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Common sense illuminates the compensation controversy 09 Oct 2009 01:47 PM

by Alan Rohrbach



In last weekend's "Triumph of common sense over benchmarks" (Long View, October 3) John Authers provided both meaningful background on what went wrong, and news on a more realistic search for a constructive way forward for portfolio management.

While his discussion of the overt problems with benchmarking is useful, the insights on its subtler pernicious effects were outstanding. Based upon sanguine assumptions of overall equity market improvement across time, the field was able to thrive by developing increasingly restrictive index benchmarks. That delighted an investing public that bought into this faux diversification in search of risk aversion. Yet it did not require managers to provide truly effective risk management across major cyclical turns.

Authers' belief that "We are going to change the way we judge fund managers" aptly summarizes how rapidly previous still currents below the surface of informed investing are shifting. It is indeed long past time for modeling and manias to be replaced by meaningful risk management.

His further conclusion is almost astounding in light of previous received wisdom: "...elaborate allocations between different styles... did not encourage skilful investing." That woefully belated epiphany has fomented the most productive development in fund management in many decades: the search for truly skillful managers willing to invest in an "active share" of stocks that do not overlap the benchmark index. That those managers with the highest "active share" significantly outperform their peers is useful information, yet not really news. While understandable within the previous financial environment, it is depressing nonetheless that the consultants are only now discovering "those with the self-discipline to sell losers can move on and prosper."

This has implications for the increasingly tedious and misguided debate over financial services compensation reform. There is little doubt that during the last two bubbles modeling mechanics were grossly over compensated for structure instead of performance. Many skilled, disciplined trend analysts and dealers who generated solid risk-adjusted profits have been denied bonuses in the wake of the mechanics' bad debt tsunami.

Especially in light of extensive taxpayer support, this adds real import to the question, "Can banks actually thrive if they cannot compensate real skill?" While it may sound alarmist, the fact is that those folks can and will decamp to the hedge funds. Rather than exotic global taxation of the whole sector, or draconian populist meddling in private compensation arrangements, the real solution suits the industry's varied roles.

Net earnings that are booked in a specific year without assuming aggressive leverage should be compensated timely. Structured investment product pay should be prorated across the life of the investment vehicle, with claw backs explicitly articulated in the contract in the event of significant underperformance.

Thanks to the FT and John Authers for bringing to light a long overdue trend toward separating investment manager performance wheat from the chaff.

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