

# Re-intermediating Investment Management

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**Abstract:** A growing number of institutional investors are unhappy with the exposures they have to long-term alternative asset classes, such as private equity, infrastructure and real estate. This frustration has little to do with the underlying assets. Rather, it relates to the sub-optimal access points and governance structures that tend to intermediate institutional investors from the assets they are trying to invest in. Put simply, external fund managers enjoy a disproportionate amount of power relative to the value they actually add in these illiquid markets. This paper thus argues that investors may want to re-intermediate their investments in alternative asset classes and work with more aligned, external agents. Drawing upon contract theory, we propose a shift towards the relational contracting method based upon trust, mutual dependency, transparency and co-operation as a more aligned governance mechanism for the long-term. Such a method of governance can be achieved through bilateral arrangements such as co-investment agreements, funds-of-one, or managed accounts. In cases where pooled vehicles, such as the Limited Partnership ‘Fund’ model, are more appropriate (and relational contracting is difficult to implement), more emphasis should be placed on fee transparency and on negotiating robust termination clauses in order to incentivize managers and reduce the power asymmetry between the two parties. Structural barriers to the implementation of relational contracts for investment management are identified and relate to the ‘LP’, ‘GP’ legal short hands used in the industry, which consolidates the power of managers as well as the role of investment consultants as gatekeepers to investment managers.

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**Key Words:** Investment Management, Institutional Investors, Alternative Assets, Infrastructure Investment, Governance, Relational Contracts

## 1.0 Introduction

The asset management industry has been under pressure to change its operating model, as the asset owners that fund asset managers are increasingly concerned by a growing misalignment of interests. Too often, the value created by external asset managers is captured by the managers rather than flowing through to the asset owners that back them (Berk and Green 2004). Worse yet, some managers do not just capture all the upside, they sometimes also capture upside (in the form of fees) off a portfolio that is underperforming; a large number of private investment managers actually generate high fee incomes (that investors do not always know about) while producing negative alpha (Malkiel 2013, Kaplan and Schoar 2005, Franzoni et al 2012, Ljungqvist and Richardson 2003). Much of the poor performance of private market investment managers has been attributed to a misalignment of interest in the governance arrangement between investors and managers (Steindl 2013, Baks and Benveniste 2010, Lerner et al. 2007, Torrance 2007). Also, when outperformance is achieved and rewards are shared with asset owners, the risks taken to generate those rewards are often not appreciated let alone measured (Franzoni et al 2012). As such, issues of trust, transparency and alignment of interest have become key issues for asset owners globally, and many are coming to believe that the investor-manager relationship is in need of new governance arrangements<sup>1</sup> (Atherton 2010, John 2009). This begs the question as to how such complex relationships can be rearranged to facilitate more alignment of interests.

We argue that, where feasible, investor-manager relationships should be governed by the principles of relational contracts, which are meant to foster long-term relationships based on mutual-dependency, as opposed to short-term discrete classical contracts. In making this argument, the paper draws upon contract theory to analyse, at a conceptual level, how investment management relationships can be better governed. We propose that the relational contracting method, from Macneil's spectrum of contracts, is a more appropriate governance framework for investors utilising investment managers, especially in the domain of private market investing. It contributes to the growing field of work spurred by the financial crisis that looks at addressing the governance problems and misalignment of interest between investors and investment managers<sup>2</sup>. In particular, it draws upon literature in economics and management on relational governance and builds on the work of Clark and Monk (2013) who utilise the theory of the firm to understand more deeply the decision-making process and effectiveness of investor organisations.

This paper is structured as follows. First, an overview of our theoretical framework is provided, including an introduction to hierarchical and governance theory of organisations using contracts. Second, we categorise the various inter-organisational contracts into discrete, neo-classical and relational contracts. Third, an explanation is given as to why the concept of relational contracts might be appropriate for the investor-manager governance. Finally, issues around the practical implementation of relational

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<sup>1</sup> A report by the SEC in 2014 found that over half of the 400 private equity firms surveyed charged unjustified fees and expenses without notifying investors. <http://www.bloomberg.com/news/articles/2015-03-23/7-ways-private-equity-is-gaming-your-pension>

<sup>2</sup> See Baks and Benveniste (2010), Anson (2010), Torrance (2009), Steindl (2013) as examples.

contracts for the investment management process are considered before the conclusions of the paper are provided.

## **2.0 Organisational Theory – Employment vs Service Contracts for Investment Management**

Prior to analysing the governance arrangements between investors and their managers, we must first provide insight into the generic decision-making process for institutional investors. Clark and Monk (2013) relate the question of in-sourcing and outsourcing of investment management to a choice between directly employing the investment managers in house or entering into service contracts with third-party providers on a fee-for-service basis (i.e. employment or service contracts). This stems from the seminal work on the nature of the firm by Coase (1937), where the question of managing production in-house or to outsource and subcontract activities is related to the ‘make or buy’ decision. More recently, scholars have related the ‘make or buy’ decision to issues of governance and hierarchy, which have relationship implications (Williamson 1979, Bradach and Eccles 1989, Gibbons 2010, Smyth 2014). If the make option is selected, governance is internal and conducted through hierarchy. Relationships are based upon hierarchical control, authority and power. If the ‘buy’ option is chosen, then the types of contract frame governance (Bradach and Eccles 1989). The types of ‘buy’ or ‘service’ contracts have been analysed by using a spectrum of contracts (which will be returned to in the next section) based on transaction cost analysis and sociology theory (Williamson 1979, Macneil 1978).

Clark and Monk (2013) discuss the difficulty in setting standardised employment contracts across an investor organisation where there are non-investment employees who carry out accounting, actuarial and custodial services (which need to be executed regardless of market conditions). They also distinguish the factors that might contribute to appraising investment talent in transparent asset classes compared with opaque assets. In transparent asset classes, it is easier to differentiate between luck and skill whereas in opaque asset classes, higher rewards could accrue to managers without knowing exactly where the source of return may have come from.

Smaller institutions that are unable to in-source the various tasks that make up an investment strategy are forced to engage in service contracts with external investment managers. The service contracts made with outsourced managers stipulate the target rate of return, related costs, and mechanisms for renewing or terminating the contract in the future<sup>3</sup>. Clark and Monk (2013) differentiate between investment management bilateral service contracts used for public market investing, that can be terminated at will and contracts in pooled investment vehicles, more common in private market investing. In the

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<sup>3</sup> In a fund structure, there is a vehicle, which is a legal construct – the most common models are the limited partnership, the limited company, and the unit trust. In a limited partnership, the partnership agreement both creates the fund vehicle and defines the contractual relationship between the fund operator and the investors. The fund operator then enters into a service agreement with the investment manager, who is usually an affiliate of the fund operator. Secondly, for a straightforward appointment of a fund manager by an investor to manage a segregated portfolio, there is a formal service contract that defines the terms and conditions of the arrangement.

latter arrangement, the terms of the contract may be different for different parties, with larger, earlier and more sophisticated investors of capital gaining more favourable terms such as discount on costs, private briefings, and direct engagement on issues of relevance. Smaller clients thus face larger costs, know little about the products, organisation or performance of external managers and are likely to come late (if at all) to the successful managers and stay longer with managers whose performance has diminished<sup>4</sup>.

The service contracts with external investment managers act as the governance mechanism for determining how the costs and benefits of the investment management process are distributed between principal investors and their agents (fund managers). Studying how the contracts are defined conceptually enables insights not only into the details of the agreement but also into the behaviours adopted by the parties.

### **3.0 Contract Theory – Transaction Cost Analysis**

Contract theory provides a framework for addressing the principal-agent issues in investment management service contracts and provides possible answers for an improved way of governing the relationship between investors and their managers. Grounded in law and economics, contract theory looks at the decision-making process of individuals and businesses under uncertain conditions or when there is asymmetric information around economic exchanges and transactions (Stone 2003). In legal scholarship and subsequently through transaction cost theory in economics, a continuum of contracts has been developed to facilitate an understanding of various human exchanges (Gudel 1998). A three-way discussion of contracts described by Ian Macneil and Oliver Williamson shows that contracts are varied and the governance structures within which transactions are executed must be adapted for the particular nature of the transaction<sup>5</sup> (Williamson 1979).

First, the classical law of contract stems from the nineteenth century and is used to model ‘one-off’, discrete and self-contained transactions. In classical contracts, the identity of parties to the transaction are considered irrelevant, the terms and limits of the agreement are carefully outlined, and the remedies are narrowly prescribed, predictable and not open-ended. Such a situation corresponds to the ‘ideal’ market transaction in economics; i.e. “of short duration, involving limited personal interactions, and with precise party measurements of easily measured objects of exchange” (Campbell 2001). Classical contracts place a large emphasis on price in the arrangement, based upon the absence of relationship recognition. Price essentially determines how the transaction is governed (Smyth 2014).

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<sup>4</sup> There are also structural disadvantages that prohibit smaller pension funds getting access to better performing managers. i.e. Many public pension boards demand that an external consultant vet a manager. But many consultants will only take the time to vet a manager if they can repackage and sell on a due diligence report. As such, consultants’ own priorities can prevent under resourced and risk averse pension funds from getting in early.

<sup>5</sup> Within law and economics literature, the classification and terminology of contracts is not used in a precise and consistent way. The spectrum used here draws upon some of the key ideas of MacNeil and Williamson, who were the earliest observers of such a spectrum existing.

Second, in recognition that a completely discrete transaction is an impossibility, Oliver Williamson formulated a hybrid form of *neo-classical* contract, which is based on the existence of transaction costs and provides an alternative contracting relation or governance structure in situations where the discrete or classical model of contract breaks down (Williamson 1979). These ‘transaction cost’ contracts are based on the realisation that the world is complex, that agreements are incomplete, and that some contracts will never be reached unless the settlement machinery provides confidence to both parties (Williamson 1979). Third-party assistance for resolving disputes in the form of arbitration as opposed to litigation is a feature of neo-classical contract. This is common in construction projects, which are rarely structured as single exchanges, and comprise a series of stage payments, each carrying transaction cost, albeit flowing from a single contract (Smyth 2014).

Third, relational contracts, at the other end of the spectrum, are characterised by long duration, personal involvement by the parties and are viewed as relations rather than as discrete transactions (Campbell 2001, Macauley 1963). The increased duration and complexity of certain contracts could not completely be covered by the *neo-classical* adjustment contract concept, which has led to the introduction of relational contracts. In contrast to classical and ‘transaction cost’ contracts, relational contracts have as a reference point for effecting adaptations in the agreement, the actual relation as it has developed over time (Williamson 1979). The planning for relational contracts is more often tentative rather than binding and focuses on planning the structures and processes to govern the relation in the future (Gudel 1998). Macneil uses the concept of relational in two ways when describing these forms of exchange (Campbell 2001). The first use of ‘relational’ refers to the fact that “all contracts occur in the context of a social matrix” and consideration must be given to societal and political influences on the exchange (Stone 2003). The second use of ‘relational’ for contract theory refers to the fact that “many contracts involve a continuing relationship between the parties, which will affect the way in which their contract operates” (Stone 2003). Relational contracts have been described as self-enforcing agreements in repeated interactions with co-operation in the present, contingent on the expectations of future exchanges. They can be formal or informal agreements sustained by the value of future relationships, connecting actors over time and space where there is reciprocity and repeated linkages, capturing the process of transacting as opposed to a discrete transaction (Poppo and Zenger 2002). Trust in these relational contracts is dependent on the trustworthy status over time through repeated exchange (Poppo and Zenger 2002). Just as trust is crucial for promises made between people, trust in relational contracts may be the product of some previous acquaintance with a person, or based on impressions of the respective personalities in the framework of on-going relationships (Kimel 2003). The table below summarizes the three categories of contracts.

Classical Contracts	Neo-Classical Contracts	Relational Contracts
'one-off', short term, discrete transactions	Alternative to classical	Longer-term
Identity of parties irrelevant	'Non-ideal', transaction costs	Process of transacting as opposed to discrete transaction
Terms and limits carefully outlined	More emphasis on third party assistance, not litigation	Planning is tentative not binding
'Ideal' market transaction	For more complex situations where parties gain confidence from settlement machinery	Repeated exchanges, based on trust, co-operation and mutual dependency
Large emphasis on price		Personal involvement of parties important
<b>Fund Model, LP/GP structure</b>	<b>Example: Construction Projects (series of stage payments flowing from single contract)</b>	<b>New Model, Managed Accounts, Funds-of-one</b> <b>Other examples: Heathrow Terminal 5 construction, pricing regulation</b>

Table 1: Classification of Service Contracts  
(Williamson 1979, Macneil 1978, Campbell 2001)

Proponents of relational theory argue that generic contracts are only as good as the relationships they create (Macaulay 1963). A social orientation and socio-psychological contract is more likely to induce decisions in the interest of a client despite seeming irrational from an economic perspective (Henisz et al 2012, Smyth 2014). When unpacked at the level of the exchange, it is the structure and quality of relationships that have a major influence on the value created. Relational contracts require norms of obligation and cooperation to coordinate the exchange. Macneil proposes the following contractual norms or behavioural patterns for relational contracts: role integrity, reciprocity, implementation of planning, effectuation of consent, flexibility, contractual solidarity, restitution, reliance and expectation interests, creation and restraint of power, propriety of means, and harmonization (Smyth 2014). These norms of relational contracting have been extended by scholars and utilised in various applications, for example in civil infrastructure projects and other inter-organisational collaborations (Henisz et al 2012, Gil 2009, Lee and Cavusgil 2006).

In a survey conducted on the travel industry to illustrate business to business marketing relationships in service industries, Schakett et al. (2011) found that service quality was only 27 percent attributable to economic bonds (exchange and transaction), 36 percent to a structural bond (contractual) and that 44 percent was attributable to social bond (norms and social contracts), pointing towards the importance of relationships. Smyth (2014) drawing upon the quote from Nahapiet et al. (2005:4) stated “the economy is also a relational economy since the structure and quality of relationships are a major influence both on the creation and exploitation of knowledge”. The prominence of relations in the

knowledge economy is even more apparent in the interdependent service economy (Uzzi 1997, Vargo and Lusch 2004).

This paper thus proposes the relational contracting method as a more suitable contracting conceptual framework for approaching the investor–fund manager relationship. However, just as a purely discrete transaction is practically impossible, it is unlikely that a pure relational contract actually exists. As such, the next section looks at how the relational contracting *concept* can be applied to the investment management setting.

#### **4.0 Re-intermediated Investment Contracts - From Discrete to Relational**

The perfect tender model, or discrete contract, presumes the existence of a complete contract covering all possible contingencies (Colledge 2005). In the event of non-performance or deviation, discrete contracts assume that the consequences are relatively predictable from the beginning and are not open-ended. However, with most investment relationships, mistakes are made, parties' interests are obscured in details and not all possible contingencies are foreseen. In the case of private market investing where long-term contracts are executed under conditions of uncertainty, 'complete presentation'<sup>6</sup> under discrete contracts is almost impossible (Gill 2009). Equally problematic is the fact that trust is a fundamental driver of success in long-term investment relationships. Overly formal contracts, however, may signal distrust with an exchange partner, and instead of discouraging, may encourage opportunistic behaviour in the relationship (Goshal and Moran 1996, Macaulay 1963).

The traditional Limited Partnership or 'Fund' model typically used by investment managers to raise capital from investors to invest in private market assets can be seen as a form of discrete contract between investors and investment managers. The Limited Partnership, as shown in the diagram below, is structured by a Manager that controls the General Partner (GP) of the Fund and is charged with making all of the investment and management decisions for the Fund. Institutional Investors buy interests into the Partnership as Limited Partners. Limited Partners (LPs) have limited liability and have no control over the daily management of the fund. There are usually a number of terms that are stipulated in the legal 'Limited Partnership Agreement' between LPs and the Manager including the Target IRR (targeted investment performance), the Hurdle Rate (the IRR that a fund must achieve before the manager or GPs may receive a share of the profits of the fund), Carried Interest (share of the profits that a GP receives after returning the required capital to investors), and Key Man Clause (if a specified member of the management team ceases to spend a specified amount of time to the Partnership, the manager is temporarily suspended from making any further new investments). Committed capital is the legally binding amount of money committed during the fund raising process, and it generally cannot change once a fund has been launched. Committed capital is drawn over time as the Partnership 'calls capital' to make

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<sup>6</sup> Quoting MacNeil (1974) "To presentiate is to make or render present in place or time; to cause to be perceived or realised as present. Presentation is only a manner in which a person perceives the future's effect on the present.; but it depends upon events outside the individual psyche, events viewed as deterring the future".

investments. Management fees are paid ostensibly annually to the GP to cover salaries and overhead costs and are calculated as a percentage of total committed capital or total invested capital (McCahery and Vermeulen 2008).

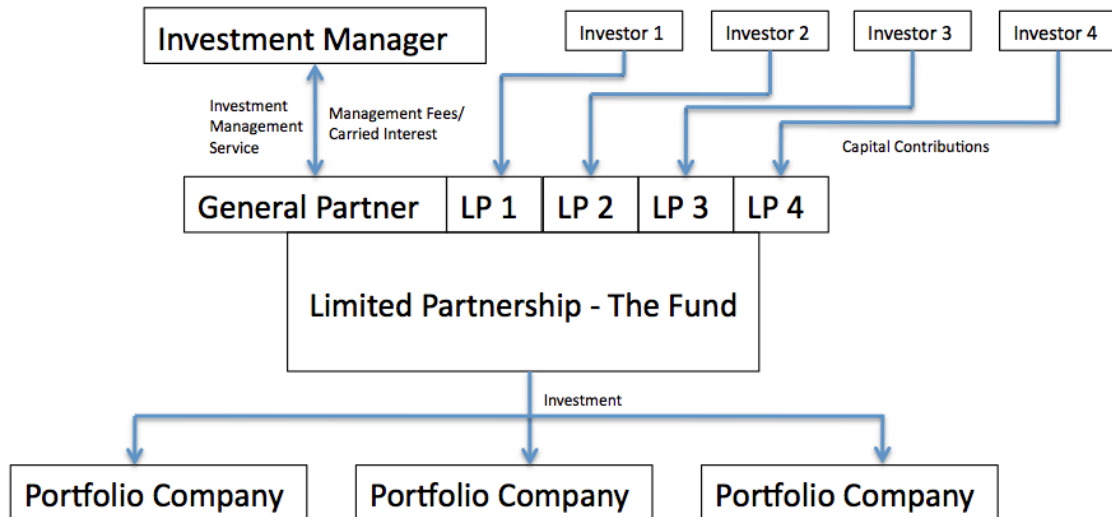


Figure 1: Limited Partnership “Fund” Structure (adapted from McCahery and Vermeulen (2008)).

Limited Partner’s usually do not have any approval rights over investments, with the decision lying solely with the GP. After an investment is made, GP’s often prepare a special announcement for their LPs, followed by an information memorandum describing the investment. Ongoing communication between the GP and LP varies but will usually include reporting packages quarterly or semi-annually to provide updates on the performance of the fund’s investment.

Despite the idiosyncratic, long-term nature and large amounts of capital being transferred, it would appear that the arrangement between institutional investors and fund managers through the limited partnership, fund model could be likened to a classical, discrete contract where the identity of parties is irrelevant and there is a strong emphasis on price as the governance mechanism. The Limited Partnership Agreement is what binds the limited partners and the general partner together, and the relationship is essentially governed solely by the terms set out in the fund documents. The investor then has very limited involvement in the management of the fund: advisory boards do not generally have much power and investors cannot easily move their assets out of the fund. It is proposed here that a shift towards relational contracting needs to occur for delegated institutional investment into private markets. However, as stated above, it is acknowledged that arriving at a purely relational form of governance may not be a reasonable assertion.

The implementation issues of relational governance have been widely discussed in the theory of contract by both economics and management scholars. Within economics, a central contribution is that of Baker et al (2002) who illustrate the difference between



formal and relational contracts and the importance of the latter for understanding informal organisational processes within firms. More recent work has looked at the theoretical interplay between formal and relational mechanisms identifying both substitutive and complementary roles between the two (Bernheim and Whinston 1998, Levin 2003, Kvaloy and Olsen 2005). The relevant management literature presents empirical findings on the contracting modes in different settings (Mayer and Argyres 2004, Argyres et al. 2007, Poppo and Zenger 2002).

Quite often, it is assumed that a relationship based on trust reduces transaction costs by ‘replacing contracts with handshakes’ (Adler 2001, Poppo and Zenger 2002). Generally speaking, increases in formal contractual complexity discourage the formation of relational governance whereas increases in relational governance discourage the use of complex contracts (Poppo and Zenger 2002). Despite this, however, it has been suggested that when repercussions or hazards are severe, the combination of formal and informal safeguards may deliver greater exchange performance than either governance choice in isolation (Poppo and Zenger 2002). Indeed, Poppo and Zenger (2002) state that:

*“The presence of clearly articulated contractual terms, remedies and processes of dispute resolution as well as relational norms of flexibility, solidarity, bilateralism, and continuance may inspire confidence to co-operate in interorganisational exchanges.”*

This same sentiment, implying a combination of formal and relational form of contract, is what provides the conceptual framework for the proposed re-intermediated governance of investment management relationships. In the investor-manager relationship, the explicit outlay of fees and other terms and conditions in the investment contract need to be accompanied by a relational form of governance that is based on trust, reciprocity and repeated exchange. The formal element of re-intermediated contracts should specify detailed schedules of roles and responsibilities as opposed to just detailed schedules disclaiming liability. Developing trust would require being in constant dialogue with investors; to go above and beyond the bare requirements of the formal contractual terms. Clear communication of key issues, such as fines, ESG, market trends, tax issues would also help build confidence for investors so that ‘shocks’ or variable performance can be contextualised and rationalised.

In the investment management industry, there is considerable uncertainty involved with how decisions are made and the performance achieved. Empirical work indicates that in cases of greater uncertainty, a relational, more flexible arrangement in the contract leads to more value (Crocker and Masten 1991). The relational value of solidarity becomes particularly important in promoting exchange into the future when conflicts may arise and the adaptive limits of formal contracts become exhausted (Colledge 2005). Adjudication is an important consideration with relational contracts given their incomplete nature. The exact arrangement will depend on the particular situation, however, third party arbitration for disputes, as described by neo-classical contracts, would be more likely and appropriate in this setting as opposed to formal judicial procedures, given the large amounts of capital at play and reluctance to have high profile law suits for both parties.

Relational governance may also promote the implementation of formal contracts. As a close relationship is developed or sustained (such as between two institutional investors for a co-investment relationship), contracts are used to formalise the arrangement or revisions to existing contracts can be made to reflect prior experiences<sup>7</sup>. What does this mean in practice for fund managers? While the specific terms and conditions of funds written into the formal contract will differ for different asset classes, some general principles can be applied.

Take as a case study for this paper the infrastructure asset class, for which fees have become a contentious issue and trust and long-term orientation is crucial. There is now greater appreciation of the diversity of risk/return profiles of infrastructure assets, and this should be reflected in the fees charged to investors. It is understandable that a fund investing in greenfield assets in the emerging markets carrying greater risk will charge a higher fee compared to a fund investing into brownfield assets in developed countries. There are various developments in fee structure that have taken place as a result of the market adjusting for differing opinions. It is widely perceived that management fees should just cover the cost of running the fund on a day-to-day basis as opposed to providing a source of profit for the manager. Given the large size of funds, a level of 2 percent management fee, common for private equity funds is considered too high, particularly for brownfield, core economic infrastructure assets in OECD countries (Watson Wyatt 2009).

In terms of performance fees, these are usually based on a hurdle rate and carried interest. Similarly, the hurdle rate will depend on the strategy employed and should be different for brownfield infrastructure assets in developed countries compared with development projects in emerging economies. It is noted that managers should only earn a performance fee if it is adding value (or generating alpha) (Watson Wyatt 2009). One of the ongoing difficulties in determining an appropriate fee structure for infrastructure funds is the holding period for investments. Unlike private equity, where the typical holding period is 4 or 5 years, infrastructure investments should perhaps be held for 10 years or more, with many investors' preferences moving towards even longer holding periods. Measurement of the value added by a manager where there are long periods without a market event (i.e. divestment) is particularly challenging.

Quite often, a bargaining game exists to determine how the value that is created by investment managers is shared between investors and their agents. Agency theory has been used to look at the investment management relationship to identify optimal contracts to address principal-agent problems (Jensen and Meckling 1976, Milgrom and Roberts, 1992, Bolton and Dewatripont 2005).

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<sup>7</sup> For example relational governance norms may facilitate the formalisation of the relationships between peer investors that are looking to form co-investment partnerships. Also, fund managers may develop relationships with investors first that then turn into a formal, more aligned fund structure i.e. forming a network (using social network theory) is not independent of incorporating relational governance (both are needed to formulate investment partnerships) – see *Monk and Sharma (forthcoming) Capitalising on an Investor's network: Co-Investment Case Studies*.

Ang (2014), draws upon the general principle that ‘an asset manager needs to look more like an asset owner in order to act like one’ when developing methods to achieve more alignment. Outcome-based contracts, which include bonuses to be paid if the manager outperforms a benchmark or peer group, enables the fund manager to share the principal’s reward. Behaviour based contracts involve asset owners monitoring asset managers’ behaviour and closely restricting managers’ opportunities to deceive investors. This may involve restricting certain investments but also rewarding certain efforts. Inference-based contracts would result in rewarding asset managers disproportionately higher for unique outperformance, or disproportionately lower for outcomes that are likely only if they were negligent. This is based on the principle that non-linear contracts are optimal (Ang 2014). The type of arrangement adopted would depend on the overall manager selection and asset class strategy of the investor.

With regards to the time horizon of unlisted funds, continuing the example of infrastructure funds, these have typically been just 10-14 years with a limited investment period of 4 or 5 years. The shorter-term focus is more suited to turn-around or development deals and the mandatory exit is not consistent with the long-term hold philosophy of core infrastructure. Contributions, valuations and liquidity are all controlled at the manager’s discretion and distributions are only made towards the end of the fund life (Prejin 2013).

Open-end funds or funds of length greater than 15 years seem to be more appropriately matched to the long-term liabilities of institutional investors and more suited to developing the type of partnership as described by relational contracting. Open-end funds have an investment period that is ongoing and provide immediate exposure to income generating assets (rather than a blind pool fund). With open-end funds, there is greater ability to grow and diversify the fund over time and no rush to deploy capital. With regards to contributions, investors have more control, valuations are regular and independent and liquidity is available from cash yield with the option of exits and redemption if appropriate. Investors also have control over reinvestment and distributions decisions (OECD 2014).

The exact terms and conditions of the formal part of the investor-fund manager contract will depend on the types of assets invested into. However, it is proposed that a relational form of governance should complement the formal aspect of the contract. This involves creating a deeper relationship with investors to help build trust by having regular dialogue, and facilitating more fluid, transparent information flows between the parties (without compromising the ability of the manager to carry out its function effectively).

## **5.0 Practical Considerations and Barriers to Relational Contracts**

### *Historical Context and Relational Governance*

It is interesting to note that, historically, institutional investors appointed investment managers to provide advisory and discretionary management services using tailored

investment management agreements (IMAs). Under these more ‘relational’ agreements, the investor was the client and the investment manager was the service provider. The purpose of the relationship was to provide services to the client. However as institutional investors started to allocate more capital into private and alternative asset classes<sup>9</sup>, investment managers started to employ the limited partnership or fund model. The funds were established as stand-alone businesses, which sought passive capital from investors. The purpose of the relationship was to provide capital for the investment manager to run its business. Investors accepted the model as they had little experience in alternative assets and private markets. However, now as investors have grown in size, sophistication and bargaining power, the default fund model is coming under scrutiny.

Reverting to the offering of managed accounts or ‘funds-of-one’ would enable a more personal relationship to be developed between investor and manager, where not only better terms and conditions are provided to investors, but an overall better duty of care is given, including frequent communication and greater transparency. The formal terms of a specialised managed account, including compensation, termination and duration can be negotiated to reflect both parties’ interests a lot more easily.

Managed accounts also allow decision makers of institutional investor organisations to more effectively monitor the activities of fund managers, and greater transparency enables them to demonstrate to their own stakeholders that they are doing so. The application of relational contracting principles and norms in these situations would be easier and more likely to lead to success for the parties involved. A movement towards discretionary IMAs with fund managers, adapting to allow investors to appoint them on this basis rather than invest in a ‘fund’, is part of the proposed re-intermediated model of relational investing we describe below.

Within the limited partnership or fund structure, the differentiated investor base entering into the arrangement makes blanket ‘relational’ offerings challenging. Larger and earlier investors are given better treatment by managers through lower fees, and greater information disclosure, which makes it harder for smaller investors to get access to the better managers. The creation of investor-led platforms that adapt the fund model may provide a solution to this problem to help smaller investors get access to private market opportunities in a more aligned way<sup>10</sup>. The importance of developing a wide network is crucial for these smaller investors when their inclusion by the top performing managers and sophisticated investors is purely discretionary. As indicated above for core economic infrastructure, there are certain aspects of the terms of a limited partnership agreement that can be revised to ensure more alignment for those investors that must use the fund model to access opportunities.

### *Fees and Termination Clauses*

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<sup>9</sup> Depending on jurisdiction, this trend started to occur towards the end of the 20<sup>th</sup> century as investors wanted to diversify their portfolios away from equity and fixed income markets.

<sup>10</sup> Please see *Monk and Sharma (forthcoming) Capitalising on an Investor’s network: Co-Investment Case Studies* for a discussion on the effectiveness and challenges associated with setting up co-investment platforms.

From a practical viewpoint, a relational perspective means redefining the terms and conditions of the agreement to include more transparency and collaboration between investor and manager. This may involve increasing the time horizon of the funds, or making them open-ended with the ability to withdraw capital under certain rules or conditions. The subject of fees is perhaps the biggest point of contention when designing the commercial contract for delegated investing. This is partly because fees in a contract need to be tied to a predetermined formula, and any situation is open to being gamed by a manager. Of particular concern is the inability to design a contract where the investor has the option of paying the manager as much as it thinks the manager is worth for a particular year, given all other factors and assessing the appropriateness of the investment decision at the time it was made.

In terms of management fees, calculations by reference to a fixed formula generally distort manager behaviour. If they are based on invested capital, the manager is incentivised to invest the money as quickly as possible; if they are based on committed capital, the manager can arguably be paid for doing very little. If a fund performs very badly, where the likelihood of beating the hurdle rate is very low, a ‘zombie’ fund may emerge where the manager has no incentive to exit investments at all. If performance fees are based on carry, the manager has the incentive to sell the asset as quickly as possible in order to release the carry, which is often calculated according to ‘internal rate of return’ calculations dependent on time as a critical factor. Similarly, rewarding managers for outperformance may encourage excessive risk-taking, which may be inappropriate for certain asset classes (such as infrastructure), particularly since there is already a built-in incentive for the managers to seek high returns as they generally need to establish historic outperformance in order to raise future funds.

Ideally, a contract would be designed so that a significant part of a manager’s remuneration is discretionary. This is in fact a lot easier to achieve with employment contracts as opposed to service contracts where, for example, a manager directly employed by an investor can have a bonus assessed on the appropriateness of their investment decisions in the context of the investment environment in which it was made.

Incentives are generally based on reward and punishment (the carrot and the stick). However, the focus in investment management has generally been solely on the reward aspect of incentivisation, with the effect that fees have been increased, without due consideration being given to the possibility of punishing managers for behaviour that the investor does not deem to be in their interest. The industry often justifies high levels of carried interest by arguing that, in the absence of such rewards, the managers might be tempted to simply take the management fees on committed capital and pay little attention to investing the fund in the interests of the asset owners. We submit that this approach fails to give sufficient regard to the other aspect of incentivisation, which is the fear of punishment. In many funds currently on the market, it is difficult if not impossible to remove an underperforming or otherwise unsatisfactory manager. If the termination provisions in fund documents were more robust, this could provide a less expensive way of incentivising managers to act in the interests of investors.

Firstly, most 'no-fault divorce' clauses (permission to remove a manager outside formal breaches of the contract) can only be triggered by a large majority of investors. This means that at least 75% of investors need to reach agreement on (a) replacement being appropriate, (b) how to fund the legal action necessary and (c) what to replace the current manager with. This can be very difficult, particularly when managers have received commitments from a diverse range of investors that do not know each other and have different priorities.

Secondly, most termination for cause provisions require a lower majority of votes (usually a bare majority) but cause is so narrowly defined in most funds, making it nearly impossible to prove. Many funds require a non-appealable court decision to trigger termination for cause, which means the investors would need to go all the way to the highest Court (by which time the fund would probably have terminated in any event).

Finally, many funds have extremely high 'break fees' where the relationship is terminated without cause (no-fault divorce), which makes it prohibitively expensive to remove a manager.

If investors were able to negotiate exit provisions more robustly, it would have a significant impact on the attitude of investment managers towards their investors<sup>11</sup>. At present, the only real discipline to go with the fee/carry incentive is the prospect of investors not committing capital in future fundraisings, which doesn't appear to have much impact. A more relational form of governance between investors and managers may involve a reduced reliance on incentivising through high fee/carried interest, and instead focus on developing more robust termination clauses in the limited partnership agreement.

#### *Other Practical Barriers to Relational Governance*

While the relational contracting idea provides a novel approach for improving the arrangement between investors and investment managers in the investment management process, there may be limitations in the practical implementation of the concept.

The first barrier is the fact that any attempt to wrestle control away from the investment management industry will face strong resistance. The industry has developed sizeable resources, which it can use to defend its lucrative rents. It would appear that there is too much money being extracted as fees and carry to expect the investment management industry to willingly move towards a fairer, trust-based approach. The number of agents in the investment chain makes it easier for the investment management industry to break down the weakest links to prevent change. It can be seen that intermediation is self-perpetuating in that the chain of intermediaries make it easier to resist change and disintermediation.

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<sup>11</sup> We do acknowledge that termination at will could create distortions towards short-termism. The factors that drive termination would need to be spelled out. These termination provisions seem to exist for most public market investments however is a lot more difficult in private market investments.

Another barrier to change is the language of fund management. For example, the 'GP' and 'LP' monikers have come to mean 'investment manager' and 'investor' across the industry. The 'general partner' and 'limited partner' terms are legal shorthands, which attach a number of rights, liabilities and obligations to each party (with all decision-making power being given to GPs) and the language itself may not be helping change. The International Limited Partners Association, for example, is handing over control to the investment managers by simply including 'limited partners' in its own organisational name. If the industry was able to remove these titles and instead refer to the functions as 'investment managers' and 'investors', that in itself could create a conceptual space to re-negotiate the relationships between the parties.

A third barrier is the investment consultant that sits in between investors and investment managers. Investment consultants also extract rents from the system by preventing managers from developing relationships directly with the investors. The amount of assets controlled by these consultants worldwide makes it difficult for the investment managers to be seen to be challenging them, or encroaching on their territory in any way. Investors should employ the services of consultants in the role of advisors as opposed to gatekeepers.

## 6.0 Summary of 'Re-intermediating with Investment Managers'

As outlined in this paper, we acknowledge the value that investment managers can bring to asset owners but believe that a re-intermediation process is needed to redefine the relationship between the two parties for deploying capital into private market asset classes. In many ways, this paper provides theoretical validation for trends that are already occurring in the industry. As such, based on theory and practice, we have come up with a 'recipe for relational investing':

For large asset owners (>\$15bn), taking advantage of their scale and time horizon, the following attributes should be pursued<sup>12</sup>:

- **Discrete Mandate:** push for purpose built Investment Management Agreements directly with Managers in the form of Separate Managed Accounts, Funds of One or Co-Investments;
- **Control:** take on greater responsibility for the success or failure of investments by moving closer (in terms of intermediaries) to the underlying assets<sup>13</sup>.

For smaller asset owners (<\$15bn), the following attributes should be sought:

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<sup>12</sup> Approximated using the categories defined by the World Economic Forum in their report: *Direct Investing by Institutional Investors: Implications for Investors and Policy-Makers. November 2014*

<sup>13</sup> There seems to be a debate around the difference between governance, and investment decision-making power. The investors can have governance, whilst the investment manager has full discretionary management power. Managers may wrongly think that governance means that the investors would be able to retrospectively second-guess their investment decisions. A clear distinction needs to be made between process (which the investors can criticise, and which the investment managers should be obligated to comply with and accountable if they do not) and judgement / discretion (which is binding on all parties). Partnership between investors and investment managers is about combining governance (including investor control and accountability) with discretionary investment power on the part of the manager.

- **Transparency:** ensure there is full transparency in the LPA over fees being charged by the asset manager (i.e. expenses should be fully disclosed, asset valuations independently made, other fees associated with portfolio company investments fully disclosed, conflicts of interest reduced, etc);
- **Termination:** clauses for termination in LPA's should be robustly negotiated to enable accountability without enabling short-term distortions;

For many asset owners, achieving these basic principles may mean reducing the number of managers in their portfolio. This consolidation may help to ensure sufficient resources are used to form relational partnerships with managers. The following flow diagram summarises the discussion in this paper on the Re-intermediation of Investment Managers using the relational contracting concept.

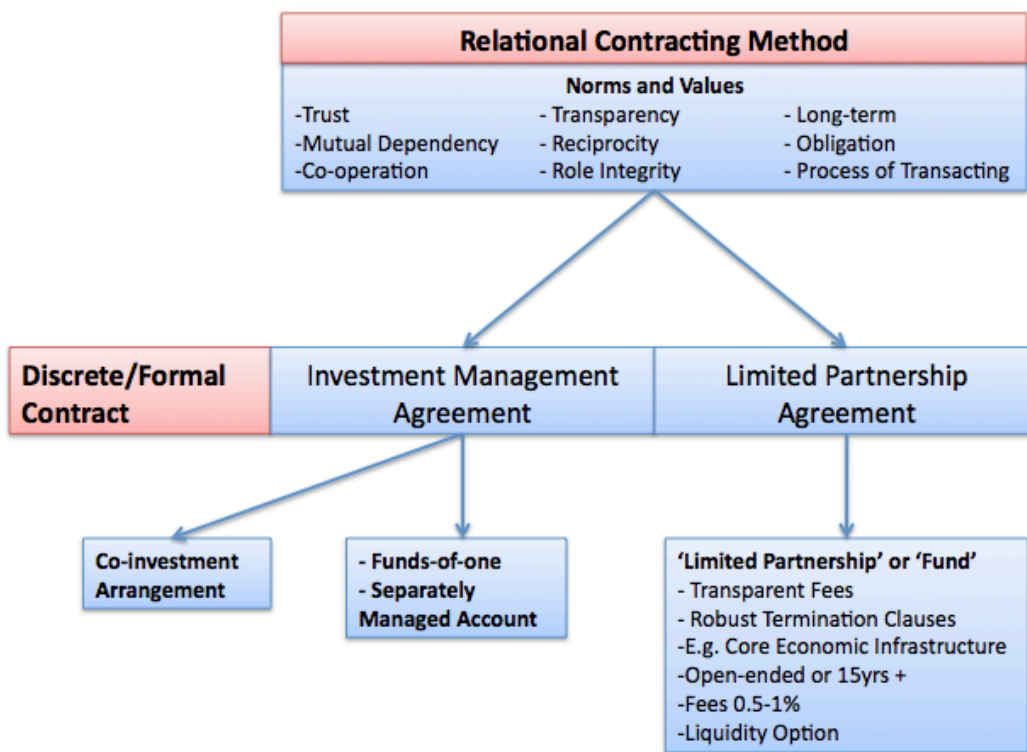


Figure 2: Re-intermediation with Investment Managers Summary Diagram

As the diagram above illustrates, both investors and investment managers should approach the investment management process with the ideals of relational contracting in mind. Depending on the type of investor, the formal aspect of the arrangement will either be an IMA or an LPA<sup>14</sup>. In the case of an LPA, attention should be focused on

<sup>14</sup> One method that has not been discussed in this paper that is starting to emerge in industry is that of seeding managers for a specific investment purpose. In these cases, asset owners provide seed capital to fund an investment team or manager to carry out investments in a predetermined attractive area. The alignment issues in the traditional fund model can be negated through this direct funding arrangement. More details on efficient platforms for institutional investment are outlined in *Monk and Sharma (forthcoming) Capitalising on Networks for Institutional Investors: Case Studies of Co-investment platforms. GPC Working Paper Series, Stanford University.*



transparency and negotiating robust termination clauses as opposed to having high fees or carried interest as the incentive for good performance.

## **7.0 Conclusions**

The principal-agent issues between investors (asset owners) and external managers have been well documented and, in the wake of the financial crisis, many believe that the financial services industry has reached a tipping point. The search for more cost-effective access points to private markets has led to a disintermediation trend amongst the largest investors and a consolidation of alternative asset managers. This paper recognises that there is a certain amount of value that fund managers can bring to the investment management process, but we argue that the way the parties approach the arrangement needs to be reconfigured. There is considerable scope to improve the situation for investors by exercising their bargaining power, having the will to do so, and being properly advised as to how to make it happen.

Contracts sit at the heart of the arrangement between investors and investment managers. How a contract is created can influence the tone of the relationship between the two parties. This paper draws upon the spectrum of contracts outlined by Williamson (1979), and Macneil (1978), to propose the relational contracting concept as a more aligned governance arrangement for investors and investment managers. Relational contracts are based upon relationships of ‘trust’ and collaboration as opposed to classical, discrete exchanges, which do not take into account wider contextual features of the relationship when defining the financial and legal terms. Discrete contracts emphasise completeness, planning, precise and tight measurements of performance – suitable for short-term transactions with limited personal interaction. Relational contracts are more suited for long-term arrangements that require flexibility to make adjustments, and are based upon future co-operative behaviour and mutual dependence.

Conceptually, it would appear that investment management contracts have been weighted more heavily towards discrete forms of exchange. Incorporating the relational contract theory concept may help to promote a more aligned, long-term relationship between investors and investment managers.

Practically, a relational perspective means redefining the terms and conditions of the agreement to include more openness and collaboration between investor and manager. This may involve increasing the time horizon of the funds, or making them open-ended (particularly for infrastructure) with the ability to withdraw capital under certain rules or conditions. A fee structure that provides discretion to the investor for rewarding or punishing managers would be preferable. Placing emphasis on a robust termination clause as opposed to paying expensive carry incentives may help to achieve more alignment.

The offering of co-investment rights for certain investors or segregated accounts by fund managers would signal a return to the more ‘relational’ form of delegated investment

governance as observed prior to the growth of fund investing in alternative asset classes. (I.E., client (investor) / service provider (manager) relationship as opposed to investors just passively funding a manager's business (unlisted fund model).) The arrangements enable a more personable relationship to be developed between investor and manager, with more flexibility over terms and conditions and an overall better duty of care. Many funds now offer these options for cornerstone investors in their funds.

Smaller investors however, would unlikely receive the same aligned treatment in funds as the larger investors and so would need to carefully appraise whether the targeted risk-adjusted net return of investments in a private fund would be a better option than investing in other asset classes. Alternatively, smaller investors could look at investor-led co-investment platforms for private market assets, such as infrastructure, that are starting to emerge to help achieve more alignment. The importance of developing an efficient, effective network for these investors to help gain access to funds or co-investment platforms is emphasised here.

There are however, a number of structural barriers that may prevent the shift towards a relational governance of investment management being implemented. Firstly, the practices of the financial services industry are so well-engrained and with sizeable resources to defend this behaviour, it is unlikely that these actors would be willing to move away from what they believe works well. Secondly, the legal short hands of 'Limited Partner' and 'General Partner' are synonymous with investors and managers respectively, and as a result attach a number of rights and obligations to each party whenever the terminology is used. The simple use of this terminology creates a power imbalance that if changed, could help to promote a more aligned governance regime. Thirdly, investment consultants positioned in between investors and managers can also prevent a close relationship from being developed. Investors need to draw upon consultants as advisors as opposed to gatekeepers to the investment opportunities presented by managers.

While a lot of the focus from this discussion of relational governance has been placed on the investment managers there is also a role that investors will need to play to facilitate a successful relationship. There will be greater responsibility placed on investors to help forge successful partnerships with their managers, particularly if greater control and scrutiny of investments are desired. Part of the reason why some managers have gotten away with dubious practices is because of a lack of oversight and interest shown by investors. This paper also highlights the importance placed on legal services and raises the question whether investors should establish their own legal services so that they can be informed consumers of the contract binding them with managers. Currently, in-house legal services (if they have them) are most often used to procure external legal services and hold them accountable. Should they be doing more? In the same way that asset owners need to attract the finest investment talent, should they also be looking to attract the brightest legal talent? How will they ensure that their own legal services are sensitive to the investment goals and objectives of the institution?

In summary, this paper has provided a theoretical and conceptual basis for how more alignment can be achieved between investors and investment managers for private market asset classes. While practical considerations and barriers are presented in the paper (based on the interviews and experience of the authors with investors and financial service providers), future work would need to empirically test the validity of some of the propositions put forward.

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