Why Trust Matters

The recent strife-filled US midterm election is just the latest example of destabilizing geopolitical developments that are upending the capital markets along with asset managers' and OCIOs' business plans. To help investment managers navigate this difficult marketplace, Chestnut is going Back to Basics, examining the research insights we've found are the key to successful growth. In this article we explore the key role of trust in the investment value chain. Investor trust (or mistrust) influences every step of that chain, notably:

- Asset pricing and market efficiency
- Asset flows
- Manager selection and termination
- Client retention
- Investor risk tolerance

Defining Trust Beyond the Matrix: In our last Back to Basics article we explained how investor trust is built via a matrix, not a straight line (as detailed in our Trust for the Win report). Today we're starting with the Merriam Webster dictionary's top definitions of trust:

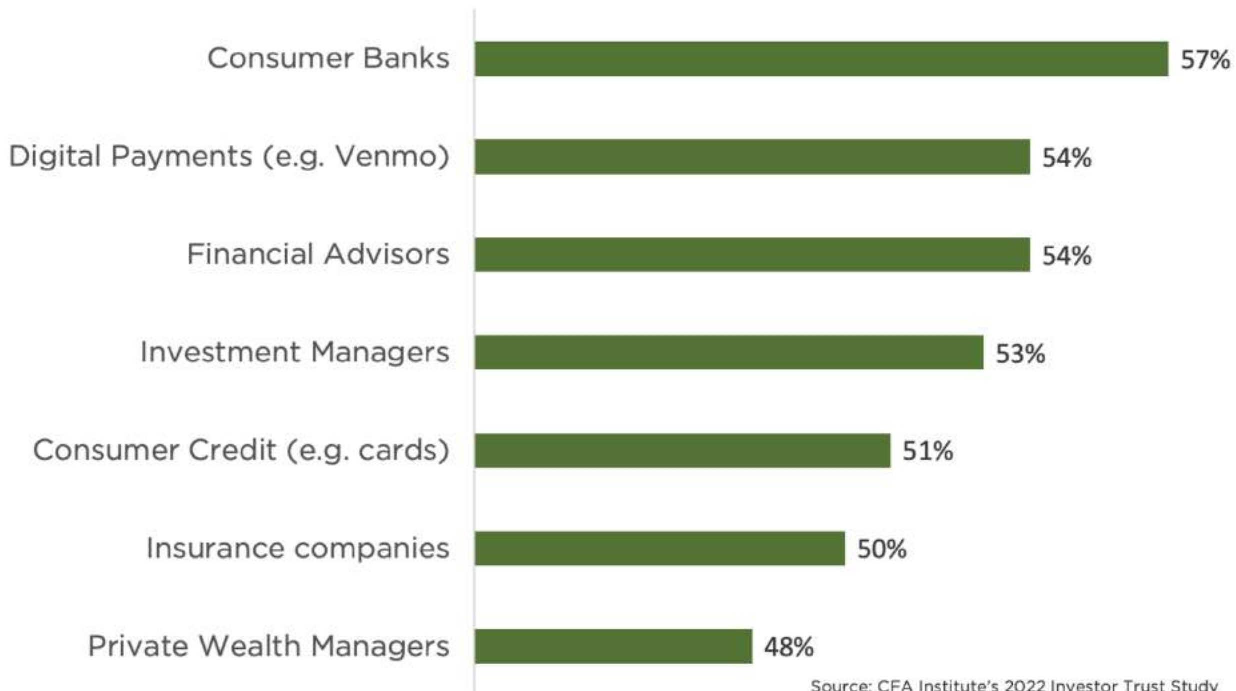
- Assured reliance on the character, ability, strength, or truth of someone or something
- One in which confidence is placed
- Dependence on something future or contingent
- Reliance on future payment for property delivered

Doesn't this sound relevant to the contract between investment managers, clients and consultants?

Asset Pricing and Market Efficiency Rely on Trust: Many studies have shown that where there is a high degree of trust, capital markets and asset prices quickly reflect this information, thereby enhancing

the efficiency of these 'high trust' markets as compared to those with lower trust. On the flip side, most major financial crises were either directly caused or significantly exacerbated by a loss of confidence in markets, counterparties, financial institutions and/or governments. The OECD puts it this way: "As financial markets are the primary mechanism to intermediate between investors and economic actors, public trust in markets is vital to its role to effectively and efficiently convert savings into productive economic growth, and in turn to reward capital providers with long-term returns commensurate with risks."

The good news is that trust in financial services was at an all-time high when measured earlier this year, with investment management firms and financial advisors logging significant recent improvements.



Trust Influences Asset Flows: Asset flows accrue to firms that have cultivated trusted relationships with financial advisors and consultants. Intermediaries in particular tend to rely on soft factors in assessing credibility because they need to reflect that belief and conviction in the recommendations they make to end investors rather than rely heavily on historical performance.

Trust can influence outflows just as much as they do inflows, as shown by studies finding serial correlation in asset flows. For example, fund management companies that announced a change in ownership were found to experience 7% outflows in fund assets , according to a study by Leonard Kostovetsky at Boston University in 2016. More anecdotally, “key man risk” has become a critical asset manager monitoring criteria. Outflows from institutional strategies following any kind of portfolio

manager turnover can easily surpass 50%. This phenomenon is evidence that investors place significant value on trust.

Trust Helps Get Managers Hired...and Terminated: The selection of an investment manager is driven by two types of assessments: quantitative and qualitative. Quantitative factors (such as performance, qualifications of key personnel, capacity) can be calculated, measured and benchmarked. Soft factors (such as investment philosophy, credibility, client focus) are to a large degree "felt" rather than objectively measured. This is evidenced by the fact that a "finals presentation" is almost always a very important criteria in institutional manager selection, by which point all quantitative assessments have already been completed. Our research shows that the top five factors driving the decision to hire an asset manager are all qualitative.

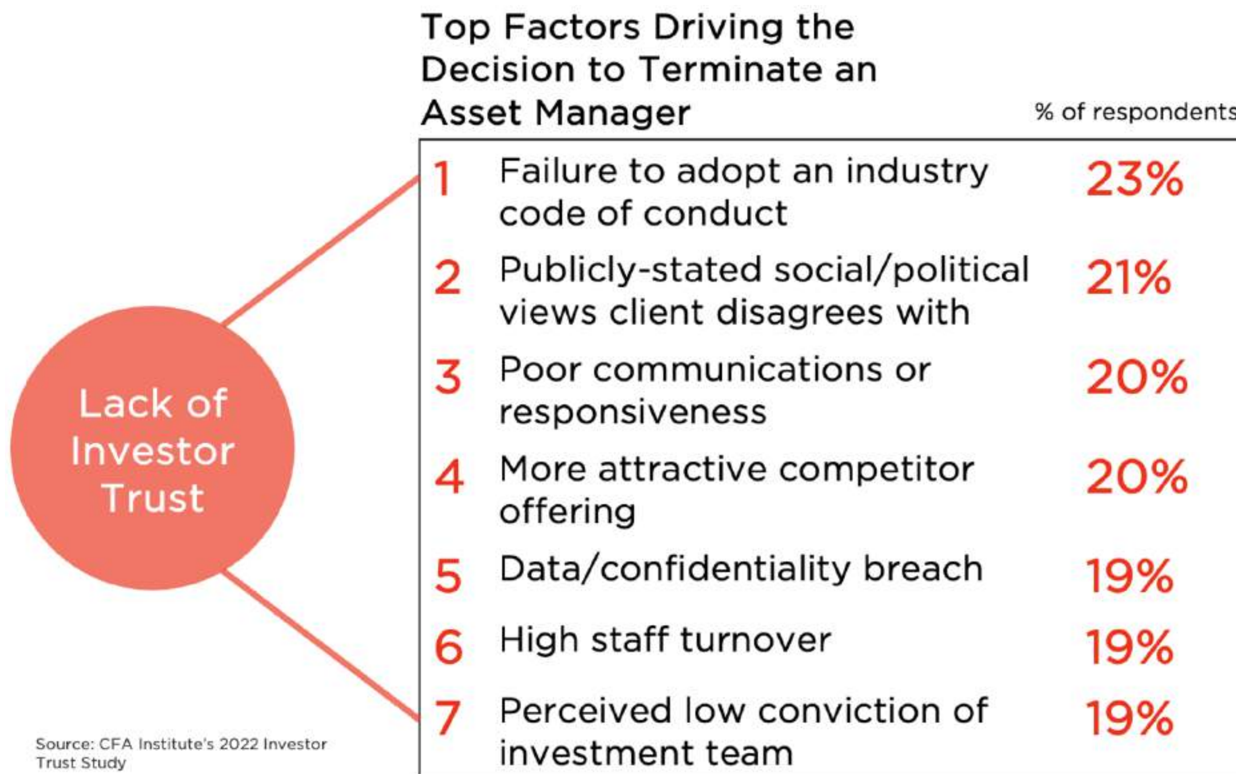
Top Factors Driving the Decision to Hire an Asset Manager

		% of respondents
1	Strong understanding of the firm's investment process	95%
2	Asset manager credibility	89%
3	Strong understanding of the firm's risk management	82%
4	Clear and consistent communication	77%
5	Confidence in the firm's business structure and incentives	77%

Source: Chestnut Advisory Group

To successfully raise and retain client capital, an asset manager must engender confidence and credibility, and show that they care deeply about the outcome for the client. In other words, the client and consultant have to trust the asset manager implicitly before awarding them the business.

Interestingly, we also see trust (in various manifestations) dominating the top reasons investors terminate investment managers, as illustrated below.



Trust Helps Asset Retention, Buying Time for Underperforming Managers: Although the analysis of long term (5-10 years) performance track records is a primary metric driving manager selection decisions, most investors will not tolerate underperformance for very long, generally no more than a few years.

In our conversations with leading consultants, we find that trusted asset managers tend to be retained at least 12 months longer (when underperforming) than managers that are less trusted. Highly-trusted asset managers are transparent and communicate proactively, especially during periods of underperformance, providing explanations and data points to continually shore up investor trust. The extra holding period that trusted managers gain not only helps the manager economically, but it often

fills the critical time that the manager needs for their style, portfolio or market to demonstrate performance improvement.

Trust Is Positively Correlated with Risk Tolerance: Where there is risk, there has to be trust. The higher the expected risk in any transaction, the higher the level of trust that there needs to be for the party bearing the risk. While this phenomenon has been long proven in studies of consumer behavior, more recent studies have confirmed that there is a moderate to strong positive relationship between trust and risk taking in an investment setting.

This is most relatable in the investor-financial advisor relationship where a high degree of trust can result in bigger stock market participation, and has also been confirmed in a study of investors in the Swedish state pension system. While we are not aware of formal studies in the institutional space, it is not a stretch to imagine a relevant common example: a first foray into alternatives for a pension fund supported by a strong recommendation from an institutional consultant. This trust/risk relationship in our opinion has fallen somewhat under the radar but may have profound implications for a more formal trust/ risk budget relationship with investor behavior.

Stay tuned for further exploration of Trust and how asset managers and consultants can align themselves to client expectations in our Back to Basics series of thought leadership and research.

Please feel free to contact Chestnut Advisory Group for more detailed insights on delivering a superior client experience.

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