nonetheless, we are mindful of the fact that size can become a significant constraint of realising the value of embedded capabilities and resources. Size begets complexity, and complexity can adversely affect coordination— thereby discounting the notional advantages of size (Clark and Monk 2015).

Case 1. Small fund, representative board, wholly-outsourced. We assume that a small fund is an organisation that manages less than US$5 billion in assets and liabilities. This assumption is somewhat arbitrary given that being 'small' does vary in relation to the jurisdiction and origin of an organisation. We also assume that the fund is governed by a board which represents the stakeholders of the fund, including the sponsor and beneficiaries. Again, the composition of such boards can vary by jurisdiction and by the type of sponsor (Tilba and McNulty 2013). Finally, we assume that this type of organisation buys the functions it needs to fulfil its mission from the market for financial services. While the fund has employees, it is assumed that they administer the process of selecting providers, including their oversight.

In this case, our stereotypical fund works through a two-tiered model of governance wherein the board delegates oversight of investment strategy and its implementation to an investment subcommittee comprised of a select number of members of the board. Ultimately, the board receives the subcommittee's recommendations and accepts or rejects their advice. In this case, the investment adviser provides the relevant capabilities and resources appropriate to framing investment strategy and its implementation through the selection of asset managers and related service providers. That is, the investment adviser *enables* investment decision-making. Indeed, given the composition of the board— and oftentimes the lack of relevant capabilities and resources—the investment adviser is the *means* by which investment strategy is conceived and realised.

This arrangement has three dimensions. First, the relationship between the client and the consultant is one of mutual dependency. Without the investment adviser, the board would not be able to make effective investment decisions and would lack the means by which to implement its investment strategy. Even so, the nature of the contract binding the parties together is framed such that it provides the client the right to terminate the relationship 'at will' (e.g. subject to a month's notice). It is assumed that the client 'controls' the adviser by the threat of termination. Second, a conservative culture tends to dominate investment decision-making. Investment strategy is framed using widely accepted concepts and tools appropriate (relevant) to the investment subcommittee, if not the entire board. Third, as a consequence, the relationship between the client and adviser references industry norms and conventions. Boards and their advisers find comfort in benchmarking investment strategy and fund performance against similar organisations (as implied by Shleifer 1985).

Case 2. Medium fund, representative board, mixed sourcing strategy. In this case, our idealised fund could be thought responsible for assets and liabilities in the region of $10 billion to $30 billion. This is, by necessity, a rather crude approximation. Nonetheless, in relation to Case 1 (above) and Case 3 (below) insights are to be derived from elaborating the relationship between clients and investment consultants in this type of fund. In this case, the fund has a three-tiered model of governance: the board; the investment subcommittee; and an investment management committee. Whereas the board is representative of sponsors and beneficiaries, members of the board are selected in part in accordance with their knowledge and understanding of finance in general and, perhaps, investment in particular. Even at the lower end of the size category, the fund may have sufficient assets to manage a portion of its assets in-house, rather than out of house. In this case, in-house investing tends to be based upon public markets and utilises the standard toolkit of investment management techniques, including portfolio diversification (Litterman and others 2004). In this case, investment consultants are less about *enabling* investment decision-making and more about *facilitating* investment decision-making. They may also be important in providing information about the *scope* of market opportunities for investment. This can complement the implementation of investment strategy.

Here, the relationship between the fund and the investment consultant is best understood in relational terms rather than the asymmetrical logic evident in the previous case. Whereas the fund <u>relies</u> upon the investment consultant, the fund does not <u>depend</u> on the adviser for investment decision-making. In effect, responsibility for investment decision-making and determining the means by which investment strategy is to be realised is shared. Furthermore, the investment adviser is able to act as a *resource* for the investment committee and, by extension, the board as well as the management committee. One implication is that this type of fund can develop a process of investment decision-making such that only strategic issues, rather than the day-to-day business of overseeing the performance of providers internal and external to the fund, come to the board. A second implication is that the relationship between the client and the adviser is marked by continuity and mutual learning.

Case 3. Large fund, representative board, reliant upon in-sourcing. In this case, our idealised fund probably has more than $40 billion in assets under management. Because of its size, and because of its importance to the sponsor or sponsors, the board is likely comprised of individuals who have a representative role *and* knowledge of financial issues consistent with the mission of the fund, if not specifically about investment management. These are rare individuals, and often command terms and conditions of appointment consistent with being a board member of a large corporation (Clark and Urwin 2010). This fund has a four-tiered governance structure with significant investment capabilities and resources located within the organisation. The relationship between the investment subcommittee of the board and the management investment committee is an essential element in the framing and realisation of investment strategy. While the board is ultimately responsible for investment strategy, the knowledge located at the management committee and the governance of the relationship between the management investment committee and the investment subcommittee are crucial in setting the mandates for its teams of portfolio managers, the fourth tier of the organisation.

Here, the investment consultant can have two rather different roles. At one level, he or she can provide members of the investment subcommittee 'independent' insight and knowledge – a not-entirely-welcome reality check on the aspirations of the fund's senior executives. To do so effectively, however, requires the investment adviser to be embedded in the investment process such that he or she understands the issues as well as the logic or rationale underpinning the fund's investment strategy and its implementation. Otherwise, the consultant may become something of a competitor to senior management. By necessity, this type of investment consultant is a highly skilled individual with a reputation to match. At another level, the investment adviser also functions as a source of information and knowledge about the investment strategies of other similarly placed organisations.

Three implications are to be drawn from this particular case. First, the relationship between the client and the consultant appears symmetrical in that the investment process honours the skills and expertise of the investment adviser in relation to the in-house team. Second, in actuality, the relationship may be discrete in that continuity of the relationship depends upon the consultant demonstrating value to the organisation in which he or she serves. This is not a relationship of dependency or reliance; this is a relationship cast in terms of cost and benefit. Note that the board, through its investment subcommittee, may come to rely upon the investment consultant to provide a critical perspective on investment strategy, otherwise absorbed by the institutionalisation of the fund's investment decision-making process. Third, there remains a role for investment consultants who can bring to the client insight, information, and opportunities which the client is unable to produce over the short to medium term. In this respect, the relationship is one of complementarity via substantive knowledge rather than dependence (Case 1) or reliance (Case 2).

Contracts and Services

In the previous section, we provided a schematic framework for understanding the role of investment consultants, emphasising the size of clients and their systems of governance and management. This is one way of conceptualising what consultants do. Just as important, we should acknowledge that investment consultants, like other service providers, do what they do through the medium of contracts for services. In principle, contracts for services provide both parties legally enforceable agreements through which to pursue their mutually advantageous but separate interests (Bolton and Dewatripont 2005). In practice, however, contracts for services must be flexible enough to accommodate the various ways in which clients and consultants work together, while providing each party with a degree of detachment consistent with evaluating the costs and benefits of such relationships (Kimel 2005).

To better appreciate the role and significance of contracts for services, we acknowledge that framing and implementing investment strategy involves networks of consultants and service providers, each of which have a role in the process. In the UK, for example, actuaries clarify the goals and objectives of investment strategies by reference to plan assets and liabilities (or obligations). Once they have established the investment goals and objectives of an organisation via a strategic asset allocation model, investment consultants provide information on the performance of various asset classes, investment managers, and opportunities. Legal advisers in conjunction with the representatives of investment managers formulate contracts for investment management services and, ultimately, the agreement of both parties. In many cases, a custodian holds and switches assets between clients and investment managers, while providing assurance that those organisations holding assets on behalf of clients do so effectively and efficiently. In some cases, a reporting agency collects performance data from the investment managers and reports back to the client. Overseeing this entire process are external accountants and internal administrators.

This characterisation of the types of organisations that make up the investment management process is, no doubt, simplistic. Nonetheless, it provides a way of situating investment consultants in the financial services ecosystem. Notice that each link in the chain is governed by a separate contract. In many respects, these contracts are rather similar in terms of their form, if not the function-specific expectations of clients and providers. As noted previously, the global financial services industry typically relies upon the laws of England and Wales to formalise the process of intermediation and govern the flow of capital around the world (Clark and Monk 2014). This is also apparent in Europe, notwithstanding the fact that some countries' legal systems do not cohere with the laws of England and Wales (La Porta et al. 1998). Under this umbrella are contractual templates or boilerplates for services, provided by associations or organisations representing different types of intermediaries. These templates allow parties to economise on transaction costs, favouring commonly accepted norms and conventions given the high costs of negotiating bespoke contracts.[5] Private agencies often provide arbitration mechanisms for clients and providers to resolve disputes in order to avoid the costs of going to court (McCormick 2010).

The standard contracts covering accountants, actuaries, investment consultants, investment managers, and information providers share three common characteristics. First, contracts are typically open-ended in terms of duration but provide clients the power to terminate at will. Second, standard contracts are typically silent on the precise nature of the services provided and, more often than not, refer to the *type* of the service provided: for example, 'actuarial services'. Third, standard contracts typically provide a statement of fees. In these ways, contracts are rather shallow documents and rely upon industry norms and conventions as to what comes with an agreement between a client and an actuary, a client and an investment consultant, et cetera. Industry respondents report that standard contracts are often accompanied by side-letters and/or appendices with detailed terms and conditions covering topics such as the liability of service

[5]/. Choi et al. (2013) explain the prevalence of standard contracts in commercial relationships, noting that law firms produce, and clients consume, contracts not so much for their substantive content as for their form. If there are differences between contracts for the same type of service, these differences tend to be marginal, trading on the 'acceptability' of standard contracts. They also observe that it is difficult for law firms to capture 'returns from contract innovation' given the risks that 'courts will interpret their terms in (an) unpredictable way(s)'.

providers, the protection of intellectual property, nondisclosure to third parties, and much else besides.[6] In sum, contracts are more than signed agreements: they are sets of documents which map the scope of engagement while providing frameworks for collaboration (Davis 2013, 85).

At one level, it could be argued that clients have a powerful lever over service providers, and especially investment consultants and investment managers, when the instrument binding the parties together enables the client to terminate the agreement with minimum notice. It would seem that this type of standard contract is, or should be, in the vernacular of contract theory, a bilateral contract which can be voided and/or renegotiated as the client desires (see generally Bolton and Dewatripont 2005). It might also be argued that the threat of termination is sufficient to ensure that the relationship between the client and its provider is equitable, even if it does not favour the client. However, the termination of such service contracts can come with significant transaction costs, including the winding down of service provision; the search for, and recruitment of, another provider; the transition between providers; and the upfront costs involved in situating the new provider in the chain of intermediaries that together manage the investment management process.[7]

Notice that contracts for services are typically between those nominated to represent the client and those nominated to represent the company providing services. On the client side, assuming that the pension fund is the legal entity, those authorised to sign such agreements are likely to include the chair of the board and a subset of board members. On the service provider side, those authorised to such agreements are likely to include the company secretary or nominated officers of the company legally entitled to sign such agreements. In substance, the 'client' of the service provider is, more often than not, the board of the fund whereas the 'service provider' is an individual or set of individuals who are employees of the service provider. Those involved may change over time as board members leave their positions and new members are appointed, and as employees of the service provider either leave to take on other responsibilities within the company or leave employment with the company. Recognising that market share is determined in part by the

[6]/. It is standard practice in commercial relationships for contractual provisions to limit or exclude damages for failing to live up to the terms of an agreed contract (Gillette 2013). If commercial relationships are ongoing and involve some measure of commitment, then these contracts may involve risk sharing and cost sharing—that is, an equitable distribution of the upside and downside of a relationship. This is rare in the global financial services industry.

[7]/. The dependence and/or reliance of funds on investment consultants combined with the transaction costs associated with the termination of services are such that small and medium-sized funds are often locked into these relationships. Investment consultants could exploit their clients by virtue of their privileged positions (Kőszegi 2014, 1104). Mediating this possibility is the importance attributed by both sides of the market to the reputation of consultants, whether personal or corporate.

continuity of advisory relationships, investment consulting companies are mindful of the value of maintaining these relationships even if the individuals involved take on other responsibilities.

Given the transaction costs involved in switching providers, and given possible changes in the membership and composition of boards, what appears to be a bilateral relationship favouring the client can become, by necessity, a contract marked by continuity rather than disjuncture. This is a significant issue for any fund, whatever its size. But consider the case of a small fund, governed by a representative board, which outsources the production of investment returns. As demonstrated above, the fund may have limited skills and expertise on its board and lack experienced staff through which to manage the fund and its relationships with service providers. In these cases, consultants provide clients the needed capabilities and resources to function as organisations. Not surprisingly, consultants standardise the services provided so as to economise on the costs of providing services to any individual client. Both sides of the market acknowledge but rarely explicitly recognise that customisation in accordance with the needs of clients is an expensive proposition – by this logic, industry norms and conventions are, on average, functionally efficacious.

By contrast, in a medium-sized fund where the client *relies* upon the investment consultant to facilitate investment decision-making and its implementation, the relationship between the client and the service provider is more equitable, if not entirely symmetrical. The costs of termination could be high given the lack of suitable internal capabilities and resources that could compensate for the termination of such a crucial service. Nonetheless, a medium-sized fund may be able to plan for long-term changes in the nature and composition of the intermediaries that make up the investment management process. Furthermore, this type of fund may be able to bring relevant expertise in-house such that reliance is mediated by informed judgement on the board and/or amongst senior officers of the fund. This may be a win-win proposition in that external advisers are able to develop relationships with knowledgeable officers who favour innovation in the process of investment decision-making and the nature and scope of investment management. Alternatively, both parties may have a common interest in entrenching their positions (see below).

As for large funds with developed investment-related capabilities and resources, the relationship between consultants and clients arguably favours clients over consultants. It would be possible to terminate consultants' services with due notice without an immediate or appreciable loss of value to clients. What is valuable about an investment adviser in these circumstances? There are three possibilities. First, the consultant and his or her company may have specialised skills and expertise not available internally to the organisation. Second, independent advisers may be a useful medium through which to interrogate the investment strategies of senior managers, testing assumptions and the plausibility of expected outcomes based upon alternative sources of information. Third, consultants may be able to bring to investment strategies knowledge and understanding of the strategies of similar organisations, otherwise treated as competitors. Continuity in these relationships depends upon the value consultants bring to investment performance.

[INSERT FIGURE 1 ABOUT HERE]

In Figure 1, we summarise this discussion by reference to six criteria that describe how fund size governs the relationship between asset owners and investment consultants. From left to right across the Figure, ‘status’ refers to the nature of the relationship, ‘function’ refers to what consultants provide clients in each instance, ’content’ refers to the material basis of the relationship, ‘knowledge’ refers to what consultants add to any discussion of the issues, ‘contract’ refers to the nature of the formal relationship between the parties, and ‘value’ refers to the net contribution of the consultant to the client. Clearly, these criteria are related, overlap, and reinforce one another. For instance, a large fund is likely to value its relationship with an investment consultant according to the degree to which their knowledge of key issues makes a substantive difference to the fund’s investment performance. Having a contingent relationship based upon adding value, clients could seek discrete rather than relational contracts.

Notice the differences between small and large funds across the six criteria. Small funds depend upon advisers to enable investment decision-making, being focused on managing the process rather than focusing upon the substantive content of the investment issues faced by clients. Because clients have limited capabilities and resources, clients expect consultants to have wide knowledge of the field. At the other end of the spectrum, large clients are not dependent upon consultants but treat the relationship as contingent and substantive, demanding specific knowledge in relation to their on-going investment programmes and projects. That is, the value of the adviser to a large fund is measurable and may be subject to a contract that is performance-oriented. In between, medium-sized funds tend to treat consultants as resources, relying upon their expertise for framing and implementing investment strategy rather than depending upon consultants for the process of decision-making itself. The difference between dependence and reliance may be slight, in some cases. But reliance can be managed whereas dependence may imply capture.

Ambiguity, Contract, and Financial Markets

In the previous section, we argued that the relationships between institutional investors like pension funds and investment consultants are governed by a type of contract that is open or ambiguous as to the specific tasks and functions required by the client.[8] Commonplace conceptions of ambiguity associate the term with something lacking coherence, precise definition, or accepted meaning. Presumably, it is something to be avoided or at least something to guard against. If so, it is perhaps surprising that contracts governing clients' relationships with financial intermediaries are open or ambiguous as to the precise tasks and functions an investment consultant must perform to be rewarded by fees and the reimbursement of costs. Here, however, are three objections to the commonplace presumption against ambiguity.

The first objection comes from Merton and Bodie (2005). In their analysis of their institutional structure of modern financial markets, they argue that, notwithstanding the primacy accorded to individual behaviour for what they call neoclassical economic theory, institutions play a key role in mediating and even resolving evident problems of coordination in episodes of market irrationality (Shiller 2005). By their account, the institutional structure of financial markets is a response to problems of coordination and agent behaviour: institutions provide a coherent framework within which agents can go about realising their separate goals and objectives. By necessity, the institutional structure of financial markets must have a degree of continuity or resilience that individual agents are not able to realise on their own account. The implication is plain: the open-textured or ambiguous nature of many service contracts is a desirable attribute rather than something problematic.

The second objection comes from Keynes (1921), Knight (1921), and scholars who believe that financial markets, more than many other types of markets, are subject to risk *and* uncertainty. By this account, the open-textured or ambiguous nature of clients' service contracts with intermediaries is a necessity rather than evidence of poor governance—given the possibility that sometime in the future the client and the service provider will need room to manoeuvre so as to adequately respond to changing circumstances. For financial organisations that either depend or rely upon investment consultants for investment decision-making and its implementation, an itemised contract specifying the tasks and functions of the consultant would be both expensive to

[8]/. See also Hart and Moore (1990, 1122) who suggest that where 'it is costly for agents to write detailed long-term contracts that precisely specific current and future actions as a function of every possible eventuality … the contracts written are incomplete and will be subject to renegotiation later on.' The implication here is that since firms are unable to write 'complete' contracts with providers, these activities are held within the firm. By contrast, in the financial services industry, ambiguity is underwritten by norms and conventions.

oversee *and* a constraint on an organisation's ability to respond to unanticipated shifts in financial markets. This objection links together the existence of uncertainty with the nature and scope of the transaction costs involved in re-contracting time and again.

The third objection is entirely situational. Industry observers note that if contracts for services are ambiguous, this provides the client with opportunities to gain access to consultants' skills and expertise going beyond that which is normally expected in any such relationship. Here, two elements are in play. At one level, industry norms and conventions typically provide clients with ready-made expectations as to the nature and scope of advice available through investment consultants. While it is a reference point, available at low cost to most clients, it need not be determinate. Clients can exploit the interest of investment consultants in the continuity of contract by pushing them beyond industry norms and conventions on a case-by-case basis. Put slightly differently, investment consultants can become the medium through which institutional investors learn about developments in the field. In doing so, investment consultants can empower their clients, thereby allowing for a change in their relationship such that it is more equitable in terms of clients' knowledge and understanding of market performance and investment strategy.

These three objections suggest that there is considerable virtue to be had in open-textured or ambiguous contracts with investment consultants. Returning to Merton and Bodie (2005), it is arguable that this feature is common to the relationships between clients and intermediaries in financial markets and is a vital component of the institutional structure of the global financial services industry. It facilitates coordination over time, it mediates apparent tendencies towards under- and over-reaction to financial market volatility, and it sustains flexibility within contractual relationships. A fixed contract with an explicit menu of roles and responsibilities could impose upon agents high transaction costs which may, in periods of significant market turmoil, threaten the stability of the entire financial system.[9]

Even so, ambiguity can come with significant costs. Norms and conventions, by their nature, reflect established practice, providing a test of what is acceptable, what is not acceptable, and what is contested. By definition, norms and conventions lag the leading edge of best practice (Clark and Urwin 2008), even if legitimised by professional bodies and organisations which certify their efficacy.

[9]/ It is also plausible that ambiguity facilitates the development of trust between parties to contracts in that the resolution of ambiguity on an issue-by-issue basis builds confidence in one another's commitment to the overarching project. By this account, trust thrives in these situations because the alternative (a complete contract) is not desired by either party. See Kimel (2005, 84) on the relationship between trust and contract.

Lacking the skills and expertise to make their own judgements about the utility or otherwise of what are deemed contested modes of investment management practice, small and medium-sized funds cling to past practices up until such practices fail in the face of changed circumstances. Clients then seek 'new' ways of doing things from consultants buttressed by reference to industry best-practice, thereby reinforcing their reliance upon these organisations. There are three kinds of costs in these arrangements: the costs of convention; opportunity costs (relative to what may have been achieved); and the costs of coming late to the market where premium returns have already been realised.

In any event, contracts with consultants are typically silent on the performance of investment consultants. But contracts are normally not silent on issues such as best endeavours, conflicts of interest, and due diligence. Once again, norms and conventions shape the expectations of clients in relation to what counts as a 'good' adviser and what counts as a 'bad' adviser. In terms of investment performance, moreover, advisers do not take responsibility for the decisions taken by boards and committees on investment strategy and its implementation. Enabling and facilitating decision-making is not quite the same as setting the parameters for an effective short- or long-term investment strategy. Investment consultants are deliberate in setting boundaries on their responsibilities in this regard. Ambiguity on this matter is not acceptable to investment consultants, their companies, or the sector.

Being embedded in epistemic communities of practice and being entrenched in long-term advisory relationships provide investment consultants protection from the vagaries of financial markets and the possible arbitrary decisions of clients. This means that investment consultants are normally neither rewarded nor penalised for investment performance. This is also true for many institutional investors. Pension funds, sovereign wealth funds, endowments, and family offices typically have an exclusive relationship with the ultimate beneficiary—in effect, they have exclusive control over the assets they manage. Perhaps, as Merton and Bodie (2005) might suggest, the permanent nature of these organisations and their relationships to beneficiaries is a response to the probable costs of overreaction to short-term events.

The fact that neither investment consultants nor the boards of institutional investors suffer directly the effects of poor performance insulates investment consultants from accountability in the face of adverse events. This minimizes the incentives on consultants to promote innovate and change in the face of market dislocation.

Modes of Innovation

It has been suggested that the relationship between asset owners and consultants is related to the size of clients (in terms of capabilities and resources) and industry norms and conventions. It has also been suggested that the contractual expression of these relationships is characterised in part by ambiguity as to what counts as performance: the link, if any, between investment consultants' role in the formation of investment strategy and its implementation, and the investment performance of their clients. In common with many other types of commercial contracts, investment consultants are insulated from the adverse results of investment decision-making. By this assessment, advisory relationships are rather stable albeit with potential for innovation.

In theory, innovation is driven by changes in the 'environment' in which organisations operate (Rosenberg 1995). Most relevant to our interests, it is widely believed that market disjuncture or failure drives the demand for innovation (Scott 2008). By this account, shortfalls in financial performance could prompt clients to demand of their investment consultants' solutions that break with the past and offer an alternative path or means for realising their goals and objectives (Birkinshaw et al. 2008, 829). Innovation can be found in the process of investment decision-making, in the mechanisms linking investment strategy and its implementation (e.g. insourcing or outsourcing), and in the choice of service providers and investment products. None of this need be 'new' in the sense of 'invented'. There may be options that have been ignored because their salience was not apparent or proven.

Market disjuncture

It is arguable that innovation in client-consultant relationships has been driven by shifts in financial market performance over the past couple of decades. This is not a new story; it has been told and retold over the past decade in the aftermath of the global financial crisis. Institutional investors and policy makers alike have responded, in part, by re-thinking their modes of practice and behaviour (see Akerlof et al. 2014). Here, though, we focus on two aspects of the relationship between clients and consultants: innovation in organisational form and functions, and innovation in the norms and conventions underpinning the framing and implementation of investment strategy.

The problem facing investors is the problem of distinguishing noise from signal—distinguishing between market information that is simply a jumble of data that requires sorting and sifting for value and market information that is unequivocal as to its implications for framing and implementing investment strategy (Clark 2014). To illustrate, Figure 2 displays the path of the FT100 stock market index since 1984. There appear to have been three rather different episodes over the past 30 years: episode 1, being the period 1984-1998, characterised by a steady trend in stock market appreciation; episode 2, being the period 1998-2007, characterised by an extended cycle from a peak (bubble) through a trough to another peak (bubble); and episode 3, being post-2008, which the Bank of England characterises as a period dominated by systemic risk. Left to the reader is episode 4, the period since markets were stabilised and economic growth returned to the UK economy and beyond.

[INSERT FIGURE 2 ABOUT HERE]

In retrospect, each episode can be readily described. But it was much harder *during* each episode to 'call' its characteristics and adapt investment strategy and its implementation. During episode 1, it would have been relatively easy to make money via a passive index tracker. This period was, as intimated above, dominated by benchmarking performance and switching between providers within asset classes according to relative performance (Shleifer 1985). As data accumulated on market performance, it became clear to academic researchers and to investment consultants alike that switching between providers in a growing market was consuming scarce resources (including the time devoted managing the switching process) (Litterman and others 2004). It was more effective to concentrate on longer-term asset allocation than benchmarking performance. As large funds adopted this strategy, the practice became accepted in the industry as medium-sized and smaller funds through their investment consultants mimicked early adopters.

The TMT bubble marked the end of an era (Shiller 2005). As global markets lost value, emerging market investment products came into their own. Initially these products were amorphous in that there was little in the way of shared attributes or ways of summarising their characteristics. Information about, and knowledge of, their underlying characteristics was at a premium. Investment consultants took-up the opportunity to compare options and tout winning products. Once again, larger asset owners tended to adopt these types of products, deploying their own capabilities and resources to inform decision-making. This changed when Goldman Sachs coined the acronym 'BRICS'—a marketing device that gave emerging markets a recognised meaning and a benchmark from which to evaluate competing products. In effect, Goldman Sachs sought to make a market for their emerging market products, bypassing investment consultants. As a consequence, it brought many small and medium-sized funds into the market for emerging market products.

Another narrative also became important: labelled the great moderation, it foretold a future of economic growth and stability underwritten by low inflation and global integration (Blinder 2015). Asset owners were asked to look forward, rather than backwards, in framing their investment strategies. Lacking data on the performance of related investment products, vendors simulated performance. Seeking investment returns in the face of declining discount rates, asset owners, large and small, were receptive to alternatives. In this environment, investment consultants were often bystanders as the narrative gained credibility, as this story was justified by a theory of stock market capitalism that discounted the likelihood of market instability (Clark 2011). Those that stayed too long in the bull market were punished by the global financial crisis (GFC). Even so, there remains hope that the market will soon return to 'normal'.

Innovation in form and function

Of the lessons learned from the GFC, three stand out in terms of the relationship between asset owners and investment consultants. First, more is expected of investment consultants, especially as regards their assessment of the likely performance of 'new' asset classes and investment providers. Even the smallest pension funds have re-evaluated their dependence on advisers, given low funding levels and the collapse in discount rates. It has also become apparent that while their business models depend on maintaining relationships with clients, investment consultants do not share the costs of poor performance, whether due to market movements or factors specific to individual funds. Third, there is a premium on innovation. In part, this is an issue of recovering lost ground. It is, as well, an issue of diversifying risk. As a consequence, the skills and expertise of investment consultants and their companies have become more important (post 1980).

One response has been to reconsider the 'form' of the relationship between investment advisors and clients. Here, asset owners foreground the contract binding the parties together rather than leaving it in the background as is typical of most contracts (see Kimel 2005, 84). By doing so, clients signal that the industry norms and conventions underwriting expectations of consultants' roles and responsibilities are no longer consistent with asset owners' particular interests. As well, it suggests that the ambiguity inherent in these relationships is not sufficient for clients to re-make investment strategies in ways that take into account new market realities. Put slightly differently, where market disjuncture breaks with past industry practices and the available scope for incremental adaptation, asset owners may be forced to confront their own inadequacies and the costs and consequences of conventional behaviour.

For some small funds, whose governing bodies are conscious of their dependence upon consultants for framing investment strategy and its implementation, one response has been to outsource these functions via fiduciary management agreements. In effect, outsourcing these functions has changed the organisational form of funds leaving in its stead a new contract for services rather than the functions normally associated with a pension fund. This provides asset consultants the opportunity to be more effective in framing investment strategy and its implementation. In essence, the related contract is for management 'performance' rather than for facilitating the process of fund decision-making *as if* the managers of such funds were able to realise their objectives.

For medium sized funds, also aware of their reliance upon investment consultants in a changing environment, one response has been to intensify their relationships with service providers. Rather than maintaining a relationship which is only periodically evaluated in terms of its efficacy, medium sized funds have sought closer relationships with their investment consultants. This has had a number of effects. At one level, intensification has subtly changed the relationship from reliance to mutual engagement. At another level, by intensifying the process of investment decision-making medium-size funds have sought to better understand the substantive issues, drawing upon the expertise of their asset consultants. In effect, asset owners have sought to redefine their relationships with consultants, going beyond the acknowledged ambiguity inherent in the scope of these relationships.

As for large funds, aware of their internal capabilities and resources and their possible power over investment consultants, their relationships with these service providers have been subject to review. In many cases, insourcing has raised questions about the benefits of asset consultants where their knowledge and understanding of the issues relevant to such funds are not nearly as developed as the investment professionals employed by funds. Equally, it is less clear as to the identity of the 'client' in these cases, especially if management committees have considerable scope in framing and implementing investment strategy. In these cases, contracts for services can be revised to focus upon adding value to the knowledge of investment staff rather than facilitating the process of decision-making. As funds develop their own legal services, contracts with asset consultants tend to become bespoke rather than reproducing industry norms and conventions.

Innovation in products and services

Over the past 20 years emerging markets were brought to the global marketplace via products that packaged securities from selected regions of the world. So, for example, longer-term trends in middle-class consumption were brought to market via value-focused stock selection investment strategies, and hitherto untraded positions were brought to market via investment partnerships and closed-end funds. Some product innovations are notorious; witness the misleading risk-rated CDOs based on the US housing market packaged and brought to market in the lead-up to the global financial crisis. Nonetheless, product innovation has provided asset owners valuable opportunities to diversify risk and gain access to certain types of investments that match their long-term objectives.

Even so, investment consultants are often identified as barriers to the diffusion of new products and new investment strategies. In part, this is because investment consultants are more often concerned with the process of framing investment strategy and its implementation than the nature of investment in its own right. Small funds depend upon investment consultants for investment decision-making, and industry norms and conventions provide a baseline from which clients evaluate the utility of their options. It would be unusual for an adviser to break with standard practice. Medium-sized funds are more attuned to alternatives in that having a modicum of knowledge and understanding of investment strategy affords asset owners the possibility of looking beyond the standard formula linking investment strategy with investment products. As such, medium-sized funds have oftentimes provided investment consultants an audience for innovation. This has been especially effective in circumstances where funds have intensified their relationships with investment consultants.

The ambiguity at the heart of the relationship between asset owners and investment consultants has also come under scrutiny, especially by large asset owners. As such, the issue of innovation for large asset owners has evolved from one dominated by assessing investment options against investment objectives, to one dominated by taking control of the investment process, improving knowledge of market dynamics, and reaching beyond the norms and conventions of the industry to concepts and tools that promote performance. In these circumstances, investment consultants have been asked to add value by bringing to the table innovative ideas and strategies. In these cases, the value of any contract for consulting services is to be had in the skills and expertise of advisors. Here, then, the onus is on the consultant to demonstrate value.

Implications and Conclusions

Our paper began with the observation that intermediation is a key characteristic of the global financial services industry; standing between individual savers and investment returns on those savings are organisations that collect, manage, and assign to investment vehicles the assets of large groups of individuals. These organisations take a variety of legal forms, including pension funds, sovereign wealth funds, insurance companies, endowments, and family offices. It was also observed that these types of organisations typically use intermediaries to frame investment strategy and its implementation. There are, of course, other intermediaries involved, including actuaries, custodians, legal advisers, accountants, and banks. The framework underpinning this paper can be applied to a wide variety of intermediaries. Nonetheless, given recent criticism of investment consultants, the substantive focus of this paper has been on delineating their roles and responsibilities.

The nature and scope of financial intermediation in any jurisdiction is determined in part by the legacy of norms and conventions specific to that country or region. Even so, it is entirely plausible to argue that the functional effectiveness of intermediation is the true test of the relevance of history and geography (Merton and Bodie 1995, 2005). To the extent that matching savers with investors is fundamental to modern economic systems, it does not matter how it is done as long as it is done in an effective manner. Likewise, it is arguable that it does not matter whether or not a financial organisation is dependent upon related but external service providers, so long as its long-term financial performance meets the requirements of its beneficiaries (Dixon 2012). If so, one might expect to see various models of management in the financial services industry, particularly in the relationships between asset owners and investment consultants. There is some variety in management models. There are also remarkable commonalities in those models across jurisdictions and types of organisations, but variable between financial institutions, according to size.

At the heart of our analytical framework is the assumption that the relationship between asset owners and investment consultants is under-determined. We might expect to see well-defined contracts governing the relationships between clients and consultants, characterised by clarity as to their respective roles and responsibilities; we find, in fact, that these types of contracts are open-ended, ambiguous as to the nature and scope of services to be provided, and virtually silent on issues such as performance. These contracts masquerade as discrete bilateral agreements where, in fact, both parties use them as relational frameworks that have no effective termination date. Ambiguity often suits both parties. For small and medium-sized financial institutions, either dependent or reliant upon investment consultants to frame and implement investment strategies, ambiguity as to their roles and responsibilities provides clients with flexibility in the face of changing market conditions. For investment consultants, concerned to maintain market share, ambiguity about what counts as 'performance' enables them to focus on process rather than substance.

What investment consultants do is set by industry norms and conventions. At the same time, contracts for services are normally quite explicit as to what investment consultants don't do and the potential liabilities they and their companies are not willing to assume. In many jurisdictions, industry norms and conventions reflect the evolution of the global financial services industry, the nature and scope of services, and the segmentation of the industry by size of client. As is often observed, norms and conventions summarise the state of play at any point in time rather than setting goals for the future. Merton and Bodie (2005) supposed that financial institutions inevitably converge on organisational forms that have the virtue of functional efficacy. Here, we have identified reasons why relationships between clients and consultants remain locked in the past. Models of best practice seek to shift norms and conventions towards higher standards of functional efficacy than that evident in customary practice (Clark and Urwin 2008, 2010).

We explain why norms and conventions have become embedded and entrenched in the industry. It is also suggested that medium-sized asset owners have had opportunities to reframe their relationships with consultants, in part by building up their own internal capabilities and resources and, in part, by seeking new ways of adapting to market turmoil. It was observed that size allows clients to discount reliance in favour of more equitable relationships such that investment consultants can provide knowledge and insight beyond that which is available internally to these organisations. This argument suggests, however, that the implementation of principles of best practice and the search for innovative ways of investing over the long term depend upon the client rather than consultant. As such, we would shift the focus of attention from investment consultants to clients and ask whether, in fact, the segmentation of the industry into small, medium, and large asset owners is consistent with a collective interest in promoting innovation and excellence in long-term investing (as intimated by the Kay Review 2012).

By this account of innovation, many financial organisations respond to the market rather than anticipate the market. This matches commentary in the academic literature to the effect that 'very few organisations have well-established and specialised expertise in the area of management innovation' (Birkinshaw et al. 2008, 830). But this does not capture the momentum amongst large financial institutions like pension funds and sovereign wealth funds towards insourcing over outsourcing, re-intermediation by exerting greater control over external providers, and redefinition of their relationships with advisers and consultants— including insourcing legal services especially where specialised knowledge is required that is asset class-specific, and project-specific. Innovation, in these circumstances, can be thought endogenous rather than exogenous: it is driven by the capacity to invest in resources as well as the realisation that scale brings with it the opportunity to solve the conflicts of interest when dealing with consultants who also advise other organisations that could be construed as direct competitors for market opportunities (as in large asset management companies).

It was noted that the ambiguity inherent in the relationships between clients and consultants, which is characteristic of the industry, may be to the advantage of both parties. Just as large financial institutions seek consultants to fulfil specific roles and responsibilities rather than provide the range of services typical of the industry, investment consultants have sought to deepen their skills and expertise in areas which few institutions are able to cover given the current state of play in the market. By this account, investment consultants have also sought to innovate so as to provide capabilities and resources that complement large clients, rather than pretend that they are a substitute for clients' capabilities and resources. As the process of disintermediation and re-intermediation gathers momentum across the industry, we could well see the emergence of more specialised boutique investment consultants, especially at the higher end of the value proposition.

The larger issue is whether innovation at this end of the market will filter down through the industry to the smaller asset owners and the consultants that enable and facilitate investment programmes. It is also important to consider whether being of a smaller size may become such a disadvantage compared to the in-house capabilities and resources of large financial institutions that, to survive, smaller asset owners may have to form alliances with larger organisations.

Bibliography

Akerlof, G., Blanchard, O., Romer, D. and Stiglitz, J. Eds. 2014. *What Have We Learned? Macroeconomic Policy after the Crisis*. Cambridge MA: MIT Press.

Allen, F. 1990. The market for information and the origin of financial intermediation. *Journal of Financial Intermediation* 1:3–30.

Allen, F. and Santamero, A. 1998. The theory of financial intermediation. *Journal of Banking and Finance* 12:1461–85.

Amin, A. and Cohendet, P. 2004. *Architectures of Knowledge: Firms, Capabilities, and Communities*. Oxford: Oxford University Press.

Bathelt, H. and Glückler, J. 2011. *The Relational Economy: Geographies of Knowing and Learning*. Oxford: Oxford University Press.

Birkinshaw, J., Hamel, G., and Mol, M.J. 2008. Management innovation. *Academy of Management Review* 33:825-45.

Blinder, A.S. 2015. Can economists learn? The right lesson from the financial crisis. *Foreign Affairs* 94(2):154-59.

Bolton, P. and Dewatripont, M. 2005. *Contract Theory*. Cambridge, MA: MIT Press.

Brennan, G., Eriksson, L., Goodin, R.E. and Southwood, N. 2013. *Explaining Norms*. Oxford: Oxford University Press.

Caplin, A. and Martin, D. 2011. Search and satisficing. *American Economic Review* 101:2899-922.

Choi, S.J., Gulati, M., and Posner, E.A. 2013. The dynamics of contract evolution. *New York University Law Review* 88:1-50.

Choi, S.J. and Triantis, G. 2013. Market conditions and contract design: variations in debt contracting. *New York University Law Review* 88: 51–82.

Clark, G.L. 2011. The global financial crisis. *Dialogues in Human Geography* 1:3-24.

Clark, G.L. 2014. Information, knowledge, and investing in offshore markets. *Journal of Sustainable Finance and Investment* 4:299-320.

Clark, G.L. and Monk, A.H.B. 2013. The scope of financial institutions: in-sourcing, outsourcing, and off-shoring. *Journal of Economic Geography* 13(2): 279-298.

Clark, G.L. and Monk, A.H.B. 2014. The geography of investment management contracts: the UK, Europe and the global financial services industry. *Environment and Planning A* 46(3): 531-549.

Clark, G.L. and Monk, A.H.B. 2015. The production of investment returns in spatially extensive financial markets. *The Professional Geographer* (forthcoming)

Clark, G.L. and Urwin, R. 2008. Best-practice pension fund governance. *Journal of Asset Management* 9: 12-21.

Clark, G.L. and Urwin, R. 2010. Innovative models of pension fund governance in the context of the global financial crisis. *Pensions*, 15: 62-77.

Coase, R. H. 1937. The nature of the firm. *Economica* 4(16): 386-405.

Coffee, J. 2006. *Gatekeepers.* Oxford: Oxford University Press.

Davis, K.E. 2013. Contracts as technology. *New York University Law Review* 88: 83–127.

Diamond, D. W. 1984. Financial intermediation and delegated monitoring. *Review of Economic Studies* 51: 393-414.

Dixon, A. D. 2012. Function before form: macro-institution comparison and the geography of finance. *Journal of Economic Geography* 12:579-600.

Ellsberg, D. 1961. Risk, ambiguity, and the Savage axioms. *Quarterly Journal of Economics* 75:643–69.

Epstein, G. and Schneider, M. 2008. Ambiguity, information quality, and asset pricing. *Journal of Finance* 63:197–226.

Faulconbridge, J. 2006. Stretching tacit knowledge beyond a local fix? Global spaces of learning in advertising professional service firms. *Journal of Economic Geography* 6(4): 517-40.

Faulconbridge, J. 2009. Managing the transnational law firm: a relational analysis of professional systems, embedded actors and time-space sensitive governance. *Economic Geography* 84:185-210.

Fox, C. R. and Tversky, A. 1995. Ambiguity aversion and comparative ignorance. *Quarterly Journal of Economics* 110:585-603.

Gennaioli, N., Shleifer, A., and Vishny, R. 2015. Money doctors. *Journal of Finance* 70:91–125.

Gillette, C.P. 2013. Tacit agreement and relationship-specific investment. *New York University Law Review* 88:128-69.

Gilson, R.J., Sabel, C.F., and Scott, R.E. 2013. Contract and innovation: the limited role of generalist quartz in the evolution of novel contractual forms. *New York University law Review* 88:170-215.

Glückler, J. and Armbrüster, T. 2003. Bridging uncertainty in management consulting: the mechanisms of trust and networked reputation. *Organization Studies* 24:269-97.

Gorton, G. and Winton, A. 2003. Financial intermediation. In *Handbook of the Economics of Finance* edited by Constantinides, G. M., Harris, M. and Stultz, R. Amsterdam: Elsevier, pp. 431–552.

Goyal, A. and Wahal, S. 2008. The selection and termination of investment management firms by plan sponsors. *Journal of Finance* 63:1085–47.

Hachigian, H. 2015. The Consequences and Management of Ambiguity for Long-Term Investors. Doctoral Dissertation. Oxford: University of Oxford.

Hart, O. and Moore, J. 1990. Property rights and the nature of the firm. *Journal of Political Economy* 98:1119-58.

Heath, C. and Tversky, A. 1991. Preference and belief: ambiguity and competence in choice under uncertainty. *Journal of Risk and Uncertainty* 4:5–28.

Helfat, C. E. and Peteraf, M. A. 2009. Understanding dynamic capabilities: progress along a development path. *Strategic Organization* 7:91-102

Jenkinson, T., Jones, H., Martinez, J., V. 2015. Picking winners? Investment consultants' recommendations of fund managers. *Journal of Finance* (forthcoming).

Kay, J. 2012. *The Kay Review of UK Equity Markets and Long-term Decision Making*. London: HM Government. Department for Business, Innovation and Skills.

Keynes, J.M. 1948 [1921]. *Treatise on Probability*. New York: MacMillan & Co.

Kimel, D. 2005. *From Promise to Contract: Towards a Liberal Theory of Contract*. Oxford: Hart Publishing.

Knight, F.H. 1921. *Risk, Uncertainty, and Profit***.** New York: Houghton Mifflin.

Knight, E.R.W. and Dixon, A.D. 2011. The role of investment consultants in transforming pension fund decision-making: the integration of environmental, social, and governance consideration into corporate valuation. In *Corporate Governance Failures: Role of Institutional Investors in the Global Financial Crisis* edited by Hawley, J.P., Shyam, J.K. and Williams, A.T. Philadelphia: University of Pennsylvania Press, pp. 217–41**.**

Kőszegi, B. 2014. Behavioural contract theory. *Journal of Economic Literature* 52:1075-2118.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. W. 1998. Law and finance. *Journal of Political Economy* 106(6):1113-1155.

Litterman, B. and others. 2004. *Modern Investment Management: An Equilibrium Approach. New York:* Wiley.

Lo, A. 2012. Adaptive markets and the new world order. *Financial Analysts Journal* 68:18-29.

Mayer, C. and Vives, X. 1995. *Capital Markets and Financial Intermediation*. Cambridge: Cambridge University Press.

McCormick, R. 2010. *Legal Risk in the Financial Markets*. 2nd Edn. Oxford: Oxford University Press.

McKenna, R. 2006. *The World's Newest Profession*. Cambridge: Cambridge University Press.

Merton, R.C. and Bodie, C. 1995. A conceptual framework for analysing the financial environment. In *The Global Financial System: a Functional Perspective* edited by Crane, D.B., Froot, K.A., Mason, S.P., Perold, A. A., Merton, R.C., Bodie, Z., Sirri, E.R. and Tufano, P. Boston: Harvard Business School, pp. 3–31.

Merton, R.C. and Bodie, C. 2005. Design of financial systems: towards of synthesis of function and structure. *Journal of Investment Management* 3 (1):1–23*.*

Roe, M. J. 2006. Legal origins, politics and stock markets. *Harvard Law Review* 120:460-527.

Rosenberg, N. 1995. Innovation's uncertain terrain. *The McKinsey Quarterly* #3:170-85.

Scott, W.R. 2008. *Institutions and Organisations: Ideas and Interests*. 3rd Edn. London: Sage Publications.

Shiller, R.J. 2005. *Irrational Exuberance*. 2nd Edn. Princeton: Princeton University Press.

Shleifer, A. 1985. A theory of yardstick competition. *Rand Journal of Economics*, 16: 319-27.

Spulber, D. 2009. *The Theory of the Firm: Microeconomics with Endogenous Entrepreneurs, Firms, Markets, and Organisations*. Cambridge: Cambridge University Press.

Storper, M.J. 2000. Conventions and institutions: rethinking problems of state reform, governance and policy. In *Institutions and the Role of the State* edited by Burlamaqui, L., Castro, A.C., and Chang, H-J. Cheltenham: Edward Elgar, pp. 73-100.

Tilba, A. and McNulty, T. 2013. Engaged versus disengaged ownership: the case of pension funds in the UK. *Corporate Governance: an International Review* 21:165–82.

Wagner, R. K. 2002. Smart people doing dumb things: the case of managerial incompetence. In *Why Smart People Can be so Stupid* edited by Sternberg, R.J. New Haven: Yale University Press, pp. 42-63.

Williamson, O. 1975. *Markets and Hierarchies*. New York: Free Press.

Wójcik, D. 2011. *The Global Stock Market: Issuers, Investors, and Intermediaries in an Uneven World*. Oxford: Oxford University Press.

Wójcik, D. 2013. Where governance fails: Advanced business services and the offshore world. *Progress in Human Geography* 37(3): 330-347.

Youngdahl, J. 2013. Investment Consultants and Institutional Corruption. Working Paper 7. Cambridge MA: Edmond J Safra Centre for Ethics, Harvard University

Figure 1. Stylised Account of the Consultant-Client Relationship

		Criteria					
		Status	Function	Content	Knowledge	Contract	Value
Size of Fund	Small	Dependent	Enable	Process	General	Asymmetrical	Unquantified
	Medium	Reliant	Facilitate	Expertise	Market	Relational	Beneficial
	Large	Contingent	Complement	Substance	Specific	Discrete	Measurable

Source: Authors

Figure 2. Path of the London Stock Exchange