Ideas @ Edelweiss Multi Strategy Funds – The Power of Incentives

Why do brokers love technical analysis? Why do large equity fund managers focus on growth? Why do wealth managers hate gold? and Why are sell-side analysts always bullish? The simple answer to these four unrelated questions is that their underlying incentives motivate them to do so. In this month's *Ideas @ Edelweiss Multi Strategy Funds* we highlight how incentives drive actions and discuss the implications for clients.

A broker makes money when you trade. Buy-and-hold is anathema for a broker because only client activity is rewarded. Hence, a broker needs a system to generate a never ending stream of recommendations. Fundamental analysis does not cut it because valuations change dramatically and the quality of companies and management is highly persistent. Hence, technical analysis becomes the tool du jour. Charts can be used to analyze stocks at any time horizon and the ever-changing demand-supply dynamics of equities are ideal for a never-ending series of trading calls.

Indian fund managers are reluctant to ever admit to capacity constraints. In a scenario, where incentives are aligned to assets under management, bigger is beautiful. Beyond a certain corpus, market liquidity forces managers to buy and hold. In that set-up, the only choice managers have is to focus on growth. Balance sheet driven arbitrages and special situations become untenable in the context of the assets being managed. The only way then to deliver returns is for underlying portfolio companies to grow their way to justify the multiples being paid for them. Hence, even the abundance of growth-oriented mutual funds and the paucity of value-oriented mutual funds.

A majority of Indian wealth management & financial distribution is driven by commissions from fund houses. In an environment in which relationship managers are incentivized by upfront payments, why would anyone get excited about a gold ETF - a vanilla product in a pure beta asset class? Even in the secular bull run for precious metals, advisors were reluctant to allocate to gold ETFs because there was nothing in it for them.

It is almost impossible to find a sell rating from the sell-side. Research analysts are structurally bullish on the companies they cover because they fear losing access to the management that they cover. In more pernicious cases, research is used as an extension of investment banking to win and close deals. It is also far easier to "sell" a positive recommendation than a negative one.

To paraphrase, Charlie Munger, never underestimate the power of incentives and always critically evaluate the incentives that drive the people you deal with.