

# Race to the bottom

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Many asset management decisions deal with long term effects. If you decide today not to paint your house anymore, it will not collapse tomorrow. On the contrary, the decision will not have any effect at all in the short run. Only if the neighbors decide their house could use some paint it may show that the own window frames are not that shiny anymore. If you wait any longer, for example until the neighbors paint their house for the second time, maybe the paint will be gone entirely on some spots. But with a hardwood window frame there still is no serious problem. It may not shine anymore, but hardwood has a reasonable resistance against rotting, and it may take a while before true weak spots occur. That still does not mean that the window frame cannot perform its primary job anymore, that is holding the window and closing the gap between window and wall. Even rotten wood has some residual strength. The only true problem with rotten wood is that you cannot paint it anymore because the paint does not stick to the rotten wood. Painting is only possible after some restoration, either by replacing the rotten pieces or by treating the rotten parts chemically (essentially converting the wood to plastic). If you wait even longer there will be no wood left to repair and the whole window frame will have to be replaced.. But even then it may still fulfill its primary task. It requires a true hole before the frame lets wind and rain through and the window will only fall out if a major part of the frame has rotted away. But that may take decades. One starts wondering why so many of us spend a fortune every x years on painting the house.

An argument often used to justify maintenance is that it extends the life expectancy of the asset. In case mentioned above that is absolutely the case. A well maintained hardwood window frame has a virtually eternal life. However, life expectancy is not a value in itself (for technical asset, for humans that is quite different). The key question is whether life extension is cost effective. Suppose every five years a paint job is needed of about 3000 Euros, but the frame would last 30 years without any maintenance (at a cost of 10000 euro), than the last option is cheaper overall. The paint jobs over a 30 year period cost 6 times 3000 equals 18000 euro, whereas the replacement only costs 10000 euro after 30 years. Even in cash flow the replacement is cheaper, but as painting occurs before the replacement, in net present value the difference is even bigger.

Extending the asset life is not the argument apparently. With regard to paint jobs one could even presume the costs are not the primary driver, the home owners just want their biggest asset to shine. Anyway, shine more than the neighbors home. A value (the shininess) that is easily observable provides good steering options. If the paint shows dull spots above a certain size it is time for a paint job. And if that is too difficult, just wait for the neighbors to paint their house.

The big question however is how to act when the value or quality is not that easy to observe. A hardwood window frame has a long life expectancy if painted, but a whitewood window frame is even in a well maintained state very susceptible for rot. If maintenance is performed one day too late (as a matter of speaking) damage may be beyond repair. And even if the wood is painted regularly, the wood may be affected by means of small cracks or fissures in the paint. No matter what maintenance regime is applied, replacement is often unavoidable after about 30 years or so.

Anyone should determine by himself if the comfort in maintenance is worth the extra investment in hardwood frames. Given the widespread use of hardwood in the Netherlands the general answer seems to be yes. But do we really get what we pay for? If the frame is delivered painted, the type of wood cannot be observed directly. A not too ethical window frame maker might be tempted to sell a whitewood frame as a hardwood frame. By the time it becomes apparent that it is whitewood instead of hardwood (e.g. when it is painted and rotten spots appear) the guarantee period might have ended, the frame maker may have changed names 3 times. This makes claims against the frame maker difficult, and most people do not want to claim anyway. If the house has been sold in the meantime the new owners may not even be aware that the window frames should have been hardwood. There is a reasonable probability the unethical frame maker will get away with providing bad products. Perhaps not with selling whitewood as hardwood (as that is easy to tell apart) but what about using low quality hardwood instead of the high quality promised and expected? That makes it tempting doesn't it?

In the economic literature this is sometimes called the “race to the bottom”. That is kind of an economic law: if the quality of the product is not observable from the outside, only the cheapest product will remain, which is unfortunately often the lowest quality as that can be produced cheaper.

This law is bad news for asset managers active in outsourcing activities. The quality of the work is often not directly observable, but only in the long run. Therefore it is to be expected that only suppliers of low quality maintenance services will remain. This happens to be precisely what the asset managers do not want, they prefer high quality maintenance so that the assets last longer.

What can be done about this? In essence there is only one solution, and that is making the quality observable. In case of the window frame, a sample can be taken to determine what kind of wood it is and then establish whether the wood has the characteristics that have been agreed with the supplier. But that presumes some knowledge on the side of the principal to know something about wood and understands that not every wood is the same. This almost means that for products with hidden qualities you can only outsource what you can do yourself. If you start outsourcing activities because you fail in doing it yourself it is an accident waiting to happen. The race to the bottom does not hurt, but hitting the bottom does.



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