Aligning Incentives

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Artificial Intelligence is the latest buzzword nowadays, but we want to talk about a different type of AI, aligning incentives. Ideally, everyone would follow their ideals and not their practical incentives. But as the saying goes — in theory, theory and practice are the same; in practice, they are different. People are human, and humans follow incentives. If you want people to follow a specific course of action, you need to align their incentives with your goal. (And yes, the pleasant glow that comes with knowing you did the right thing is itself an incentive, but it is often more amorphous and weaker than many competing counter-incentives.) And if you want to predict and understand what people will do in different situations and under different sets of circumstances, follow the incentives.

In general, the greater the split between the actions and the goal, the more important the crafting of incentives is to keep the process on track. On the most basic level, even within your own self, there is often a conflict between your long-term goals and aspirations (for a banal example, take losing weight) and your immediate gratification and short-term incentives (say, the can of soda or bowl of ice cream). To keep your long-term plan on track, you need to craft or shape your short-term incentives to match. (Perhaps a weekly reward of some sort for staying on your diet plan.)

But the problem of misaligned incentives really explodes when the goal-setter is not the same as the one actually tasked with reaching the goal. Different people can have wildly different goals. Not only different goals pointing in different directions, but often contradictory goals pointing in opposite directions. This is known as the principal-agent problem and is a difficult, but crucially important, problem to tackle wherever it rears its head.

As investors, the need to properly align incentives appears on three different levels. Firstly, within the company itself — aligning its employees, customers, and suppliers with the overall benefit of the company. Secondly, between the company and its shareholders — aligning management, the board, and controlling shareholders with public shareholders. And thirdly, on the investor side — aligning the fund manager with the limited partners and long-term investment success. Let's look at these one by one.

Aligning the Business

Some business models inherently have to struggle with the issue of misaligned incentives. One classic example is health insurance. Doctors and hospitals are highly incentivized to prescribe unnecessary tests and treatments (for which they are paid), and patients have little incentive to push back. Perhaps they suffer some inconvenience and time, but if the patients are not paying for it, they often prefer to be on the safe side. All this, of course, comes at the expense of the health insurers, who spend much of their time and expense attempting (not super successfully) to grapple with this issue — the split between payor and consumer of healthcare. The answer, of course, is paperwork. Tons and tons of paperwork. (I kid, but this is the root source of much of the paperwork.) Naturally, consumers experience these misaligned incentives in the other direction. The patient has an issue which they are desperately seeking to diagnose and treat, and the health insurer refuses to authorize and cover expensive MRIs or newer, better drugs.

Even when the essential business model does not struggle with misaligned incentives, every business has to incentivize their employees at every level to perform in line with the goals that management sets. Poorly crafted bonus schemes can often backfire, sometimes in a big way. A few years ago, Wells Fargo famously experienced this when they set aggressive incentives for their rank-and-file employees based on how many accounts and products they sold per customer. Those incentives succeeded in getting their employees to open lots of accounts and sell lots of products — even without the customer's consent. Opening fraudulent accounts was clearly not the company's intention, and these fake accounts mostly did not even make any money for Wells Fargo, as they were accounts without fees and without usage, accounts the customers didn't even know about. So, Wells Fargo gained nothing from these fake accounts. Instead, Wells Fargo suffered tremendously from the resultant regulatory actions and massive public relations hit, and Wells Fargo still suffers from the knock-on effect years later. All from incentives gone awry.

From an investor's perspective, the internal business alignment or misalignment, like much of the day-to-day management of the business, is usually not visible from the outside per se. Unless it blows up, as it did in Wells Fargo's case. Investors generally need to make a judgement call on management's overall competence, which includes this subsection of management together with everything else. In some sorts of businesses, where incentives are more obviously the focus of top-level management (e.g., sales-based businesses), there is sometimes more transparency on this issue.

Aligning the Management

The main focus that investors tend to have while considering alignment is aligning top management with the ultimate benefit of shareholders. A CEO's main goal is often to keep his cushy job and get substantial pay raises and hefty bonuses. One way to earn that is to do a good job running the business. Another way, however, is to look like he's doing a good job running the business by milking it short-term, while neglecting its long-term health and competitive positioning. Or the CEO can simply stack the board with friend who will not take too close of a look at his performance when setting his pay package to be "in line with peers".

Earlier this year, we ended our multi-year investment in Viemed (at a substantial profit), prompted in major part by the ongoing unconscionable percentage of profits which went to line management's pockets rather than accruing to the benefit of shareholders.

Although investors often can't affect the situation in any particular company (short of the time and expense of going activist), it is definitely an important item to keep an eye on when choosing which companies to invest in. It is always heartening when company insiders have substantial skin in the game. Even how these incentives are crafted is important. The standard way of incentivizing management — by issuing stock options — leaves much to be desired. Although grants of stock options to management are supposed to align their incentives with the shareholders, in actual fact they do not do such a great job. Not least because many boards are quick to reprice existing options or to grant new options if the stock price suffers. Which defeats the purpose of aligning management with shareholders.

Much better is when management (or an involved board member) owns a substantial chunk of stock (whether from having founded the company or through open-market purchases) with the same economic benefits and risks as any other shareholder. The alignment is then natural and not contrived, although one potential pitfall to look out for is whether they can self-deal to the detriment of minority shareholders. For example, through a management-led buyout at low prices.

Aligning Incentives

At times, investors can take advantage of managers' misaligned incentives and profit from them. In Joel Greenblatt's deservedly famous book *You Can be a Stock Market Genius*, he is a strong proponent of investing in certain types of spinoffs. The ideal situation is where a large company spins off a small division and *top management sticks with the small division*. In such cases, the fact that management is sticking with the small spinoff usually means that they see a lot of value there. Yet they have little incentive to extoll the spinoff's praises in advance, because they prefer a cheaper stock price debut so as to price their own option grants low (as option grants are generally priced at the current market price). So, they often do little promoting of the spinoff, providing the market with the bare minimum of detail that they can get away with.

And because the spinoff is much smaller than the parent company (and sometimes in a different industry or geography), the original shareholder base often sells it automatically as being out of their investment mandate. (You can take advantage of their incentives as well!) Between heavy selling pressure from the original shareholders and little promotion and explanation from the company, the spinoff starts trading very weakly and drops to a very attractive price, at which point management can price attractive option grants and start explaining the company to the market. You as an outside investor can enter at this point, aligning yourself with management, in what can often prove to be a very lucrative investment. See the book for many such examples, both for spinoffs and other related corporate actions.

The Fund's investment in the aforementioned Viemed began as just such an investment. We originally bought in shortly after it spun off from an umbrella home healthcare company in Canada, a spinoff spearheaded by the original founders of Viemed who left the parent company to focus on Viemed. We started buying shares a few months after the spinoff, and we did very well with our Viemed investment indeed, with an IRR of about 25% over the approximately 5 years that we were invested.

Aligning the Investor

Aligning employees is generally out of the investor's hands and is often not even visible to outside observers. Aligning management is also out of any particular investor's hands, but it is something he can and should keep an eye on, and he should avoid particularly egregious situations. Although aligning management is where most investors expend the bulk of their focus on aligning incentives, we actually think that the most important alignment for an investor is aligning oneself. For a portfolio manager, aligning one's own fund to be in line with your limited partners' benefit and long-term investment success is something that is directly in the portfolio manager's control and is something that we view as crucially important. When we launched the Fund, we thought long and hard on how to structure the Fund to encourage aligned incentives and foster the best environment for investment success. To do this, we landed on a fairly unique structure that we believe is an integral part of our ensuring long-term success.

Win–Win; We Win When You Win

At Focus Capital Management, we are paid no management fee whatsoever, only an incentive fee of 25% of profits. We don't want to make money unless our investors make money. We win when you win.

Performance vs. Asset Gathering

As a corollary from the deliberate lack of management fee, we avoid an altogether too common trap. It often seems that managers build something of a track record and then open the fundraising spigot, massively boosting the size of their fund even while returns stagnate. Because that's where the money is, that's where their incentives lie. We don't want to simply be asset gatherers. And with our structure, we have little incentive to raise assets if it will hurt our performance, because we are paid solely based on our performance. This way, we are incentivized to put performance above everything else. In fact, if and when we judge our strategy to be within 30-50% of capacity, we intend to close the Fund to new capital so as to preserve years of runway to invest and grow the capital we already have.

Keeping Focused on the Long Term

Although many managers profess to be long-term investors, the realities of the business make it very difficult for them to follow through. It is very difficult for managers to keep their eyes on the long term when they are constantly scored and compared on a short-term basis. Managers know that if they underperform over a few months or quarters, they can face sizable outflows from their investor base. Consciously or subconsciously, they react accordingly. Even the (increasingly rare) funds that feature lock-ups generally allow withdrawals on an ongoing basis once the lock-up expires, so that most of the time, the majority of the invested capital does not have any lock-up in force. We believe that the short-term focus engendered by these misaligned incentives is a major contributor to why many managers underperform over the long term.

To combat this and to properly align incentives to encourage long-term investing, we have structured Focus Capital Management with renewing two-year lock-ups. When the capital is eligible for withdrawal, if the investor chooses to remain invested in the Fund, the capital is again locked up for another two calendar years, and the high-water mark resets. With this renewing multi-year lock-up, both the Manager and the Investors remain focused on what really matters — long-term investing. (Arguably, even two years is too short, but we had to strike a balanced compromise between the ideal and the pragmatic.) We believe our ability to arbitrage the market's incessant focus on the short-term future with our patient long-term focus to be one of the strongest advantages we have when investing.

Conclusion

When you start viewing the world through the prism of incentives, you find misalignment and its effects to be a common theme throughout all the spheres of life — personal, social, political, and economic. As we've discussed, misaligned incentives are very relevant to an investor as well. It behooves us to pay attention to incentives when choosing where to invest. Even more importantly, when it comes to ourselves, it is crucially important to structure our environment and our own incentives to foster and encourage investment success. Because we are all human, and humans follow incentives.