An investigation of the role of trust in the relationship between pension fund trustees and investment managers: an Indonesian case study

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Chapter 4

A Trust Theory Approach to the Relationship Between Trustees and Investment Managers

1. Introduction

The previous two chapters examined the roles and functions of the investment manager and the duties and power of the trustee. It was found that there is a financial intermediation relationship between the trustee and the investment manager when the trustee gives a mandate to the investment manager to manage active investments on his/her behalf on the proviso that the investment manager adheres to the trustee's investment guidelines. In this chapter, a trust theory is discussed because there is some evidence that trust is an important component in a business relationship. It enhances the quality of a relationship and reduces risks.

This chapter begins by examining the general theory of relationship as used in finance: the agency theory. However, the agency theory has limitations for resolving agency problems that may occur between a trustee and an investment manager. Therefore, a trust theory is needed to explain the relationship between the trustee and investment manager. A theoretical model of trust proposed by Mayer, Davis, and Schoorman (1995) is used to find the key factors of trustworthiness of an investment manager. The stages of trust development
proposed by (Lewicki and Bunker, 1996) is used to examine the stages of a trust relationship developed between the trustee and the investment manager, and the key activities performed by them which brings this about. The sequence of discussion of these topics in this chapter is outlined below:

2. Theory of Relationship.

The most usual type of relationship in finance is an agency relationship, that is, a relationship between an agent and a principal. This type of relationship has been exhaustively researched using the agency theory introduced by Jensen and Meckling (1976). An agency relationship is defined as “a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent” (Jensen and Meckling, 1976, p 308). In this relationship, agency problems may arise if: (i) the goal of principal and agent is
conflict, (ii) the cost for the principal to monitor and to evaluate the behavior of 
the agent is expensive, or (iii) the principal is difficult to monitor and evaluate the 
behavior of the agent (Eisenhardt, 1989; Keil, 1995).

Byrd, Parrino, and Pritsch (1998) identify four types of principal-agents conflicts 
or agency problems and provide a summary of empirical evidence on these 
problem. These four agency problem are: (i) effort, (ii) horizon, (iii) differential 
risk preferences, and (iv) use of assets, as follows:

(i) The effort problem may occur when the executive’s efforts in creating value to 
the shareholders is less than the expectation of the shareholders towards 
him/her because he/she joins to the board of directors of another firm (Byrd, 
market reaction to the effort problem due to adding another member to the 
board of directors from other firm. Their findings indicate that the reaction of 
market participants to the announcement is very negative when inside directors 
own less than 5% of the firm’s common stock outstanding.

(ii) The horizon problem may occur when the executives of a firm have different 
time horizons to the stockholders (Byrd, Parrino, and Pritsch, 1998). If an 
executive has a limited time of employment in the firm, he/she will prefer to 
implement strategies that produce short-term rather than long-term outcomes. 
For example, Murphy and Zimmerman (1993) investigated the behavior of a 
variety of financial variables with a CEO turnover. They concluded that 
research and development costs, advertising expenses, and capital expenditure
are declined surrounding CEO turnover, especially when the firm has a poor performance.

(iii) The differential risk preference problem may occur when an executive of a firm believes that his/her responsibilities for the firm's poor performance are greater than his/her benefits received during the firm's period of good performances (Byrd, Parrino, and Pritsch, 1998). For example, an executive prefers to take a low risk by acquiring a firm as part of integration or diversification strategy to improve firm's performance. Berger and Ofek (1994) investigated the diversification's effect on a firm's value by imputing stand-alone values for individual business segments, with a sample of 3,659 firms and 16,181 observations. Their findings indicate that the firm's value decreased by 13% to 15% from diversification during 1986-1991. This evidence indicates that the executive gains some benefits from using diversified firms, but the expenses transfer to stockholders (Byrd, Parrino, and Pritsch, 1998).

(iv) An asset use problem may occur when an executive of a firm uses a firm's assets for personal purposes, or an executive makes investment decision to increase the firm's size for the purpose of increasing his/her income (Byrd, Parrino, and Pritsch, 1998).

An agency problem, such as the horizon problem, may occur in the relationship between the trustee and the investment manager. The agency theory, however, has limitations as a guide to resolve conflicts that may occur in the relationship
between them. There are several reasons for this. Firstly, the agency theory does not specify the key variables used as sources of building the relationship. Secondly, it does not specify the key activities of the principal or the agent to develop and to enhance their relationship. Thirdly, the agency theory does not specify the stages of the relationship, or the progress of the relationship. Taking account of these limitations, in this thesis it is proposed to use the trust theory to explore the relationship between the trustee and the investment manager. A trust theory will be used to explain the relationship between the trustee and the investment manager.

3. Trust Between the Trustee and the Investment manager

In implementing the investment strategy, the trustee can hire and give a mandate to the investment manager to manage active investments on his/her behalf. For example, Ennis (1997), showed that most large American pension funds are continuing to use many investment managers for active investments. Approximately 25\% of 200 large pension funds use 10 or more investment managers for active investments, and another 65\% use between 4 and 9. However, there is no guarantee that the investment manager will always perform well. For example, Malkiel (1995) and Gruber (1996) provide empirical evidence that in aggregate, active investment management has failed to provide the returns above the benchmark. Only a few types of actively managed mutual funds are able to provide returns above the benchmark, these include: managed aggressive
growth funds which outperformed the benchmark by an average of 2 or 3% in 1976 to 1985 (Grinblatt and Titman, 1993).

It can be inferred from the inconclusive evidence of the performance of an actively managed investment that the trustee is the vulnerable party and must be willing to accept the risks of the investment manager failing to achieve the trustees' investment objectives. The trustee must rely on trust in a relationship because not only are the investment returns involved but also the trustworthiness of the investment manager lessens the trustee's uncertainties. A number of researchers have shown that there is some evidence that trust is an important aspect in a business relationship (e.g., Shemwell, Cronin, and Bullard, 1994; Wray, Palmer, and Bejou, 1994; and Fram, 1995), an important determinant of the quality of the relationship and a source of building a long-term relationship (e.g., Ganesan, 1994; Andaleeb, 1996; Chow and Holden, 1997; Inkpen and Currall, 1997; and Moore, 1998).

4. Meaning of Trust Relationship.

Interest in trust relationships have grown rapidly in recent years, for two main reasons (Glover, 1995). The first reason is that the changing business values in society have brought about an emerging trust relationship. "Commercial interaction is now investigated more critically and the rightness of marketplace outcomes is no longer passively accepted. A majority of people, it is thought, find the uncorrected morality of the marketplace unacceptable" (Glover, 1995, p.17).
The second reason is that the structural changes in modern economics have increased the number of new economic actors, such as the professional investment manager (Glover, 1995). These actors are trusted to perform functions on behalf of others and receive payment for their services (Glover, 1995).

Glover (1995) argues that a trust relationship is similar to a fiduciary relationship - a term derived from the Latin *fiducia*, which means trust or reliance - and he identifies its two main characteristics as: an undertaking and reliance. Firstly, “the *undertaking* conception of the relationship has its genesis in the acceptance by one party of another party's trust” (Glover, 1995, p.51). For example, the relation between the broker and the trustee of pension fund, in some of its aspects, could be considered as a fiduciary relationship. The broker executes the trustee's orders, and takes the initiative to buy and sell stocks on behalf of the trustee. This relationship has a fiduciary aspect, because the broker has been authorised to hold the trustee's money and stocks. Therefore, the trustee will have trust in the broker who is expected to act honestly and with appropriate skill and knowledge in order to protect the interests of the trustee.

Secondly, reliance as a characteristic of a fiduciary relationship may include two things “either a person may *rely in fact* on another, or, in the circumstances, the person may be *entitled to rely*” (c.f. Glover, 1995, p.74). This means that reliance can be divided into: mutual reliance, or a one-sided reliance (Glover, 1995). Mutual reliance will occur if the persons in the relationship have trust and confidence in each other (Glover, 1995). For example, in a partnership, the
relationship between partners can be categorised as mutual reliance, because the partners have similar objectives, depending on each other, and placing their trust in each other to build a partnership.

A one-sided reliance will occur if one party in the relationship has trust and confidence in the other but it is not reciprocated (Glover, 1995). He concludes that a one-sided reliance is unequal that one party is superior to the other. As a consequence, the person in an inferior position must place his/her trust in the person of superior power and accept the risks of reliance. For example, the relationship between the trustee of a pension fund and the investment manager may be categorised as a one-sided reliance because the trustee places his/her trust in the investment manager, who is more knowledgable, has greater skills and has much time than the trustee in managing active investments, and accepts the risks of the performance of the investment manager.

According to the common characteristics of a fiduciary relationship, it is argued here that the common features of the relationship between the trustee and investment managers is risk and trust. There are two reasons for this. Firstly, the trustee relies on the investment manager who is in a superior position to that of the trustee, in terms of access to information with varying degrees of knowledge and skill in active investment management and other essential skills. Therefore, the trustee must, in fact, trust in the investment manager. Secondly, the trustee accepts the risks of hiring an investment manager because the outcome of the relationship depends on his/her performance. Therefore, most trustees agree, and
are well aware, that the decision to hire an investment manager involves a great
deal of risk especially as the trustee is responsible for his/her decision in hiring an
investment manager and must report the results to the members of the fund.

5. Risk and Form of Relationship

Every form of relationship has a specific risk and a way to reduce risk (Sheppard
and Sherman, 1998). They assume that relationships vary in terms of form and
depth and define:

relational form as the type of interdependence in a given relationship and
relational depth as a structural feature of a relationship that is a product of
the important, range, and number of points of contact among parties
(Sheppard and Sherman, p.423).

Sheppard and Sherman (1998) also define a relational form as either
interdependent or dependent, and a relational depth as either shallow or deep. By
combining the relational form and depth, Sheppard and Sherman (1998) propose
four forms of relationship: (i) shallow-dependence, (ii) shallow-interdependence,
(iii) deep-dependence, and (iv) deep-interdependence relationship. The key
elements of these forms of relationship are risk and the qualities of
trustworthiness (Table 4.1).

In this chapter, Sheppard and Sherman’s (1998) form of relationship is used as a
basis for recognising the types of risk and the qualities of trustworthiness in the
relationship between the trustee of the pension funds and the investment
manager.
Table 4.1: Form of Relationship, Risk, and Trustworthiness.

<table>
<thead>
<tr>
<th>Form of Relationship</th>
<th>Risks</th>
<th>Qualities of Trustworthiness</th>
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<tbody>
<tr>
<td>Shallow-Dependence</td>
<td>Unreliability</td>
<td>Discretion</td>
</tr>
<tr>
<td></td>
<td>Indiscretion</td>
<td>Reliability</td>
</tr>
<tr>
<td>Deep-Dependence</td>
<td>Cheating</td>
<td>Competence</td>
</tr>
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<td></td>
<td>Abuse</td>
<td>Integrity</td>
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<td>Neglect</td>
<td>Concern</td>
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<td></td>
<td>Self-esteem</td>
<td>Benevolence</td>
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<tr>
<td>Shallow-Interdependence</td>
<td>Poor Coordination</td>
<td>Predictability</td>
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<tr>
<td>Deep-Interdependence</td>
<td>Misanticipation</td>
<td>Consistency</td>
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<td>Foresight</td>
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<td>Empathy</td>
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5.1. Shallow-Dependence Relationship.

Dependence arises because the trustee gives a mandate to the investment manager to manage active investments on his/her behalf. There are two key risks for the trustee who builds a shallow dependent relationship with an investment manager: unreliability and indiscretion (Sheppard and Sherman, 1998). The first is the risk of possible unreliable behaviour of the investment manager which may deviate from the expectation of the trustee, for example, the investment manager may not perform the function of active investment management appropriately, protect the interests of the trustee or adhere to the investment management agreement. The second is the risk of indiscretion in which the trustee assumes that important information for managing active investment was not shared by the investment manager. For example, the investment manager does not submit up-to-date market information; report the information used to make buying or selling decisions; may use information for his/her personal gain.
To reduce the risks of unreliability and indiscretion, Sheppard and Sherman (1998) propose three factors of trustworthiness of an investment manager: these are discretion, reliability, and competency. These factors are similar to the most common features of a trustworthy person such as: integrity, competency, consistency (Butier and Cantrell, 1984), ability (Swan, Trawick, and Silva, 1985), expertise (Crossby, Evans, and Cowles, 1990), and expertise and tactfulness (Moorman, Deshpande, and Zaltman, 1993). For example, Butler and Cantrell (1984) conducted two experiments to investigate the trust relationship between subordinate and superior. In the first experiment, the participants act as subordinates and are asked to make decisions about the extent to which they would trust their hypothetical superiors. In the second experiment, the participants act as superiors and are asked to make decisions about the extent to which they would trust their hypothetical subordinates. The results of these experiments indicated that integrity, competence, and consistency are key determinant features of trust in one’s superiors and in one’s subordinates.

5.2. Shallow-Interdependence Relationship

In a shallow-interdependence relationship, the trustee has in mind three key risks: unreliability, indiscretion, and poor coordination (Sheppard and Sherman, 1998). This is because, the investment manager needs to be reliable and discreet; the behavior of investment manager must also be predictable. The trustee and the investment manager become more interdependent but the trustee bears the risk of poor coordination (Sheppard and Sherman, 1998). For example, the trustee is responsible for managing investments for the benefit of the members of
the pension funds. He/she can give a mandate to the investment manager to manage active investment in securities, but the responsibility of the investment performance is still the trustee's. Therefore, the investment manager must protect the interests of the trustee, adhere to the trustee's investment policy, submit reports as needed by the trustee to prepare reports to the members. This means that the investment manager needs, not only to perform the investment function but also, provide investment services as required by the trustee.

To reduce the risk of poor coordination, Sheppard and Sherman (1998) suggest that the investment manager must demonstrate that his/her activities to achieve the desired goals is consistent and predictable. These are similar to the most common features of a trustworthy person such as consistent behavior (Butler, 1991) and predictable behavior (Dasgupta, 1988).

5.3. Deep-Dependence Relationship

The essential characteristic of a deep-dependence relationship is that the investment manager's skill, knowledge and experience are higher than that of the trustee. As a consequence, the trustee has difficulty in monitoring the behavior of the investment manager (Sheppard and Sherman, 1998). A particular risk associated with a deep-dependent relationship is that the risk of cheating by the investment manager, a risk derived from the asymmetry of knowledge and experience (Sheppard and Sherman, 1998). For example, the trustee may ask for the services of the investment manager in setting an investment policy. The investment manager may not set the best investment policy for the trustee but one
which is best for the investment manager because he/she is aware that this investment policy will be used by the trustee to measure his/her performance.

Sheppard and Sherman (1998) suggest that in a deep-dependence relationship, the trustee requires specific factors of trustworthiness of the investment manager that will reduce any cheating, abusing, or neglecting behavior. For example, to reduce the risk of cheating, the investment manager must have honesty and integrity that mitigate the investment manager to take opportunity to cheat (Sheppard and Sherman, 1998; Schindler and Thomas, 1993). To reduce the risk of abusing and neglecting, the investment manager must have concern and benevolence (Sheppard and Sherman, 1998; Posner and Schmidt, 1984; Frost, Stimpson and Maughan, 1978). For example, Frost, Stimpson, and Maughan (1978) conducted one experiment on seven separate groups of participants. The members of each group were asked to give their perception about how much they trusted each other, by using the Janis and Field self-esteem inventory, and Rotter's internal-external form. The result of this experiment indicated altruism is a key determinant to trust in others.

5.4. Deep-Interdependence Relationship.

In a deep interdependence relationship, the trustee and the investment manager must be concerned with the quality of communication between them (Sheppard and Sherman, 1998). However, it is not always possible to increase the quality of communication, such as regular communication, because the investment manager
has clients from more than one trustee, and the complexity of the tasks of an investment manager may prevent regular and speedy communication to all equally. The essential risk, therefore, in a deep interdependence relationship is misanticipation: "the risk that, without specific instructions, one will not be able to anticipate the other’s need or actions" (Sheppard and Sherman, 1998, p.425). In these circumstances, the trustee loses the ability to monitor the performance of the investment manager, and lacks the means to communicate regularly with him/her. There is room for misunderstanding the intentions of the other party. To reduce this risk, the trustee must select an investment manager who has empathy, intuition and foresight (Sheppard and Sherman, 1998).

5.5. The Relevance of Form of Relationship to This Study.

In summary, Sheppard and Sherman’s (1998) four forms of relationships (Table 4.1) are useful to recognise the characteristics of a relationship between the trustee and the investment manager, these are: (i) the trustee bears risks in a relationship with an investment manager; (ii) the type of risks borne by trustee depend on the dependent or interdependent form of relationship with an investment manager, and (iii) trustee selects an investment manager whose trustworthiness has been proved suitable to reduce specific risk in a relationship. This thesis therefore explores the key factors of trustworthiness of the investment manager, and key activities for building and developing the relationship between the trustee and the investment manager.

The definition of trust has changed rapidly since scholars from other disciplines have added their views. However, the only agreement reached is that the critical element of trust is a willingness to be vulnerable, and that trust is a psychological state. The perspective of the social psychologist on trust, emphasizes the nature of trust in an interpersonal relationship, and that the level of trust may be developed gradually over time. Research on trust in many disciplines has provided evidence that it plays an important role in business relationships either as a feature or a determinant.

6.1. The Development of Definitions of Trust

The definition of trust as applied to commercial and fiduciary relationships has evolved and developed rapidly under an inter-disciplinary perspective. In the early development of the definition of trust, regardless of the underlying discipline of the scholar, the critical elements of the definition of trust were: confidence and expectation (e.g., Rotter, 1967).

Rotter (1967, p 651) defined trust as “an expectancy held by an individual or a group that the word, promise, verbal or written statement of another individual or group can be relied upon”.

In further development of the definition of trust, scholars emphasis willingness to be vulnerable, confident, and expectation, as the critical elements of trust (e.g., Mayer, Davis, Schoorman, 1995; Lewicki, McAllister, and Bies, 1998; Doney, Cannon, and Mullen, 1998)
Mayer, Davis, and Schoorman (1995, p.712) define trust as "the willingness of a party to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustor, irrespective of the ability to monitor or control that other party".

Lewicki, McAllister, and Bies (1998, p.439) defined trust in terms of "confident positive expectations regarding another's conduct, and distrust in terms of confident negative expectations regarding another's conduct".

Doney, Cannon, and Mullen (1998, p.604) define trust as "as a willingness to rely on another party and to take action in circumstances where such action makes one vulnerable to the other party".

The most recent definitions of trust emphasise risk and interdependence as essential elements (Rousseau, Sitkin, Burt, and Camerer, 1998). Some scholars, across the disciplines, agree that a risky situation is an important condition for the need of trust to arise (e.g., Williamson, 1993; Chiles and McMackin, 1996; Bhattacharya, Devinney, and Piluta, 1998). The relationship between risk and trust is reciprocal (Rousseau, Sitkin, Burt, and Camerer, 1998) in that risk generates a situation of trust, and trust leads to risk taking.

Interdependence is also an important condition for trust to arise (Sheppard and Sherman, 1998). They argue that in a form of relationship, the nature of risks and the quality of trustworthiness change as interdependence increases. Interdependence, as an important condition for trust to arise, can also be found in the Hagen and Choe (1998, p.590) definition of trust:

Trust is the expectation that the promise of another can be relied on and that, in unforeseen circumstances, the other will act in a spirit of cooperation with the trustor.
The recent developments in the definition of trust show that, there is no accepted scholarly definition (Rousseau, Sitkin, Burt, and Camerer (1998). The diversity in conceptualisation reflects the lack of agreement among scholars about the most suitable definition of the concept (Hosmer, 1995), and this is a disappointment to many scholars (Bigley and Pearce, 1998). For example, Zucker, 1986, p.56) explained that “recognition of the importance of trust has led to concern with defining the concept, but the definitions proposed unfortunately have little in common other than the informal character of trust”. Shapiro (1987, p.624) said that “the conception (of trust) has received considerable attention in recent years, resulting in a confusing potpourri of definitions applied to a host of units and levels of analysis”. Similarly, Reichman’ (1989, p.185) reviewing trust and its violation in sociological terms, concludes that there is “considerable uncertainty about what trust is and how precisely it falters”. Hagen and Choe (1998) argue that any discussion of the construct of trust need to clarify the terms and assumptions being used.

Although there is no universally accepted definition of trust, Rousseau, Sitkin, Burt, and Camerer (1998, p. 395) argue that tentative agreement on the meaning of trust has been achieved among scholars. The first agreement is that trust is psychological state that was interpreted by researchers in various disciplines as confidence and positive expectations. The second agreement is that trust is not a behavior or a choice but an underlying psychological conditions that can be dependent or independent from an action. Finally, risk and interdependence are necessary conditions for trust.
6.2. The Study of Trust.

The wide variety of approaches that have been taken to the multi-dimensional nature of trust in relationships make a single definition difficult and perhaps not desirable. The adopted perspective of trust will depend upon the nature and objectives of the analysis under consideration. For example, Rotter (1980) views trust as a personality characteristic. Zucker (1986) conceives trust as a preconscious expectation. Gambetta (1988) suggests trust is a rational decision. Williamson (1993) views trust as calculative. In response to these diverse concepts, some scholars suggest the need to categorise trust based on how it is viewed (Lewicki and Bunker, 1996), the extent to which trust is needed in an exchange relationship (Barney and Hansen, 1994) or how to understand trust (Brenkert, 1998).

In the literature of several of the social sciences, each discipline uses its own lens and approaches to define trust. An effort to integrate these different perspectives would be useful for research on trust. For this reason, Lewicki and Bunker (1996) suggest that the concept of trust may be categorised based on how trust is viewed: (i) as an individual characteristic, (ii) a characteristic of interpersonal transactions, and/or (iii) as an institutional phenomenon.

Firstly, the view of personality theorists is focused on individual characteristics (Lewicki and Bunker, 1996). In this category, trust is conceptualized as a personality trait or generalized response (Webb and Worchel, 1986). For example, Rotter (1971. P.651) defines trust as “an expectancy held by an
individual or group that the word, promise, verbal, or written statement of another individual or group can be relied on”. In this definition, an individual must have the belief and expectation to trust another.

Secondly, the view of the social psychologists is focused on interpersonal transactions characteristics (Lewicki and Bunker, 1996). In their view, trust can be defined as “the expectation of the other party in a transaction, the risks associated with assuming and acting on such expectations, and the contextual factors that serve to either enhance or inhibit the development and maintenance of that trust” (Lewicki and Bunker, 1996, p.116). Boon and Holmes (1991, p.194), for example, defined trust as “a state involving confident positive expectations about another’s motives with respect to oneself in situations entailing risk”. This definition implies that an individual must have expectations and confidence to take the risk to trust another.

Thirdly, sociologists and economists focus on trust as an institutional phenomenon (Lewicki and Bunker, 1996). In their view, trust can be conceptualised “as both a phenomenon within and between institutions and as the trust individuals put in those institutions” (Lewicki and Bunker, 1996, p.115).

In this thesis, the definition of trust is adopted from a social psychologist perspective because the objectives of the analysis are to examine the role of trust in the relationship between trustee of pension funds and investment manager and how trust operates in their relationship.
6.3. Trust - Static or Dynamic?

Some scholars view trust as static where trust and distrust are viewed as one bipolar construct (Rotter, 1971), or either as trust or distrust (Lewicki and Bunker, 1996). For example, personality theorists such as Rotter (1971) argue that "trust and distrust exists at opposite ends of a single trust-distrust continuum". In this view, distrust is similar to opportunism (Barney and Hansen, 1994). The behavioral decision theorists, such as Miller (1992), argue that trust and distrust exist at opposite ends of a single cooperative and non-cooperative conduct continuum. Trust is similar to cooperative conduct, whereas distrust is similar to non-cooperative conduct. Social psychologists, such as Lewicki and Bunker (1996), view trust as either complete trust or complete distrust. Rousseau, Sitkin, Burt, and Camerer (1998) maintained the reason for this belief is that this static view is linked to the dominant laboratory experiment in early research into trust and that under this research method, the level of trust reflects a single point, rather than a distribution.

Several trust theorists view trust as dynamic, that is, as developing gradually over time (Rempel, Holmes, and Zanna, 1985; Holmes, 1991). Trust levels assume a slow start, gradually increasing through several stages: building, developing, declining, and even resurfacing in a long-standing relationship (Swan, Trawick, and Silva, 1985; Lewicki and Bunker, 1996; Jones and George, 1998). This means that the changing quality of the relationship affects the level of trust within the stage or between stages. There are several explanations for this view. Firstly, Jones and George (1998) use moods and emotions as a basis to recognize the
changing level of trust. Other researchers agree that trust is a product of a person's emotions, at least to some extent (Rempel, Holmes, and Zanna, 1985; Holmes, 1991; McAllister, 1995). Trust, like all emotions, is dynamic.

At every exchange point - from the initial encounter on - moods and emotions affect the ongoing experience and meaning of the relationship. The extent to which one or both parties experience positive moods and emotions in the context of relationship (1) affects their immediate perceptions and judgements that the other party can be trusted, and will not harm or exploit them, and (2) enhances the likelihood that the parties will develop shared interpretive schemes. Successful behavioral exchanges are accompanied by positive moods and emotions, which help to cement the experience of trust and set the scene for the continuing exchange and building of greater trust. In contrast, negative moods and emotions accompany unfavourable evaluations of the other party, signalling a lack of trust" (Jones and George, 1998, p.536)

Secondly, Lewicki and Bunker (1996) assert that the increasing and declining of the levels of trust is a general process. Sometimes, the level of trust declines into a low level due to a severe violation by one party. Other times, the level of trust rises gradually. They describe it as follows:

It begins with relationship a relationship in which mutual trust has become established and where the parties have achieved an equilibrium. One of the parties is perceived by the other as acting in such a way that trust is violated. This creates instability and upset the recipient, who then assesses the situation at both cognitive and emotional levels. Cognitively, the individual thinks about how important the situation is and where the responsibility for it lies. Emotionally, individuals often experience strong feelings of anger, hurt, fear, and frustration; these reactions lead them to reassess how they feel about the other (Lewicki and Bunker, 1996, p.125)

This thesis adopts the view that trust is dynamic because the relationship between the trustee and the investment manager may develop gradually because the degree of trust by of trustee in an investment manager may be determined by the degree
of trustworthiness of an investment manager; and trust development may be
determined by the key activities performed by both trustee and investment
manager.

6.4 Trust Betrayal

Trust relations may not always provide benefits for the trustor (Husted, 1998).
There are violations or abuses of trust in organizations. For example, Elangovan
and Shapiro (1998) refer to the Barings Bank collapse in Britain and the copper
trading scandal at Sumitomo, as employees violated trust of the supervisors in
them. Jones and Burdette (1994) reported evidence of violation of trust in a
workplace composed of 25.4% men and 9.4% women where violation of trust
by co-workers or the boss was identified.

Several researchers have noted that the conditions for raising trust also allows for
its abuse (Morris and Moberg, 1994). For example, Elangovan and Shapiro (1998)
showed that lack of expertise is not only a condition for the trustee to trust in the
investment manager but also an opportunity for the violation of trust. They
provide five characteristics of betrayal of trust in organizations, as follow:

First, betrayal in the workplace is voluntary. Second, betrayal involves
the violation of pivotal expectations of the trustor. Third, both parties
must be mutually aware of (even if it is implicit) but need not necessarily
accept these expectations as central to the relationship or contract. Fourth,
betrayal involves a behavior (an actual violation), rather than just
the thought of betraying. Fifth, betrayal has the potential to harm the
well being of the trustor (Elangovan and Shapiro, 1998, p. 550).
6.5. The Empirical Evidence of Roles of Trust in Relationship.

Many scholars have found that trust plays an important role in various types of relationships. In business relationships, for example, Moorman, Zaltman, and Deshpande (1992), propose that there are two important roles of trust: as a feature, and as a determinant. Aulak, Kotabe, and Shay (1996) identify three important roles of trust in interorganizational relationships: an important deterrent to opportunistic behaviours, as a substitute for hierarchical governance, and as an alternative to ownership control.

6.5.1. Trust as Feature of Relationship.

Trust is a feature or an aspect of a relationship quality that, with other factors such as: satisfaction, communication, and commitment, are important aspects of a relationship. Shemwell, Cronin, and Bullard (1994) researched the important aspect of the relationship between customers and their primary care physicians, their automobile mechanics, and their hairstylists. The sample is determined from a population of a medium sized city in the Southeast US. The finding indicates that the level of trust and commitment are important aspects of providing a customer service relationship. The higher level of trust and commitment the higher the probability of customer to continue his/her relationship with the service-provider.

Wray, Palmer, and Bejou (1994) researched the factors contributing to the quality of the buyer-seller relationship. The sample of this study consisted of the customers of financial services' intermediaries. A telephone survey was conducted
by using structured questions to interview 1,944 adult members of households. A neural network was used to analyse the 564 questionnaires. The result of neural network analysis indicated that satisfaction and trust are two indicators of a quality relationship.

Fram (1995) conducted research into purchasing a partnership to find out how they are evaluated and what measurement is used to evaluate the partnership. Professional interviewers were hired to interview 38 buying personnel and industrial firms by telephone. These respondents were selected randomly from a sample of US manufacturing firms that had purchased partnerships. The results of his study showed that openness of communication and interpersonal trust are important factors in purchasing a partnership.

6.5.2. Trust as Determinant of Relationship

Trust is a determinant of the quality of the relationship that could be an inter-firm, or an intra-firm relationship. The findings indicate that trust plays an important role, it enhances satisfaction, determines long-term orientation, enhances buyer loyalty, reduces conflict, and enhances commitment.

6.5.2.1. Inter-firm Relationship

Anderson and Narus (1990) studied working partnerships between the distributor and the manufacturer. They developed a working partnership model by incorporating trust as an element. The analysis was based on a questionnaire mailed to 488 firms or 1952 informants. A total of 1365 questionnaires
completed and returned. The results of the analysis indicated that manufacturers claim that trust is able to enhance satisfaction.

Ganesan (1994) conducted a research study to investigate the role of trust in a buyer-vendor relationship. The data were collected by a mail survey to retail buyers and their vendors from six regional department chain stores. These stores' annual sales are more than US$200 million. The analysis is based on 124 retail buyers and 52 vendors who returned the questionnaire. The findings indicate that trust and dependence are key determinant of long-term relationship between retail buyers and their vendors.

Andaleeb (1996) conducted an experimental study to investigate the role of trust in enhancing satisfaction and commitment in marketing channels. The analysis is based on a sample of 72 business managers from sales or purchasing who had considerable experience in negotiating transactions with other organizations. Information was provided by business managers about their relationship with the buyer and seller during one year. The findings of this study indicated that trust has a significant effect on satisfaction and commitment in the relationship.

Chow and Holden's (1997) study examined whether trust has a major effect on the purchasing strategies of a buyer, and whether this effect is large. They collected data by sending questionnaires to 297 buyers of electronic circuit board companies in 7 different industries in Massachusetts. This industry was chosen for research because of the diverse nature of buyers, a wide range of product from
low to high technology, and simple to complex purchasing decisions. The findings indicate that trust has a significant effect on the buyer’s attitude toward the product, and the buyer’s loyalty.

Inkpen and Currall (1997) conducted research into trust and its role in the process of international joint ventures (IJV) in North America. The sample was 125 joint venture firms between Canadian and Japanese firms in the automotive supply industry. A questionnaire was sent to each senior Canadian manager in the venture that had been identified before sending the questionnaire. The response rate was 28%, that is 35 questionnaire were completed. Trust was measured at 2 levels: the level of IJV manager trust in the counterpart IJV manager, and the level of trust in the partner firm as a whole. The findings indicate that the higher the level of trust in the partner’s firm the lower the risk in a joint venture: the higher the level of trust in a partner produces the greater level of partner forbearance.

Moore (1998) researched the roles of trust and commitment in logistic alliances from the buyer’s perspective. A sample frame was created by identifying US firms listed in the 1995 Council of Logistics Management membership. He sent questionnaires to 1259 buying firms. The analysis is based on the 339 firms that returned questionnaires and indicated they had at least one logistic alliance with a duration, on average, of 6 years. The study provided an important finding that trust and commitment are important elements in logistic alliances.
6.5.2.2. Within Firm Relationship.
Mishra and Mishra (1994) studied the role of mutual trust in downsizing strategies by attempting to identify why only a few firms use organization redesign and systematically change strategies for downsizing. They interviewed 33 executives from the North American automotive industry in order to gather in-depth information related to the aim of the study. They mailed questionnaires to 792 members of top management teams of 91 firms. Their analysis is based on the 551 questionnaires returned, a response rate of 65%. This study revealed two important findings. Firstly, mutual trust within the top management teams is negatively related to the work force reduction strategy, but positively related to the organization design. Secondly, mutual trust between top management and employees is positively related to work force reduction strategy.

6.6. Summary of Concept of Trust and The Relevant to This Study.
The definition of trust has changed rapidly because of the input of scholars from many disciplines. There is no single accepted scholarly definition of trust but most scholars have reached an agreement that a willingness to be vulnerable is one of the critical elements of trust. For these reasons, the definition of trust used here is that proposed by Mayer, Davis, and Schoorman (1995). In their definition, the participants in a trust relationship consist of at least two parties such as a trustee and an investment manager. The trustee is in a vulnerable situation and the investment manager is expected to act benevolently toward him/her.
Studies of trust may be grouped, according to the perspectives of scholars, such as: personality theorists, sociologists, economists, and social psychologists. In the context of this study, the definition of trust is that viewed by the social psychologists, for three reasons. Firstly, the perspective of the social psychologists on trust emphasises the nature of trust in interpersonal relationships and this could be the case in the relationship between the trustee and the investment manager. Secondly, social psychologists incorporate risk as a central element in their definition of trust. This may be the case when the trustee bears the risk of unreliable behavior of the investment manager. Thirdly, social psychologists emphasise the roles of the context that serves to enhance or maintain a trust relationship. For example, the dramatic changing index of the stock market may influence the relationship between the trustee and the investment manager.

Finally, the multi-disciplined research on trust has provided evidence that it plays an important role in a relationship either as feature or as determinant. These roles indicate that trust is dynamic and able to influence the quality of the relationship. This evidence is seen as an encouragement to use the trust theory to study the relationship between the trustee and the investment manager and used here to act as a guide to explore the relationship between the trustee and the investment manager.

7. A Theoretical Model of Trust

Theoretical models of trust have been proposed, for example, by Mayer, Davis, Schoorman (1995) that emphasize the psychological factors of a person's trust in
another and risk taking in a relationship. McKnight, Cummings, Chervany (1998) propose a model of an initial formation of trust in which the details of the constructs and processes come from four research streams: personality, institutional, calculative, and cognitive-based. Bhattacharya, Devinney, and Pillutla (1998), propose a rationalist model of trust which combines individual differences in trusting and trustworthy behavior in an economic situation that may affect trusting and trustworthy behavior.

In this thesis, the theoretical model of trust developed by Mayer, Davis, and Schoorman's (1995) is used, for two reasons. Firstly, their theoretical model focuses on the role of trust in a risk taking relationship such as where the trustee is aware that investing in the stock market is more risky than term deposit, and although, a mandate is given to an investment manager to manage the active investments, there is no guarantee that the investment manager will always perform well. Therefore, there is a risk element in the relationship with the investment manager. Secondly, the Mayer, Davis, and Schoorman's (1995) model incorporates explicitly, the key factors of trustworthiness of a trustworthy person. The trustee of the pension funds can use these key factors to assess trustworthiness of an investment manager.

The theoretical model of trust developed by Mayer Davis, and Schoorman (1995) is as follows:
In the context of the relationship between the trustee of the pension funds and the investment manager, the term trustor is replaced by that of trustee while the term trustee is replaced by that of investment manager. For the purpose of illustration, the term trustee and investment manager are used in the discussion of the theoretical model of trust.

7.1. The Key Factors of Trustworthiness

The level of trust of the trustee in the investment manager may be low or high depending on the factors of trustworthiness shown by the investment manager. For example, Moorman, Deshpande, and Zaltman (1993) found integrity, confidentiality, expertise, tactfulness, sincerity and congeniality are the factors of trustworthiness in a person. In more recent studies, Doney and Cannon (1997)
defined that credibility and benevolence are indicators of a trusted person. Similarly, Whitener, Brodt, Korsgaard, and Werner (1998, p.513) stated that “trust in another party reflects an expectation or belief that the other party will act benevolently”. Thus, it can be inferred from these studies that the level of trust of the trustee in the investment manager depends on the degree of trustworthiness shown by the investment manager.

Trustworthiness means “different things, depending upon the nature of the risk being assumed in the relationship” (Sheppard, and Sherman, 1998, p.426). Based on an exhaustive review on trustworthiness, Mayer, Davis, and Schoorman (1995) found that the trustworthiness of a person can be shown in many ways, such as intention and ability (Cook and Wall, 1980), reliability and honesty (Johnson-George and Swap, 1982), ability and value congruence (Sitkin and Roth, 1993), and competence, consistency, openness, integrity, and loyalty (Buttler and Cantrell, 1984; Schindler and Thomas, 1993). Finally, Mayer, Davis, and Schoorman (1995) conclude that the most common factors of trustworthiness of a trusted person proposed by scholars are:

- ability,
- benevolence
- integrity.

In response to Mayer, Davis, and Schoorman’s (1995) conclusion above, Tinsley (1996) argues that benevolence and integrity should be separated from ability, as the underlying factors of trust. This is because, ability has no ethical
connotations, but is similar to the concept of capability. For example, a person with high ability is not always a trustworthy person, whereas, a trustworthy person with low ability is ineffective. For research purposes, therefore, he suggests ability should be excluded, as an underlying factor of trust. In reply to Tinsley's (1996) suggestion, Schoorman, Mayer, and Davis (1996) provide several explanations for its inclusion. Firstly, they agreed that only for certain research questions should the trustworthiness and the capability aspects be separated. Secondly, they disagree that benevolence has ethical connotations, but is an aspect of quality relationships. Finally, Schoorman, Mayer, and Davis (1996) believe that there are three factors of trustworthiness: benevolence, integrity, and ability.

7.1.1. Ability as a Key Factor of Trustworthiness

Ability is that group of skills, competencies, and characteristics that enable a party to have influence within some specific domain (Mayer, Davis, and Schoorman, 1995, p. 717).

Ability can be expressed in many ways, such as: expertise, or competence. For example, a good track record of an investment manager is important evidence that shows his/her ability in managing active investments. Ability, as a key factor of trustworthiness of sales people, has been studied by Swan, Trawick, and Silva (1985). They conducted a survey to investigate the way industrial sales people gain a customer's trust. The respondents were 42 medical representatives. The results of this study provide strong evidence that sales people can gain trust from their customer by demonstrating their competency and honesty.
Crossby, Evans, and Cowles (1990) conducted a survey to study the features of sales person-customer relationship as perceived by the customer. They then developed a relationship quality model in order to show what are the antecedents and consequences of the relationship in service selling. Questionnaires were sent to 469 randomly selected members of policyholders between the ages of 25 and 44. The findings indicated that the expertise of the sales person are important in affecting the customer's commitment in the relationship.

Moorman, Deshpande, and Zaltman (1993) researched the factors affecting trust in market research relationships. The questionnaires were sent to 1,868 respondents, of these some recipients, who were not willing to be respondents, returned the questionnaires. This reduced the sample to 1,719. In total 779 questionnaires were completed and returned: a 43.3% response rate. The findings indicate that researchers' expertise and tactfulness are important factors in building trust.

7.1.2. Benevolence as a Key Factor Trustworthiness

Benevolence is the extent to which a trustee is believed to want to do good to the trustor, aside from an egocentric profit motive (Mayer, Davis, and Schoorman, 1995, p. 718).

Benevolence is expressed in a number of ways, such as loyalty, and supportiveness. In a working relationship, benevolence is part of the trustworthy behavior of the manager and consists of three actions: "(1) showing consideration and sensitivity for employees' needs and interests, (2) acting in a way that protects employees' interests, and (3) refraining from exploiting others for the
benefit of one’s own interests” (Whitener, Brodt, Korsgaard, and Werner, 1998, p. 517). These actions may lead employees to perceive their manager as loyal and benevolent. For example, Gabaro (1978) interviewed several executives to identify factors of a trust relationship between subordinates and superiors. He found that the loyalty of the superior is an important factor in enhancing the subordinate’s trust in the superior. Loyalty is important to subordinates because they are concerned with the motives of their superiors. Posner and Schmidt (1984) conducted a research survey using 6,000 American executives and managers to study what principles guide managerial behavior. The questionnaires were returned by 889 executive managers, 422 middle managers, and 149 supervisory managers. The results of their study indicate a superior leader is perceived to have the ability of leadership and be supportive to subordinates.

7.1.3. Integrity as a Key Factor of Trustworthiness

Integrity is commitment in action to a morally justifiable set of principles and values, where the criterion for moral justification is reality—not merely the acceptance of the values by an individual, group, or society. Because survival and happiness are the ultimate standards of morality, life—not subjective opinion—is the foundation of integrity (Becker, 1998, p.157-158)

Becker’s (1998) definition of integrity implies that integrity is not only a matter of words but it requires acting with rational values and morality. Integrity as an important determinant of trust in interpersonal and group relationships has been studied by Gabaro (1978), Buttlar and Cantrell (1984), Schindler and Thomas (1993). For example, Butler and Cantrell (1984) conducted two experiments to study the relative importance of five dimensions of trust. In the first experiment,
participants were treated as subordinates, and in the second experiment, participants were treated as superiors. These experiments showed that integrity, competence, and consistency were stronger than loyalty or openness as determinants of trust in one's superiors and in one's subordinates.

Schindler and Thomas (1993) investigated whether the elements of interpersonal trust differ among three organizational relationships: upward to the supervisor, downward to a subordinate, and laterally to co-workers. The respondents were asked to answer questionnaire items at their work place during regular working hours. In total 66 were completed and returned. These were from 66 supervisory and managerial level employees from a large firm producing geriatric health-care products. The findings indicate that integrity is the most important element of interpersonal trust in the three organizational relationships.

7.1.4 Interrelationship Among the Three Key Factors of Trustworthiness

A trustworthy person can be determined by three key factors: his/her ability, benevolence, and integrity. These factors are not separable but combine together in determining the overall level of trust (Mayer, Davis, and Schoorman, 1995). A low level of one factor will be offset by a high level of another. Thereby, "trustworthiness should be thought of as a continuum, rather than the trustee being either trustworthy or not trustworthy" (Mayer, Davis, and Schoorman, 1995, p.721). For example, if an investment manager's ability, benevolence, and integrity are perceived by the trustee of the pension funds to be high, this investment manager would be deemed trustworthy. In another example, an
investment manager has low ability, but he/she demonstrates strong benevolence and integrity towards the trustee who if he/she believes that benevolence and integrity are important factors of trust, then the trustee still trusts the investment manager, although the level of trust is not as high as in the former example. On the other hand, if the trustee believes that ability is the important factor in trust, the trustee of the pension funds will not trust the investment manager. From the interrelationship among the three key factors of trustworthiness, it is proposed in this thesis to ascertain from the Indonesian interviewees:

What are the key factors of trustworthiness of the investment manager from the perception of the trustee of pension funds in Indonesia?

7.2. The Propensity to Trust.

The propensity of trust will influence the level of trust (Mayer, Davis, and Schoorman, 1995). The concept of propensity to trust is defined as “the willingness to make oneself vulnerable to others in a variety situations” (Ross and LaCroix, 1996, p.330). For example, the propensity of the trustee of the pension funds to trust reflects his/her willingness to trust in the investment manager. Thereby, Mayer, Davis, and Schoorman (1995) argue that propensity of trust varies among people depending on their personality type, experiences, and cultural background. To illustrate this further, Mayer, Davis, and Schoorman, 1995) provide an example of an extreme case that propensity to trust may be stable across situations.

Some individuals can be observed to repeatedly trust in situations that most people would agree do not warrant trust. Conversely, others are unwilling to trust in most situations, regardless of circumstances that would support doing so (Mayer, Davis, and Schoorman, 1995,p.715).
Mayer, Davis, and Scoorman’s (1995) argument and example implies that trust in their model may be viewed as a dispositional or individual difference factor (Ross and LaCroix, 1996). The earliest work on trust measurement as a psychological construct was developed by Rotter (1967). He argued that “a low level of trust will lead an individual to behave in a less trustworthy fashion and be generally more suspicious than that of high-trust individuals”. In a negotiation context, Ross and LaCroix (1996, p.317) provide similar arguments that:

people who had higher trusting score on Rotter’s (1967) self-report questionnaire were less likely to use deceptive tactics in interpersonal dealings.

In addition to Rotter’s trust measurement, Yamagishi (1986) developed a scale that measures whether individuals are predisposed to trust. For example, using Yamagishi’s (1986) scale of trust, Parks, Henager, and Scamahon (1996) conducted experiments to study how both high-trust and low-trust individuals react to explicit information about the opponent’s planned behavior. The subjects were 111 undergraduates students. The findings indicate that: (a) high-trust individuals respond positively to co-operative intention, (b) low-trust individuals responded negatively to competitive intentions and, (c) low-trust individuals can be induce to co-operate temporarily.

In recent works, Jones and George (1998) propose that the propensity to trust is determined by the interplay of people’s values, attitudes, and moods and emotions, as follows:.
Values provide standard of trust that people strive to achieve in their relationships with others, attitudes provide knowledge of another person’s trustworthiness, and current moods and emotions are signal or indicators of the presence and quality of trust in a relationship (Jones and George, p.535).

In summary, the propensity to trust of a person may be stable across situations (Mayer, Davis, and Schoorman, 1995), and may influence the level of trust in other (Jones and George, 1998).

### 7.3. Definition of Trust.

On the basis of the review definition of trust proposed by Johnson-George and Swap (1982) and Kee and Knox (1970), Mayer, Davis, and Schorman (1995) proposed the following definition of trust:

> Trust is willingness of a party to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustor, irrespective of the ability to monitor or control that other party (Mayer, Davis, and Schorman, 1995, p. 712).

Their definition implies that there are three critical factors of trust: one party’s willingness in a vulnerable situation, willingness to have good expectations, and confidence in the other party’s trustworthiness. Mayer, Davis, and Schoorman (1995) suggest that their definition of trust is applicable to a relationship with another identifiable party who is perceived to act with integrity, and demonstrates his/her benevolence in a relationship with an incorporated risk. Mayer, Davis, and Schoorman’s (1995) suggestion leads to defining trust in the context of the
relationship between the trustee of the pension and the investment manager as follow:

Trust is willingness of the trustee to be vulnerable to the actions of the investment manager based on the expectation that the investment manager has a high degree of trustworthiness and will perform a particular action important to the trustee, irrespective of the ability to monitor or control the investment manager (Adapted from Mayer, Davis, and Schoorman, 1995).

7.4. Risk Taking In a Relationship.

Most perspective on trust acknowledge that risk is required for trust to influence choice and behavior (e.g., Lewis & Weigert, 1985; Schlenker, Helm, & Tedeshi, 1973). Mayer, Davis, and Schoorman (1995) follow up this research and place risk as an essential component in their theoretical model of trust. They argue that:

There is no risk taken in the willingness to be vulnerable (i.e., to trust), but risk is inherent in the behavior manifestation of the willingness to be vulnerable. One does not need to risk anything in order to trust; however, one must take a risk in order to engage in trusting action (Mayer, Davis, and Schoorman, 1995, p.724).

Mayer, Davis, and Schoorman (1995) distinguish between trust and trusting behavior. The former is a willingness to assume risk and the later is the assuming of risk. This means that trust will lead to risk taking in a relationship, but the degree of trust will affect the amount of risk the party is willing to take (Mayer, Davis, and Schoorman, 1995). They conclude that the outcome of trust proposed in their model of trust is a risk taking relationship that can occur only in the
context of a specific, identifiable relationship with another party. Similarly, from a survey of physicians, automobile mechanics, and hairstylists, Shemwell, Cronin, and Bullard (1994) provide evidence that the higher the level of trust in a customer service-provided relationship, the greater the probability that the consumer will continue the relationship, and the lower the level of perceived risk inherent in the relationship.

Mayer, Davis, and Schoorman (1995) refer to their term of risk taking in a relationship as similar to the decision in Sitkin and Pablo’s (1992, p.9) definition of risk that “risk is a characteristic of decisions that is defined as the extent to which there is uncertainty about whether potentially significant or disappointing outcomes of decision will be realized”. They conclude that risk exists due to (i) outcome uncertainty, (ii) outcome expectations, and (iii) outcome potential.

Mayer, Davis, and Schoorman (1995) use outcome expectation, positive or negative outcome, as essential elements of risk perception in their model of trust.

The perceptions of risk involves the trustor’s believe about likelihoods of gains or losses outside of considerations that involve the relationship with the particular trustee (Mayer, Davis, and Schoorman, 1995,p.726).

Similarly, Sitkin and Pablo (1992) argue that the expected outcome itself does not constitute a risk but the degree to which that outcome would be positive or negative. For this reason, Mayer, Davis, and Schoorman (1995) suggest two categories of factors that will influence the likelihood of disappointing outcomes.
these are: (i) the relationship with the trusted person, and (ii) the factors outside the relationship that make the decision significant and uncertain.

Finally, Mayer, Davis, and Schoorman (1995) provide a suggestion to a person who will be involved in a risk taking relationship, as follow:

The level of trust is compared to the level of perceived risk in a situation. If the level of trust surpasses the threshold of perceived risk, then the trustor will engage in risk taking in relationship. If the level of perceived risk is greater than the level of trust, the trustor will not engage in the risk taking in relationship (Mayer, Davis, and Schoorman, 1995, p.726).

This suggestion implies that at least three factors determine the reason for a person to make the decision to trust in another: (i) the degree of trustworthiness of a person, (ii) the potential outcome of relationship, and (iii) the features of the relationship between the parties.

7.5. Summary of the Theoretical Model of Trust and Its Relevance to This Study

Mayer, Davis, and Schoorman (1995) proposed and described a model of trust between at least two parties - for example given here is the trust between a trustee and an investment manager. Their model is based on three concepts: the key factors of trustworthiness, the propensity to trust, and the risk in relationships. Firstly, trustworthiness of the investment manager, for example, may be determined by three major elements, ability, benevolence, and integrity. These three elements combine together in determining the overall level of trust in the investment manager, as perceived by the trustee. Secondly, the propensity of trust by the trustee, for example, may be depend upon his/her personality, experience.
and cultural background. In this regard, the personality traits of the trustee is an important factor that will affect the degree of trust of the trustee in the investment manager. Thirdly, risk is the core of a trust relationship. The degree of the trustee trust in the investment manager may be directly related to the willingness of the trustee of the pension funds to take some of risks in the relationship. From this summary, it concluded here that the theoretical model of trust proposed by Mayer, Davis, and Schoorman (1995) is useful for exploring the major research questions in the case study, namely:

**Q1. What are the key factors of trustworthiness of the Indonesian investment manager from the perception of the trustee of pension funds in Indonesia?**

The trustee’s reasons for hiring an investment manager will determine his/her propensity to trust in him/her. The key factors of trustworthiness of the investment manager will determine the level of trust of the trustee in the investment manager. The model of trust relationship between the trustee and the investment manager is follow:
8. The Stages of Trust Development

Trust develops along with the relationship through: (i) mutual satisfaction and increasing confidence in the relationship (Driscoll, Davis, and Lipetz, 1972), (ii) a good past experience and interactions (Rempel, Holmes, and Zanna, 1985), and (iii) several processes to gain trust (Swan, Trawick, and Silva, 1985). However, McKnight, Cummings, and Chervany (1998) argue that a high level of trust can occur in the initial interaction between the parties in special cases.

8.1. The Sources of Trust Development.

The development of trust may rely on cognitive and affective sources. The affective source include the trustor's ways of handling psychological dilemmas
The cognitive source include the calculation of potential gains and losses (Doney and Cannon, 1997). For example, Donney and Cannon, and Mullen (1998) propose five cognitive trust-building processes in a business relationship, as follows:

1. *calculative process* ... trustor calculates the costs and rewards of a target acting in an untrustworthy way.;
2. *prediction process*...trustor develops confidence that a target's behavior can be predicted;
3. *intentionally process*...trustor evaluates a target’s motivations;
4. *capability process*...trustor assesses a target's ability to fulfill his or her promises, and
5. *transference process*...trustor draws on proof sources from which trust is transferred to a target (Donney, Cannon, and Mullen, 1998, p.604).

8.2. The Stages of Trust Development.

Trust development during a relationship may move forward or back to the previous stage (Lewicki and Bunker, 1996). In a romantic relationship, for example, Holmes (1991) suggests that this relationship moves through three development stages: (a) the romantic love stage, (b) the evaluative stage, and (c) the accommodative stage, as follow:.

In the romantic love stage, the parties experience a surge of positive feelings and an idealization of the partner..... In the evaluative stage, sustained close contact between the parties reveal imperfections in the other, leading them to want to step back and evaluate the relationship more broadly.... In the accommodative stage is marked by a negotiation of conflicting needs, expectations, and perceived incompatibilities (c.f. Lewicki and Bunker, 1996:118).

Lewicki and Bunker (1996) argue that in a professional relationship, trust does not begin with emotional development but with a process evaluation and information exchange. They propose three stages of trust development: calculus-
based trust, knowledge-based trust, and identification-based trust. These three stages assume that the two parties are building a new relationship, there is no past experience of a relationship between them and the parties are uncertain about each other and the future longevity of the relationship. They argue that trust develops gradually as the parties move from one stage to another.

Lewicki and Bunker (1996) provide essential elements to trust development, as follows:

1. Trust evolves and changes. If a relationship goes through its full development into maturation, the movement is from calculus-based, to knowledge-based, to identification-based trust. However, not all relationships develop fully; as a result, trust may not develop past the first or second stage.
2. Relationship building begins with the development of calculus-based trust activities. If these activities develop in a manner that confirms the validity of the trust (the other party is consistent, and deterrence is not
frequently required), the parties will also begin developing a knowledge base about the other's needs, preferences, and priorities. However, the parties may not move past calculus-based trust.

3. The movement from knowledge-based trust to identification-based trust occurs in a similar manner. As the parties come to learn more about each other, they may also begin to identify strongly with others' needs, preferences, and priorities and come to see them as their own. However, many productive relationships remain in the knowledge-based trust stage.

4. The movement from one stage to another may require a "frame change" in the relationship.


8.2.1. Calculus-Based Trust

In this view, trust is determined by the economic value of the relationship. "Trust is an ongoing, market oriented, economic calculations whose value is derived by determining the outcomes resulting from creating and sustaining the relationship relative to the costs of maintaining or severing it" (Lewicki and Bunker, 1996, p.120). However, this kind of trust may not really be trust, since a rational calculation of the benefits and the costs of trust and the probability of detection in the case of cheating allows the parties to develop appropriate safeguards to protect themselves (Husted, 1998).

Lewicki and Bunker (1996) argue that calculus-based trust, driven by both the benefits and the costs of a relationship, needs adequate and effective deterrent elements. For the deterrent to be effective, at least the following condition must exist (Lewicki and Bunker, 1996):

- The potential loss of future interaction with the other must outweigh the profit potential that comes from defecting from the relationship or violating expectations.
b. Deterrence requires monitoring the other's behavior for it to work: the parties must continue to monitor each other and be willing to tell each other when a trust violation has been noted. (Lewicki and Bunker, 1996, p.120)

Calculus-based trust may relate to Donney and Cannon's (1997) calculative process where a person calculates the benefits and costs in trusting others.

In summary, an appropriate metaphor for calculus-based trust is the children's game of Snakes and Ladders (Lewicki and Bunker, 1996). In a calculus-based trust, the progress of a relationship is made by ladder climbing by one or more steps at a time. If a single event is inconsistent, the relationship may move back several steps. Therefore, Lewicki and Bunker (1997) argue that in calculus-based trust, trust is partial and quite fragile. The key activities for building the calculative-based trust is that the party must be able:

(a) to identify the benefits and the costs of relationship.

(b) to set punishment of the investment manager's untrustworthy behavior.

(c) to monitor the investment manager's behavior regularly.

In the context of this study, the trustee may develop the initial trust in the investment manager as a calculus-based trust, for several reasons. Firstly, an early trust relationship between the trustee and an 'unknown' investment manager is assumed to develop on the basis of the benefits and the costs of the relationship. Secondly, the trustee of the pension funds must regularly monitor the activities and behavior of the investment manager. Thirdly, in an early relationship, trust is
quite fragile. This relationship may be discontinued by the trustee of the pension funds due to the poor performance or behavior by the investment manager.

8.2.2. Knowledge-Based Trust.

In this stage, the level trust of a person depends on his/her ability to use past experience to predict the behavior of other. The characteristics of trust include reliance on information rather than deterrence, reliance on past interactions, predictability of the investment manager’s behavior, and confidence in the trustworthiness of the investment manager (Donney, Cannon, and Mullen, 1998).

The relationship between the trustee and the investment manager may move from an early to a long-term relationship depending on the ability of the trustee to having information about the investment manager's past behavior and to using this information for making prediction about the investment manager’s future actions. Shapiro, Sheppard, and Cheraskin (1992) provide suggestions related to the activities that are useful in establishing understanding and predictability: (i) regular communication, and (ii) courtship. The first is that regular communication make the parties in the relationship in regular contact with each other, exchange information about wants, preferences, and approaches to problems (Shapiro, Sheppard, and Cheraskin, 1992). The second is courtship that will permit the party in the relationship to assess the real compatibility in order to determine the interpersonal fit between them. Courtship is conducted by interviewing and by observing the other (Lewicki and Bunker, 1996).
In summary, the appropriate metaphor for knowledge-based trust is like gardening (Lewicki and Bunker, 1996). Thus, in a relationship, the trustee of the pension funds and the investment manager building their knowledge of each other by regular communication. At this stage, if trustee believes and can receive adequate explanation or understand the investment manager’s behavior, he/she will accept and forgive an inconsistent behavior of investment manager. The key factors of knowledge-based trust is that the trustee of the pension funds must be able:

(a) **to set regular communication with the investment manager,**

(b) **to maintain trustworthiness of the investment manager,** and

(c) **to evaluate the performance of the investment manager.**

In the context of this study, the trustee develops a trust relationship with the investment manager as a knowledge-based trust, for several reasons. Firstly, the trustee will complete first hand information about the performance and the trust behavior of the investment manager. Secondly, the trustee of the pension funds will be able to develop the relationship with the investment manager on the basis of past performance and to predict future performance of the relationship. Thirdly, a trust relationship will be broken by the dishonesty of the investment manager.

**8.2.3. Identification-Based Trust.**

At this stage, trust exists because both parties in the relationship effectively understand and appreciate each other’s wants. “This mutual understanding is developed to the point where one party can effectively act for the other” (Lewicki and Bunker, 1996, p.122). In the identification stage, trust is based on
identification with the other's motives and intentions, for two reasons. First, using the intentional process to establish trust, the trustee of the pension funds can interpret the investment manager's words and behavior and attempt to determine his/her concern to the interests of trustee (Linkskold, 1978). Second, trust emerges if the trustee of the pension funds perceives that the investment manager is genuinely interested in the trustee's interests and motivated to further them (Larzelere & Huston, 1980; Mayer, Davis, and Schoorman, 1995).

According to Lewicki and Bunker (1996), the identification-based trust develops when both parties are able to predict the other's needs, choices, and preferences. A suitable metaphor for identification-based trust may be a musical one, such as 'harmonizing' (Lewicki and Bunker, 1996). They suggest that the key activities for developing identification-based trust include:

(a) to share information and goals.
(b) to think alike.
(c) to be equal in position.

In the context of this study, the trustee develops long-term trust relationship with the investment manager on an identification-based trust, for several reasons. Firstly, they will have a mutual understanding that they have built together. Secondly, the trustee will be able to think as an investment manager and gather information that is useful for the investment manager to make investment decisions.
8.3. Summary of The Stages of Trust Development and Its Relevant to This Study.

It has been shown in this chapter that in Lewicki and Bunker's (1996) view, trust evolves and changes through three stages: calculus-based trust, knowledge-based trust, and identification-based trust. In the first stage, trust is determined by the economic value of the relationship and regular monitoring of the behavior of the parties is a key factor to developing trust at this stage. Trust is determined by the results of past experience and regular communication between parties is a key factor in developing it. In the third stage, trust is determined by mutual understanding; the sharing of information and goals is a key factor in developing and maintaining trust. This stage trust development model proposed by Lewicki and Bunker (1996) is useful for exploring the second major research question namely:

Q2. How do pension fund trustee and investment manager develop their trust relationship?


In this chapter, a trust relationship, including form and theories of relationship that lead to a focus on the trust theory were explored. The exploration of the trust theory focused on its concepts, the theoretical model, and the stages of trust development. The results of this exploration support the contention that trust can be an important component of the relationship between the trustee and the investment manager. Firstly, the trustee takes risks in the relationship with the investment manager but the hiring of trustworthy investment managers will
reduce these risks. Secondly, there is strong evidence that trust plays an important role in a business relationship. This could be in the form of features or the determinants of a long-term relationship. Thirdly, Mayer, Davis, and Schoorman (1995) proposed a theoretical patterns of the trustworthiness of a trusted person that could be used to explore the key factors of the trustworthiness of the investment manager. Fourthly, Lewicki and Bunker (1996) proposed the stages of trust development that can be used to explore building a relationship between the trustee and the investment manager. Fifthly, there are three important research questions derived from this exploration.

In the next chapter, the researcher will explore the effectiveness of the case study method to gather and analysis data in order to find the answers to the research questions.