
Defining Dimension of Demand for Investment Consulting - Scientific Components of Explanation -

Abstract

In many aspects, the demand for investment consulting can be explained by phenomena investigated in the theories of the new institutional economics. Significant drivers of demand are information risks, delegation risks and problems resulting thereof, such as asymmetrical information distribution, asymmetrical assessment and asymmetrical competence regarding problem-solving. These problems can be mitigated by the intermediary function of investment consultants. These theoretical phenomena can also be found in practice in investment consulting and therefore are of high relevance for the actual market participants. They constitute the next major challenge in the asset management industry as a whole.

Keywords: Investment consulting, delegated portfolio management, improving the efficiency of coordination and exchange processes, neo-institutional explanatory approach, new institutional economics, information economics theory, transaction cost theory, property rights theory, principal agent theory, information asymmetry, adverse selection, hold-up, moral hazard, hidden information, hidden characteristics, hidden intention, hidden action, signaling, screening, reputation building, incentives, monitoring.

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Defining Dimensions of Demand for Investment Consulting

There are various theories regarding the epistemological explanation of demand in general and, therefore, of investment consulting also. As investment consulting services are contractual goods based on know-how and trust, and as demand for them is characterized by high information asymmetry and uncertainty, theories from certain fields of 'new institutional economics' might contribute to the explanation of demand and to the very existence of this type of consulting service. The term 'new institutional economics', whose origins can be traced back to the article 'The Nature of the Firm', published in 1937¹ by Coase, was coined in 1975 by Williamson.² Therefore, the sequence of scientific theories that are relevant for this study mainly follows Williamson's 'Mind Map', which gives an image of the basic line of thought of new institutional economics.

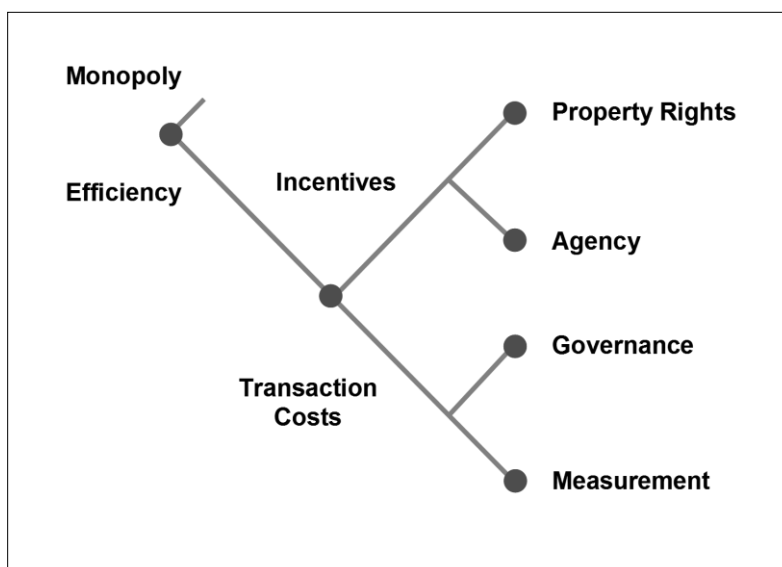


Fig. 1: 'Mind Map' as basis of new institutional economics.³

As a neo-institutional explanatory approach, which explicitly takes into account the imperfections of the market, new institutional economics were developed in response to the *non-realistic*, idealized, static world of neo-classics. The neo-classical assumptions of a perfect market as the only institution that efficiently provides rationally acting market participants with all information at any time, on the basis of which perfect pricing occurs through exchange processes without transaction costs based on ideal contracts, has been

¹ See Coase (1937): The Nature of the Firm, pp. 386 ff.

² See Williamson (1975): Markets and Hierarchies, pp. 1 ff.

³ See Williamson (1985): The Economic Institutions of Capitalism, p. 24.

rejected as insufficient since 1937 by various scientists' theories. The assumptions on which the 'new' theories are based, are the market powers of suppliers and buyers, temporary market anomalies and the pricing margins that are the result of both of the aforementioned phenomena. Further assumptions are transaction costs through exchange, imperfect contracts due to asymmetrical information, adaptive behavior by increasing knowledge and opportunism together with limited rationality of the acting persons.

Within the framework of these assumptions, new institutional economics are dealing with the influence of institutions on the behavior of individual economic subjects.⁴ Thus, the new orientation is mainly based on the inclusion of institutional contexts in the economic analysis. Institutions within the context of this theory are both explicit formally and implicit with informal rules including enforcement mechanisms which influence behavior during transactions. They help to reduce information asymmetry and the uncertainties resulting thereof and improve the efficiency of coordination and exchange processes. Creating and using such institutions causes transaction costs which is why the forming of individual rights through contracts influences the economic result.

New institutional economics' subsegments include the information economics theory, the transaction cost theory, the property rights theory and the principal agent theory⁵, whose relevant characteristics are shown in the figure below.

	'Information Economics'	'Transaction Cost Theory'	'Property Rights Theory'	'Principal Agent Theory'
Subject	Information symmetry and quality	Transactions Hold-up problems	Institutions Property rights	Contracts Incentives
Point of origin	Before concluding a contract		Before or after concluding a contract	
Problem characteristics	A reduction in information and quality assurance as well as search costs	A reduction in negotiating costs, decision making costs and implementation costs	Safeguarding property rights within the context of contracts between acting parties	Incentives to align the interests of acting parties through contracts
Approach	Analysis of offerings	Analysis of offerings and contract possibilities	Analysis of contract possibilities	

Fig. 2: Subspecialties of new institutional economics in comparison.⁶

⁴ See Furubotn/ Richter (1991): The New Institutional Economics, p. 1.

⁵ The principal agent theory is along with the theory of implicit contracts to be categorized in economical contract theory. The theory of implicit contracts is the theory on how contracts are implemented, as well as the theory of relational contracts that investigates opportunistic behaviour that occurs after a contract is concluded.

⁶ Illustration on the basis of Kim/ Mahoney (2005): Property Rights Theory, Transaction Costs Theory, and Agency Theory, p. 231.

The subspecialties partially overlap, as they were individually created in a non-systematic way and only later aggregated to form new institutional economics. The theories of information economics, transaction cost theory and the principal agent theory can be seen as competing, whereas the property rights theory is regarded as complementary.⁷

In many aspects, the demand for investment consulting can be explained by phenomena investigated in these theories. Significant drivers of demand are information risks, delegation risks and problems resulting thereof, such as asymmetrical information distribution, asymmetrical assessment and asymmetrical competence regarding problem-solving. These problems can be mitigated by the intermediary function of investment consultants.

Information Economics

The thoughts of Williamson, which led to the creation of new institutional economics, are rooted in deliberations on the degree of market efficiency. Starting with a comprehensive analysis of literature, he stated in 1985, "Investment and information asymmetries are expressly introduced."⁸ In this context Williamson does not refer to information efficiency in the sense of capital market theory⁹, but to the problems of 'private', i.e. unilaterally existing information within the frame of contract theory.¹⁰

Together with price as the only decisive element in the perfect market of the neo-classics, information is seen by new institutional economics as a second constitutive element. On the one hand, information helps to coordinate economic activities based on the division of labor, and on the other hand it can be traded as an economic asset. Its explicit and central inclusion as input into the economic process as well as the existence of incomplete information, especially in the form of asymmetrical information distribution in bilateral exchanges, are significant improvements on former approaches¹¹. This is due to the economic information level determining to a large extent the efficiency of any given organizational structure and its governance. According to Stiglitz, "Information Economics represents a fundamental change in the prevailing paradigm within economics"¹².

⁷ For an explicit comparison of the theories see Kim/ Mahoney (2005): Property Rights Theory, Transaction Costs Theory, and Agency Theory, pp. 223 ff.

⁸ See Williamson (1985): The Economic Institutions of Capitalism, p. 26.

⁹ Efficient Market Hypothesis.

¹⁰ See Williamson (1985): The Economic Institutions of Capitalism, p. 28.

¹¹ See Arrow (1996): The Economics of Information, pp. 119 ff.; Stigler (1961): The Economics of Information, pp. 213 ff.

¹² Stiglitz (2002): Information and the Change in the Paradigm in Economics, p. 472.

Literature distinguishes between ignorance, unsafety and uncertainty as forms of lack of information. Ignorance is if a market actor is not sufficiently informed and he is able to change this. Certain types of information – especially on the always uncertain future – can be acquired by actors only with great effort and even then only to a certain limit. But they can build subjective probabilities for the occurrence of future events. This type of lack of information is known as uncertainty. If the building of subjective probabilities is impossible even with the intensive acquisition of information, we speak of unsafety.

A milestone of 'information economics' is the article 'The Market for "Lemons"' by Akerlof from 1970, in which he deals with the level of information, information quality and information distribution of economic actors. Information asymmetry and the resulting unsafety of decision-makers in trade relations are the focus of his publication.¹³

There is a distinction between event unsafety (exogenous uncertainty) and market unsafety (endogenous uncertainty). The degree of unsafety depends on the type of goods. Without particular measures it is extremely difficult to verify the quality of search goods before purchase, to verify the quality of experience goods - typically after and sometimes before purchase, and to verify the quality of credence goods in general. Services that require direct cooperation with the customer, including professional investment consulting, belong to a large extent to the categories of experience and credence goods. Their complexity and future realization lead to information problems, thereby increasing unsafety¹⁴. The reduction of information deficits and asymmetries serves to reduce quality safety by acquiring information on performance promises (selection problem) and on behavior (incentive problem)¹⁵ of transaction partners before conclusion of contract. The aim is to largely avoid faulty, potentially costly and therefore disadvantageous selections. According to economic theory, information is therefore an input good that causes costs through acquisition and delivery, which have to be systematically taken into account.

The basic information asymmetry types appear as 'hidden information', 'hidden characteristics', 'hidden intention' and 'hidden action', as can be seen in the following figure.

¹³ See Akerlof (1970): The Market for "Lemons", pp. 488 ff.

¹⁴ See Kaas/ Schade (1995): Unternehmensberater im Wettbewerb, p. 1071; Kaas/ Schade (1995): Unternehmensberater im Wettbewerb, pp. 1067 ff.

¹⁵ The targeted creation and usage of informational problems through an interactional partner is classified within the context of this work to the principal agent theory.

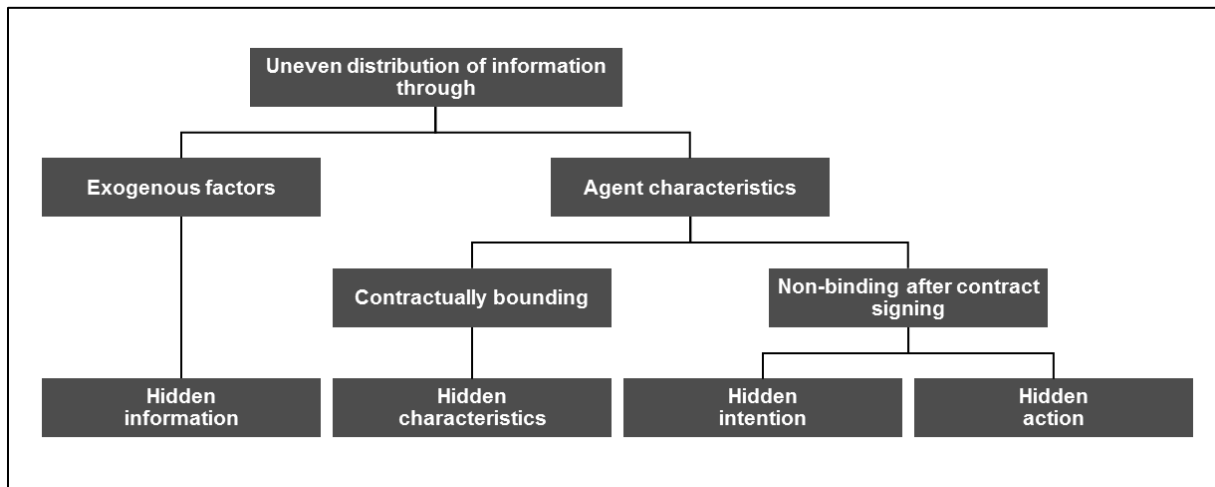


Fig. 3: Basic types of asymmetrical information.¹⁶

These types of asymmetric information cause problems of 'adverse selection', 'hold-up', and 'moral hazard', which are the central problems in the principal agent theory. Information economics, therefore, is of fundamental significance to the principal agent theory.

In the case of 'hidden information', the agent is in possession of relevant information on performance characteristics, which are unknown to the principal. If the agent maintains this information advantage deliberately, and uses it to deceive the principal, we speak of 'moral hazard'. In the case of 'hidden characteristics', the agent deliberately withholds certain risks or deficiencies, which are unknown or can hardly be known to the principal while concluding a contract. As this can lead to wrong choices by the principal, it is called 'adverse selection'. In the case of 'hidden intention' the agent takes advantage of the principal's dependence on him – for instance by contractually binding long-term investments, which are detrimental to the principal – , which is called 'hold-up'. 'Hidden action' means that the agent abuses discretionary freedom to act and to decide in order to deceive the principal.

In 2001, the Nobel prize in economics was granted to three scientists considered to be the founders of modern information economics. Together with Akerlof, who was awarded for his fundamental research results, Spence and Stiglitz received this honor for two different, but equally significant approaches to overcome information asymmetry. Possible strategies to resolve relevant problem phenomena are 'signaling', which was introduced by Spence, and 'screening', which was developed by Stiglitz.

In the case of 'signaling', the effort to overcome the asymmetry comes from the side that is in possession of more information, typically the service provider or agent. Here, the actors of

¹⁶ See Ries (2009): Die Entlohnung von Fondsmanagern, p. 94.

the better informed side give credible signals regarding the quality of promised performance before transaction, thus reducing information asymmetries and search costs of the principal.¹⁷ The very labor and therefore cost intensive process of information provision by asset managers within the scope of manager selection can be called 'signaling', because only asset managers with high performing, competitive investment strategies are able to assume the task of comprehensive due diligence.¹⁸ The same can be said for investment consultants. The high reputation of investment consulting providers has a mitigating effect on quality uncertainty. This increases the chances of successfully acquiring consulting mandates. On the other hand, proven and therefore transparent success in consulting, including manager selection, is required to be shortlisted as a relevant provider.¹⁹

In addition to the steps that are taken by the better informed side to reduce information asymmetry, the other side – typically the principal – can contribute to tackling imbalances. Stiglitz uses the term 'screening' to describe the method chosen by the uninformed side to reduce information deficits and thus information asymmetries through acquisition of information.²⁰ The lesser informed side will acquire information as long as the additional benefit is higher than the additional costs incurred.²¹

'Screening', however, has its limits: the better informed side can retain information or the evaluation requires special knowledge and abilities that surpass those of the actor. In this case, a third party can be included, e.g. a specialized intermediary who is able to acquire, interpret and assess the information. Manager selection by investment consultants is the professionalized way of 'screening'. Therefore, consulting is also a business entailing uncertainty²² and consequently phenomena in 'information economics' provides fundamental reasons on the demand for investment consulting.

¹⁷ See Spence (1973): Job Market Signaling, pp. 355 ff.; Spence/ Zeckhauser (1971): Insurance, Information, and Individual Action, pp. 380 ff.; Spence (2002): Signaling in Retrospect and the Informational Structure of Markets, pp. 434 ff.

¹⁸ See Kellermann (2008): Implikationen für institutionelle Vermögensverwalter aus der Zusammenarbeit mit Investment Consultants, p. 171. Regarding the problem of 'signaling' within the context of delegated portfolio management see Huberman/ Kandel (1993): On the Incentives for Money Managers, pp. 1065 ff.

¹⁹ With regards to management consulting see Faust (2002): Managementberatung eingebettet, p. 98; Kaas/ Schade (1995): Unternehmensberater im Wettbewerb, pp. 1067 ff.

²⁰ See Stiglitz (1975) The Theory of 'Screening', Education, and the Distribution of Income, pp. 283 ff.; Rothschild/ Stiglitz (1976): Equilibrium in Competitive Insurance Markets, pp. 630 ff.; Stiglitz (2000): The Contributions of the Economics of Information to Twentieth Century Economics, pp. 1450 ff.

²¹ For the practical meaning of 'screening' in delegated portfolio management see Bhattacharya (1999): Delegated Portfolio Management, pp. 1 ff.

²² See Heinecke (2002): Methodische Differenzierung als Geschäftsstrategie, p. 230.

Transaction Cost Theory

The foundation of transaction cost theory was laid by Coase in 1937 with his publication of 'The Nature of the Firm', where he asked why corporations exist in a world, in which the market is considered the only instrument of coordination, and why resources are allocated by market mechanisms.²³ He comes to the conclusion that corporations exist as an alternative coordination mechanism to the market, as using the market causes costs, which he later termed transaction costs.²⁴ Williamson further developed this approach and articulated the following principle: "Organize transaction so as to economize on bounded rationality while simultaneously safeguarding them against the hazard of opportunism."²⁵

Transaction cost theory is closely related to property rights theory, as corporations are seen as a form of cooperation based on hierarchical contract networks and transactions are seen as institutional arrangements for transferring property rights, through which facilitating exchange is enabled.²⁶ The expenses for initiation, coordination, contracting, handling, adjustment and control are called transaction costs, and which are the core subject of analysis.²⁷

This transaction cost approach puts the coordination of economic performance relations in the center – and not the participating economic actors. It is a model for the explanation of alternative contractual agreements in economic activities. Analyzed are the conditions under which it makes economic sense to deliver performance exchanges, i.e. transactions, not through the market, but by division of labor and specialization. This means the transaction cost approach aims to define the vertical degree of work processes, providing a theoretical basis for the very practice-oriented question of 'make or buy' or 'in- or outsourcing'²⁸.

²³ See Coase (1937): The Nature of the Firm, pp. 386 ff. For the foundational works see Arrow (1974): The Limits of Organization, pp. 1 ff.; Monson/ Downs (1965): A Theory of Large Managerial Firms, pp. 221 ff.; Silver/ Auster (1969): Entrepreneurship, Profit, and Limits on Firm Size, pp. 277 ff.; McManus (1975): The Costs of Alternative Economic Organization, pp. 334 ff.; Williamson (1975): Markets and Hierarchies, pp. 1 ff.; Williamson (1985): The Economic Institutions of Capitalism, pp. 1 ff.; Grossman/ Hart (1986): The Costs and Benefits of Ownership, pp. 691 ff.; Alchian/ Woodward (1988): Review: The Firm Is Dead, pp. 65 ff.; Williamson (1996): The Mechanisms of Governance, pp. 1 ff.; Williamson (1998): Transaction Cost Economics, pp. 23 ff.; Williamson (2002): The Theory of the Firm as Governance Structure, pp. 171 ff. For an empirical examination of the theory see Klein/ Shelanski (1995): Empirical Work in Transaction Cost Economics, pp. 335 ff. For criticism on this theory see Ghoshal/ Moran (1996): Bad for Practice: A Critique of the Transaction Cost Theory, pp. 13 ff.

²⁴ See Coase (1960): The Problem of Social Cost, pp. 1 ff.

²⁵ Williamson (1985): The Economic Institutions of Capitalism, p. 32.

²⁶ See Coase (1937): The Nature of the Firm, pp. 391 ff.

²⁷ See Williamson (1985): The Economic Institutions of Capitalism, p. 28.

²⁸ See Williamson (1975): Markets and Hierarchies, pp. 1 ff.; Williamson (2002): The Theory of the Firm as Governance Structure, pp. 179 f.

Taking this into account, there is a direct link to performance delegation in economic processes and thus to the principal agent theory.²⁹ Real-world recommendations for optimum division of labor can be derived, for instance, by defining segments of a work process in a way that the organization of these processes allows for the easiest and fewest transactions possible.

Efficiency and therefore the defining criterion is – ceteris paribus – the level of transaction costs.³⁰ In this context the cost benefits of economies of scale and economies of scope of external specialists are generally valid, but they are opposed by internal transaction cost disadvantages, which are mainly influenced by the complexity of communication and coordination.³¹ This means that a corporation compares the external costs of a transaction with the internal costs and decides between a market solution or an internal coordination solution according to economic criteria. Therefore, the carrying out of an activity within a corporate hierarchy is desirable to the degree of how transaction costs are minimized. Thus, the existence of transaction costs explains the choice between market or hierarchy, in the form of a corporation, as a coordination mechanism. Williamson's approach is based on certain conditions that determine the level of transaction costs, which can be assigned to three categories: behavioral assumptions, environmental factors and transaction cost atmospheres.³²

Behavioral assumptions include bounded rationality and hazard of opportunism.³³ The assumption of bounded rationality is the prerequisite for opportunistic behavior, because with unlimited rationality, opportunism would be absolutely meaningless for there would be no room for opportunistic behavior.³⁴

Williamson defines opportunism as, "self-interest seeking with guile"³⁵ and "this includes but is scarcely limited to more blatant forms, such as lying, stealing, and cheating. More often, opportunism involves subtle forms of deceit."³⁶ In this context, opportunism relates to deliberately *incomplete* or deliberately distorted passing on of information – and is responsible for a real or artificial information asymmetry. On the other hand, opportunism requires an already existing information asymmetry.

²⁹ See Klein/ Shelanski (1995): Empirical Work in Transaction Cost Economics, pp. 341 ff.

³⁰ See Picot/ Dietl/ Franck (1999): Organisation, p. 73.

³¹ On the topic of pension funds' economies of scale see Bikker/ Steenbeek/ Torracchi (2010): The Impact of Scale, Complexity, and Service Quality on the Administrative Costs of Pension Funds, pp. 1 ff.

³² See Williamson (1975): Markets and Hierarchies, pp. 40 ff.; Picot/ Dietl/ Franck (1999): Organisation, pp. 68 ff.

³³ Williamson (1998): Transaction Cost Economics, p. 31.

³⁴ See Williamson (1985): The Economic Institutions of Capitalism, pp. 30 f.

³⁵ Williamson (1975): Markets and Hierarchies, p. 26.

³⁶ Williamson (1985): The Economic Institutions of Capitalism, p. 47.

Among the environmental factors are unsafety, specificity, strategic significance and the transaction factor. With regards to unsafety, a distinction is made between parametrical unsafety, which describes the occurrence of future, unpredictable environmental influences, and behavioral unsafety, which relates to the potentially opportunistic behavior of actors. The lesser the unsafety concerning performance quality, i.e. the easier and clearer the expected result can be defined in advance, the better a transaction can be outsourced.

Specificity of a transaction means individuality or uniqueness, and therefore 'non-interchangeability' of goods or services. The higher the degree of specificity, the bigger the loss that occurs if this performance – in form of goods or services – is not delivered in the agreed and designated way. The more specific the transaction, the higher the dependence on the transaction partner.

High transaction specificity is not an indication for outsourcing, because according to Williamson specificity-induced dependence can be taken advantage of in an opportunistic way. Here, the safety need is greater, for opportunistic behavior of a partner causes a significant disadvantage. For the transaction cost approach, the influence of the specificity factor is especially relevant. The transaction factor describes the frequency of transactions between the respective partners. With an increasing amount of identical transactions, transaction costs are reduced and the effects of economies of scale and synergy are realized, which means that a low frequency indicates outsourcing or external delegation. However, the influence of the transaction factor is effective only with high specificity, where it reaches strategic significance.

Another environmental factor that is not to be neglected is the transaction atmosphere. This term comprises all general conditions that are relevant for the coordination of performance relations such as social, legal and technological framework conditions, which Williamson calls "interaction effects".³⁷

Summarizing, it has to be noted that – ceteris paribus – transaction costs increase with transaction specificity and rarity. If all environmental factors are only minimally developed, external solutions have to be preferred, i.e. low unsafety together with low performance frequency and low specificity indicate the use of external service providers. From a cost perspective it generally makes sense to hire a consultant if the external costs resulting from this³⁸ are lower³⁹ than the savings of internal costs.⁴⁰ In this context it has to be underlined

³⁷ Williamson (1975): Markets and Hierarchies, p. 71.

³⁸ Consultation fees, performance fees.

³⁹ Information and search costs, costs from experience, opportunity costs.

⁴⁰ See Kleeberg/ Schlenger (2000): Die Rolle von Consultants im Rahmen der Spezialfondsanlage, p. 876.

that consulting companies through economies of scale and economies of scope contribute to a limitation of transaction costs, as the latter are at least partially passed on to the customer.⁴¹

In an environment that is characterized by the above described conditions, a purely market-oriented coordination that trusts primarily in market mechanisms is not sufficient. To limit transaction costs, institutions are required, which constrain the decision and maneuvering possibilities with regards to stimulation, control and sanctions systems. Beyond that, professional and experienced intermediaries are necessary, which guarantee development and upholding of rules through such measures as, for instance, monitoring.

Property Rights Theory

Property rights theory goes back to the fundamental works of Coase, Alchian and Demsetz and includes together with the study of property rights also the maximization of individual economic benefits with regards to the actors, the origin of transaction costs and external effects.⁴²

The behavioral assumption of individual benefit maximization – as in other theories of new institutional economics – a central, fundamental assumption which states that the economic agents participating in economic processes always strive to pursue their own interest within the framework of their opportunities to act and to decide.⁴³ Jensen and Meckling state that, "since the specification of rights is generally affected through contracting (implicit as well as explicit), individual behavior in organizations, including the behavior of managers, will depend upon the nature of these contracts."⁴⁴

⁴¹ See Niewiem/ Richter (2007): Make-or-buy Entscheidungen für Beratungsdienstleistungen, p. 59; Canbäck (1998): The Logic of Management Consulting – Part 1, pp. 3 ff.; Canbäck (1999): Transaction Cost Theory and Management Consulting, pp. 31 ff. Canbäck (1998): The Logic of Management Consulting – Part 2, p. 5.

⁴² See Coase (1960): The Problem of Social Cost, pp. 1 ff.; Alchian (1965): Some Economics of Property Rights, pp. 816 ff.; Alchian (1965): The Basis of Some Recent Advances in the Theory of Management of the Firm, pp. 30 ff.; Alchian (1968): Corporate Management and Property Rights, pp. 1 ff.; Alchian/ Demsetz (1973): The Property Rights Paradigm, pp. 16 ff.; Demsetz (1964): Some Aspects of Property Rights, p. 11 ff.; Demsetz (1966): Some Aspects of Property Rights, pp. 61 ff.; For further foundational works see Furubotn/ Pejovich (1972): Property Rights and Economic Theory, pp. 1137 ff.; Grossman/ Hart (1986): The Costs and Benefits of Ownership, pp. 691 ff.; Hart/ Moore (1988): Incomplete Contracts and Renegotiation, pp. 755 ff.; Hart/ Moore (1990): Property Rights and the Nature of the Firm, pp. 1119 ff.

⁴³ Further behavioural assumptions, especially with regards to individual utility functions, don't exist within this context.

⁴⁴ Jensen/ Meckling (1976): A Theory of the Firm, p. 309.

In this sense, the individual actions as such are not of interest, but rather the property rights by which they are determined.⁴⁵ From the viewpoint of economic contract theory, property rights allow the implementation of economic decisions and actions regarding material goods⁴⁶ or immaterial services⁴⁷ within the framework of respected social relations. The better the enforcement, the more efficient is the validity of the respective property right and, as a result thereof, the more limited is the scope of other actors. This determines the definition of accepted norms of legitimate or permitted behavior and action, which also includes such informal rules of social control and conventions as reciprocity. If non-permitted opportunities to act against these norms are taken, this is not seen as a property right, but as a "power of disposition".⁴⁸

Clearly defined and enforceable property rights are a prerequisite for economic growth through investing. There are little incentives if such rights do not exist, as the distribution of benefits resulting thereof is unclear.⁴⁹ Therefore, definition and enforcement of property rights are in the collective interest, even if it is in the individual interest not to respect these rights.⁵⁰

From a business point of view, property rights theory contributes to a more differentiated picture of the organization⁵¹ by interpreting it as a dynamic nexus of contracts⁵². This means that individual contractual relations are not seen as isolated from each other, but as part of an overarching institutional set of rules and regulations. Therefore, such a set of individual property rights rules is a constitutive element of any institution, which ex ante represents a coordination and incentive function of individual interests and actions, and ex post the possibility of their enforcement,. The efficiency of this set of rules determines the quality of

⁴⁵ That is, state authorized legal norms (laws and regulations) and autonomously formulated privity of contracts (legal agreements).

⁴⁶ For example, personnel performance and payments in kind.

⁴⁷ For example, patents, copyrights, receivables.

⁴⁸ See Schreyögg (2008): Organisation, pp. 360 ff.

⁴⁹ See Demsetz (1967): Toward a Theory of Property Rights, pp. 350 ff.

⁵⁰ A double prisoner's dilemma exists here. On the one hand, it is collectively beneficial for all participants to act in accordance with the property rights theory, but individually it is, however, better if they don't concord with it. On the other hand, it is in the collective interest to punish legal violators of the property rights theory, but it is individually advantageous not to participate in the costs incurred from penalization.

⁵¹ An organization within the scope of the sociological research approach is the social structure of an institution that is consciously created out of a planned and therefore target oriented collaboration of people. An institution, on the other hand, is generally conceivable without any associates. In the sociological context, an institution is a body of rules and regulations of behavioural norms, policies and examples. In contrast to the sociological and socioscientific definition, New Institution Economics equates an organization to an institution.

⁵² Jensen/ Meckling (1976): Theory of the Firm, p. 311; Furthermore, see Alchian/ Demsetz (1972): Production, Information Costs, and Economic Organization, pp. 777 ff.; Cheung (1983): The Contractual Nature of the Firm, pp. 1 ff.

relations and interactions between actors and stakeholders of an organization and the trust in the organization as institution. Institutions constitute a trading order of market participants, thereby causing costs, as allocation, transfer and enforcement of property rights causes transaction costs.⁵³ These comprise not only explicit and directly quantifiable monetary values, but also implicit costs such as information, search and opportunity costs.

From an economic perspective, property rights theory contributes to explain the effects of economic decisions as external effects within an existing structural order of property rights. As external effects frequently lead to welfare losses⁵⁴, they represent together with transaction costs those parameters that are paramount for the shaping of property and action rights. Such an order is most efficient if it minimizes transaction costs and welfare losses caused by external effects. This shows that high transaction costs and a high level of external effects indicate that new institutional solutions are required, such as, for instance, the use of intermediaries. The demand for investment consulting can consequently also be explained by this. Furthermore, property rights theory offers an explanation for the sets of the many property rights of institutional investors regarding the delegation of portfolio management and other services.

Principal Agent Theory

The principal agent theory analyzes the behavior of actors within and between organizations from the perspective of organization theory. In this context, the type of formal organizational structure is secondary, for it is implicitly assumed that the behavior of organization members cannot be controlled by its rules and regulations.⁵⁵

In literature, organizations, especially in the form of a legal person or a company, are traditionally seen as units from a contract-related viewpoint. As early as 1937 Coase was the first to differentiate between explicit and implicit contracts within the framework of a company, indicating implicit contractual links, whose theory he investigates with regard to transaction costs.⁵⁶

⁵³ See Furubotn/ Pejovich (1974): Introduction – The New Property Rights Literature, p. 2.

⁵⁴ The main feature of external effects is that they have no impact on the originator, since no market or contractual relationship exists. External effects lead to market failures and resource misallocations which cause the market equilibrium to be out of pareto-optimality.

⁵⁵ See Schreyögg (2008): Organisation, pp. 360 ff.

⁵⁶ See Coase (1937): The Nature of the Firm, pp. 386 ff.

In 1976, Jensen and Meckling coin the term 'nexus of contracts' positing that organizations are legal fictions, "which serve as a nexus for a set of contracting relationships among individuals".⁵⁷ They draw on the approach of Coase, include insights of information economics theory and property rights theory, and develop an artifact of contract theory to present an organization model as a network of explicit and implicit mutual contracts, which contains a significant amount of conflicts of goals and interests.⁵⁸ By this, they established the principal agent theory.

The agency theory deals with the institutional organization of contractual relations between principal and agent, where a principal delegates decision-making authority to an agent to make sure orders are issued in his interest.⁵⁹ It is a microeconomic model whose research subject is a delegation relationship, and whose starting point lies in agency problems.

Substantial elements of this model are uncertainty, permanently latent conflicts of interest and the impossibility to conclude all-encompassing contracts regulating each and every aspect of expected behavior and decision-making.⁶⁰ Asymmetrical information as such is not a significant problem, if there were no potential conflicts of interest between the actors.

Conflicts of interest are based on dyadic contractual relations and are characterized by asymmetrical levels of information with the principal having an information disadvantage⁶¹. This creates discretionary maneuverability for the agent and thus the danger to abuse it to the principal's detriment without any moral scruple.⁶² The principal has no guarantee that the agent isn't pursuing his own interests, thus causing them harm, for constitutive assumptions of this theory are that both sides have their own and thus frequently diverging interests and that the agent influences through his actions not only his own, but also the principal's level of benefit.⁶³ By this, behavioral expectations with regards to the formal delegating relationship

⁵⁷ Jensen/ Meckling (1976): Theory of the Firm, p. 311; See Fama (1980): Agency Problems and the Theory of the Firm, p. 289.

⁵⁸ For criticism on this approach see Eisenberg (1999): The Conception That the Corporation Is a Nexus of Contracts, pp. 819 ff.

⁵⁹ See Jensen/ Meckling (1976): Theory of the Firm, pp. 305 ff.; Meyer (2004): Prinzipale, Agenten und ökonomische Methode, pp. 1 and 64 ff. For the foundational works of the principal agent theory see Ross (1973): The Economic Theory of Agency, 134 ff.; Harris/ Raviv (1978): Some Results on Incentive Contracts, pp. 20 ff.; Harris/ Raviv (1979): Optimal Incentive Contracts with Imperfect Information, pp. 231 ff.

⁶⁰ See Levinthal (1988): A Survey of Agency Models of Organizations, pp. 153 ff.

⁶¹ The foundational basis of a principal agent relationship can be identified in Jost (2001): Die Prinzipal-Agenten-Theorie im Unternehmenskontext, pp. 11 ff.

⁶² See Schreyögg (2008): Organisation, pp. 360 ff.

⁶³ See Picot/ Dietl/ Franck (1999): Organisation, p. 72.

are undermined and even turned around, as it is the agent that becomes the actual power holder.⁶⁴

The types of problems 'adverse selection', 'moral hazard', and 'hold-up' result from a categorization according to the object of information asymmetry, i.e. 'hidden information', 'hidden characteristics', 'hidden intention', and 'hidden action', as well as according to their time of origin.

	'Adverse Selection'		'Hold-up'	'Moral Hazard'
Subject	'hidden information'	'hidden characteristics'	'hidden intention'	'hidden action'
Point of origin	Before concluding a contract		After concluding a contract	
Problem characteristics	Missing possibility of evaluating ex ante the level of information of contract partners	Missing possibility of evaluating ex ante the qualitative characteristics of contract partners	Missing possibility of evaluating ex ante contract partners' intentions	Missing possibility of evaluating ex ante contract partners' conduct
Cooperational designs as solutions	Signalling Screening Reputation Rating Guarantees		Signalling Reputation Incentives Covenants	Monitoring Reputation Incentives

Fig. 4: Problem types of the principal agent theory.⁶⁵

'Adverse selection' is a pre-contractual agency problem that arises as a result of 'hidden information' and 'hidden characteristics' and describes the wrong selection of an agent by the principal. Such an incorrect selection of an agent can occur, if, before deciding, the principal does not know properties of the agent that cannot be changed but are relevant for their choice.⁶⁶ This kind of information asymmetry can occur as communicative disagreement with an underperforming agent deliberately concealing these properties or as communicative divergency with an overperforming agent being unable to communicate to a sufficient degree.⁶⁷ Cooperation designs as methods for solutions are 'signaling', i.e. the provision of information by the agent and 'screening', i.e. the provision of information by the principal. Further instruments to mitigate information asymmetries and thus to prevent 'adverse selection' are reputation building⁶⁸, the assurance of guarantees, and third party ratings.

⁶⁴ See Schreyögg (2008): Organisation, pp. 360 ff.

⁶⁵ Illustration on the basis of Bernet (2003): Institutionelle Grundlagen der Finanzintermediation, p. 94; Picot/ Dietl / Franck (1999): Organisation, p. 91.

⁶⁶ Unchangeable also includes characteristics that could, if altered, incur notable costs.

⁶⁷ See Akerlof (1970): The Market for "Lemons", pp. 488 ff.

⁶⁸ For delegated portfolio management reputational issues see Huddart (1999): Reputation and Performance Fee Effects on Portfolio Choice by Investment Advisers, pp. 227 ff.

'Hold-up' is a problem associated with 'hidden intention', where the agent takes opportunistic advantage of the principal's dependence.⁶⁹ The problem arises if disadvantages from a relation specific investment, which influence the future benefit of the principal, are recognizable by the latter after contract conclusion, but cannot be verified in front of third parties, e.g. in court. This leads to the awkward situation where the principal does not make any efficient investment decisions. Furthermore, after making the investment, the principal has no possibility of using sanctions to influence the agent's behavior. Together with 'signaling' and reputation building, instruments to prevent 'hold-ups' include incentives to align the interests of both sides, and to create contractual safeguards in the form of 'covenants'. However, as future situations cannot be regulated even by the most detailed contract, the agent's room for maneuvering cannot be limited entirely. For this reason, it makes additional sense to turn one-sided dependence into mutual dependence.⁷⁰

'Moral hazard' is a serious problem associated with asymmetrical information distribution, which emerges after the conclusion of a contract and whose subject is 'hidden action'⁷¹. Due to unequal distribution of information and limited possibilities of the principal to control the agent, there is moral hazard that the better informed side – typically the agent – uses its information advantage to the detriment of the lesser informed side.⁷² Depending on the contract structure, two cases are possible. First, the agent, while providing his services, can take actions that are not in the interest of the principal. Due to a lack of information, the latter has no knowledge thereof. This can occur, if no clear objective is laid down in the contract. In the second case, the principal is unable to determine how the agent has achieved the agreed goals in spite of clearly defined targets. This means that the principal is unable to determine whether the contract's successful accomplishment is owed to the agent's performance or to external influences. According to the generally assumed intention of individual benefit maximization by the agent, in both cases it can be assumed that the latter will use his freedom for actions and decisions to achieve his own goals - even to the detriment of the principal. Possible solutions to correct such situations are 'monitoring', reputation building, and setting incentives to align the interests of both sides.

⁶⁹ See Grossman/ Hart (1986): The Costs and Benefits of Ownership, pp. 691 ff.; Picot/ Dietl/ Franck (1999): Organisation, p. 89.

⁷⁰ See Picot/ Dietl/ Franck (1999): Organisation, p. 84.

⁷¹ Moral hazard describes the perils of an agent, once left unobserved, that could cause a disadvantage to other contractual parties out of selfishness. The term originates from property insurance and originally described behaviour where immediately upon having something insured, a person would become more comfortable being somewhat more careless with it, and therefore, the probability of damage would increase. Today, the term has generally found its way into Contract Theory, especially in the Theory of Delegation and the Principal Agent Theory.

⁷² See Jensen/ Meckling (1976): Theory of the Firm, pp. 305 ff.

As information asymmetry together with conflicts of interest - which can also be the result of different risk behaviors of principal and agent ⁷³ - is a constitutive characteristic of the principal agent theory, the 'best solution' of creating complete information symmetry is theoretically impossible. Maintaining information asymmetry without corrections is considered the 'third best solution'. In the case of information deficits, the aim is to achieve the 'second best solution' - a reduction of information asymmetry. This requires agency costs, adding a further dimension to the conflicts of interest.

According to Jensen and Meckling, agency costs, which are a loss of welfare, are subdivided into three categories: "monitoring costs", "bonding costs", and "residual loss".⁷⁴ 'Monitoring costs' are the expenditures for scrutinizing the agent and for developing an adequate compensation system. 'Bonding costs' are defined as expenses that are designed to motivate the agent and not to act against the interests of the principal. 'Residual loss' is the difference in value, which exists – after the application of monitoring and bonding measures – between the decisions made by the agent and the possible decisions of the principal. Agency costs arise due to the effort to minimize the risk of the agent deviating from the interests of the principal⁷⁵, i.e. the agent receives incentives to behave in line with the best interests of the principal.

These theoretical and generally described phenomena can also be found in practice in asset management⁷⁶ and therefore also in investment consulting, for "given the twin separations between beneficiary and institutional investor and between institutional investor and asset manager, important principal-agent issues may arise. Self-interested behavior of agents (such as asset managers) may not always be fully in line with the interests of those bearing the risks (such as the corporate sponsors or ultimate beneficiaries)"⁷⁷. According to Ambachtsheer, this is the next major challenge in the asset management industry and he pleads for an integration of these information effects into the old, i.e. traditional 'modern portfolio theory'.⁷⁸

Globally, the largest share of wealth is not directly invested by private customers, but via financial institutions in the form of institutional investors. This intermediary function comprises an agency contract in terms of the principal agent theory. This means that asset

⁷³ Risk neutrality, risk aversion or risk appetite are possible on both sides in principle. This depends on the aims, characteristics and the respective situation of the stakeholders.

⁷⁴ Jensen/ Meckling (1976): A Theory of the Firm, p. 309.

⁷⁵ See Schreyögg (2008): Organisation, pp. 360 ff.

⁷⁶ See Jensen/ Meckling (1976): Theory of the Firm, pp. 354 f.

⁷⁷ Davis/ Steil (2001): Institutional Investors, p. xxiv.

⁷⁸ See Ambachtsheer (2007): Pension Revolution, pp. 24 ff.

management is one of the most important market segments for the effects of this theory in practice – both micro- and macroeconomically⁷⁹. Additionally, it is more complex than classical models⁸⁰, because the agent in form of a portfolio manager has an influence on the results and on the environment, i.e. on risks⁸¹, as several levels of mediation are implied.⁸² Furthermore, the incentivization for the alignment of interests in multi-dimensional contractual relationships – which are a given in contractual relationships and investment consulting – pose particular problems.⁸³

Therefore, the microeconomic perspective of asset managers (secondary agent)⁸⁴ and investment consultants (primary agent) is of relevance to this study. The principal agent theory is an approach to explain the existence of external service providers in general, which includes investment consultants.

Problems of principal-agent relations observed in real life can be found, for example, in the governance of the organization of institutional investors, in the delegated portfolio management of asset managers and in manager selection by investment consultants. Lakonishok, Shleifer and Vishny postulate in this context that "those in charge of the plan must show that they are doing some work to preserve their position"⁸⁵ and that, among other reasons, the often weak performance of institutional portfolios can be explained by problems

⁷⁹ See Stracca (2005): Delegated Portfolio Management, p. 7.

⁸⁰ See Stiglitz (1974): Incentives and Risk Sharing in Sharecropping, pp. 219 ff.

⁸¹ See Grossman/ Hart (1983): An Analysis of the Principal-Agent Problem, p. 43; Stracca (2005): Delegated Portfolio Management, p. 10.

⁸² See Stracca (2005): Delegated Portfolio Management, p. 32.

⁸³ For a solid inspection of the incentive problem in delegated portfolio management see Li/ Tiwari (2009): Incentive Contracts in Delegated Portfolio Management, pp. 4681 ff.; Sannikov (2007): A Continuous Time Version of the Principal-Agent Problem, pp. 957 ff.; Roiger (2007): Gestaltung von Anreizsystemen und Unternehmensethik, S 1 ff.; Elton/ Gruber/ Blake (2003): Incentive Fees and Mutual Funds, pp. 779 ff.; Ross (2004): Compensation, Incentives, and the Duality of Risk Aversion and Riskiness, pp. 207 ff.; Carpenter (2000): Does Option Compensation Increase Managerial Risk Appetite?, pp. 2311 ff.; Heinkel/ Stoughton (1994): The Dynamics of Portfolio Management Contracts, pp. 351 ff.; Sappington (1991): Incentives in Principal-Agent Relationships, pp. 45 ff.; Grinblatt/ Titman (1989): Adverse Risk Incentives and the Design of Performance Based Contracts, pp. 807 ff.; Starks (1987): Performance Incentive Fees: An Agency Theoretic Approach, pp. 17 ff.

⁸⁴ See Bhattacharya/ Pfleiderer (1985): Delegated Portfolio Management, pp. 1 ff. This early and trend-setting research, however, concerns itself exclusively with the term 'hidden information', whereas in the meantime 'hidden action' is the term referred to in delegated portfolio management. This is because the actual investment of the assets occurs through an asset manager and consequently no investment recommendations are provided. For an overview of the literature on the Principal Agent Theory with regards to delegated portfolio management see Stracca (2005): Delegated Portfolio Management, pp. 1 ff. For further works see He/ Xiong (2011): Delegated Asset Management and Investment Mandates, pp. 1 ff.; Dybvig/ Farnsworth/ Carpenter (2010): Portfolio Performance and Agency, pp. 1 ff.; Hoppe/ Kusterer (2009): Conflicting Tasks and Moral Hazard, pp. 1 ff. and 27; Leibundgut (2004): Moral Hazard in Portfolio Management, pp. 1 ff.; Mitnick (1996): The Hazards of Agency, pp. 1 ff.; Stoughton (1993): Moral Hazard and the Portfolio Management Problem, pp. 2009 ff.

⁸⁵ Lakonishok/ Shleifer/ Vishny (1992): The Structure and Performance of the Money Management Industry, p. 342.

of principal-agent relations between sponsors and asset managers.⁸⁶ In their research on mutual funds, Chevalier and Ellison confirm this and establish that there is a convex relation between netinflows and performance, which provides an incentive for asset managers to increase or to decrease portfolio risks – especially in the fourth quarter of a calendar year. This means, that good performance is followed by high net inflows, which in turn leads to a deliberate increase of portfolio risks.⁸⁷

The investor expects the asset management company to maximize his benefit or to reach his target, e.g. a risk-adjusted performance that is above average and that surpasses the benchmark. The conflict of interest is based on the fact that the investor cannot completely assess ex ante the asset management company's performance. For the sponsor, there is a risk that the asset manager uses the discretionary space, which is the result of incomplete information, to his own advantage. The phenomenon of 'overconfidence' additionally aggravates the 'moral hazard' problem of delegated portfolio management.⁸⁸ Contracts can be helpful, but they incur costs.

Only in a limited way can the relationship between sponsor and investment consultant be categorized as a relation in the sense of agency theory, as the investment consultant – at least in the authentic form – is only authorized to make recommendations on decisions to be made, but not to act on his own in a discretionary manner. This makes such a relationship fundamentally different from that of an institutional investor and asset manager.

Agency costs are used, among others, to assess the advantages of using investment consultants. As long as the advantages from reducing information asymmetries and welfare losses surpass the agency costs, the use of external consultants makes economic sense.⁸⁹

The disadvantage and thus the danger of due diligence in manager selection is that not all desirable, better than average providers, participate in beauty contests. This is because some of them want to avoid the information, labor and cost effort that come with such contests. This can lead to the problem of 'adverse selection'. Especially, the small, specialized asset management companies, whose human resources in marketing and

⁸⁶ See Lakonishok/ Shleifer/ Vishny (1992): The Structure and Performance of the Money Management Industry, pp. 372 ff.

⁸⁷ See Chevalier/ Ellison (1997): Risk Taking by Mutual Funds as a Response to Incentives, pp. 1169 f. und 1197 f. Together with convexity effects resulting from performance fees see Wei (2009): Explicit and Implicit Incentives in Delegated Portfolio Management, pp. 1 ff.

⁸⁸ See Keiber (2005): Overconfidence in Continuous-Time Principal-Agent Problem, p. 13.

⁸⁹ See Kleeberg/ Schlenger (2000): Die Rolle von Consultants im Rahmen der Spezialfondsanlage, p. 876.

distribution are limited, have frequently no adequate internal infrastructure to support investment consultants.⁹⁰

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⁹⁰ See Kellermann (2008): Implikationen für institutionelle Vermögensverwalter aus der Zusammenarbeit mit Investment Consultants, p. 171.

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