The Principal - Agent Dilemma

Both clients and advisors should consider what is known as the principal - agent problem. What is this you may ask? At its core, it is quite simple: It's all about incentives and ensuring that those incentives are aligned as closely as possible.

Charlie Munger, the late business partner of Warren Buffett at Berkshire Hathaway, had a well-known maxim: "*Show me the incentives and I will show you the outcome*."

In the world of investing there are **principals** (the owners of capital) and **agents** (the people who manage that capital on their behalf). Principals are the clients. Agents include fund managers, advisors, stockbroker and any other intermediary who assists with investment decisions.

Alignment of interests is crucial. Unfortunately, in the financial world it is the exception rather than the rule.

In certain situations, agents may have incentives that differ from those of their clients. Some of these misalignments can include:

1) Compensation structure
Clients are interested in the performance of their investments and the risk taken to achieve those returns. Many agents, however, may be incentivised by factors such as new business flows and commissions, rather than delivering long-term results.

2) Increased complexity
Financial products are often made more complex than necessary, in order to justify higher fees. The more opaque the financial product, the harder it is for the principal to assess whether real value is being created.

3) Short-term thinking and career risk
Clients should, and typically do, take a long-term view of their investments. However, fund managers are usually evaluated on shorter-term performance, which can influence decision-making and also encourage consensus thinking.

Alignment

The **principal-agent** dilemma is difficult to eliminate entirely. While regulation and increased transparency have improved alignment in many areas, incentive mismatches can still arise. We believe alignment is best improved by focusing on simplicity, investing alongside our clients, and maintaining meaningful ownership within the business among key decision-makers.

When evaluating an agent, it is worth considering the following:

1) How are they compensated?
2) Do they invest alongside their clients?
3) Is the investment approach clear and understandable?
4) Are they focused on long-term outcomes?

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If you have any questions, Ian and our team would love to hear from you on investmentteam@seedinvestments.co.za.