THE 300

The Role of the Investment Management Industry and a Prescription for the Future

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Introduction

The 300 Club has taken the current pandemic as a moment for reflection on the state of the industry. During this crisis, we have all been made acutely aware of the fact that companies should not just be primarily profit generating machines but purposeful providers of solutions to the needs and wants of real people. The consequence of fulfilling those purposes are long term sustainable returns to investors.

We created ourselves in the aftermath of the GFC because of deep concerns about the fact that the investment management industry does not serve its clients and society well and should be improved in order to be fit for purpose going forward. We see encouraging signs. The conversation about investing is changing in the direction of long-term value creation.

Nonetheless, a lot has still to be done by all participants in the investment chain in order to get there. In this paper, we clarify the direction of travel for the industry going forward. We think this change is necessary in order to fulfil our true purpose and to maintain our license to operate sustainably as an industry.

Our core investment beliefs are that investment is long-term by nature and that successful investment benefits both investors and society. Real success comes from underlying, sustainable wealth creation and is measured by absolute returns that are long-term, cumulative, and sustainable. It delivers the returns investors need, grows the pie for the benefit of society more widely and protects the planet. The principal risk to avoid is permanent loss of capital.

Shorter-term asset management approaches measure success by short-term relative returns generated by speculation on short-term price movements. Relative volatility is seen as being the key risk that needs controlling. These approaches are a perfectly legitimate part of the capital market structure. Indeed, their role in price discovery has value for proprietary trading, but they are not fit-for-purpose from the perspective of the investors on whose behalf the industry is supposed to act as agents and fiduciaries. Together with passive index tracking strategies, they account for the vast majority of the investment industry's assets under management.

When we talk about the "investment industry" we are describing a chain of capital that takes capital from those who have it and invests it with those who need it. All of the links in the chain are either agents or fiduciaries and they owe their clients a very special duty of care. This chain comprises three key links, all of whom may, or may not always all be present and encompasses advisers, asset owners and investment managers.

In this paper, we set out an articulation of the purpose of an industry that is dedicated to investors' needs. We show that following this purpose will not only deliver better outcomes for investors, but that it also has great power to grow social value for everyone. We identify the most egregious dysfunctionalities of the current model. And we set out a broad framework within which firms could compete profitably whilst successfully delivering the purpose.

The purpose of the industry – Sustainable Wealth Creation

The industry's providers of capital range from Sovereign Wealth Funds, representing the interests of millions of citizens and pension funds, collectively representing the interests of hundreds of millions of members, to insurance companies, Family Offices and individuals. These providers of capital and, where they act on behalf of others, the ultimate beneficiaries, are collectively the investment management industry's clients. Here we define them as "investors."

These are hardly homogenous groups. But they do share two critical features. First, everyone's overall financial needs span a very long time horizon. And secondly, investors have a legitimate interest in their agents exercising the collective influence and powers that come with the stewardship of significant ownership stakes to promote their overall wellbeing as well as their financial security – and, of course what is good for investors' overall long-term wellbeing is overwhelmingly likely to also to be good for society. Stewardship is not therefore a distraction from the interests of investors. On the contrary, it is utterly bound to their interests in every way.

Investors rely on intermediaries, asset owners and investment managers to use their skill, knowledge and scale to secure better outcomes to meet these needs than they would be able to achieve on their own. That is why we define the purpose of the investment industry as being to ensure that investors' capital is deployed and stewarded in such a way as to create wealth sustainably.

Why this is important

Investors rely on the investment management industry

1. To build their capacity to deal with unexpected financial shocks (a second line of defence after "rainy day" cash savings)
2. To allow them to buy and do the things they dream of
3. To enable them to enjoy a decent standard of living as they get older…
4. …in a world that's worth living in.

These objectives are of critical importance to investors, so their agents and fiduciaries have a profound responsibility to do everything in their power to succeed.

The investment management industry has an additional importance that arises from its role as a turntable of capital, collecting and pooling capital from investors and allocating it to companies, infrastructure, real estate projects and government funding. It backs new investments in the economy that create wealth. As single firms and even more so collectively, the industry has the potential to exercise significant influence and utilise its powers where necessary to direct corporate behaviour.

The investment industry could be a decisive force to incentivise and require business to act in alignment with the purpose of sustainable wealth creation and to sanction those that are willing to sacrifice the long-term to get a bigger pay-out today.

It can also be a decisive force in allocating the $ trillions that are needed to ensure a just transition to a low carbon economy that keeps climate change below levels that will be enormously destructive of life, health and prosperity and delivering on the ambitions of the Sustainable Development Goals.

This cannot be achieved by state-sponsored aid and philanthropy alone. The investment industry will need to fund profit seeking approaches to solve the biggest problems facing humanity. This requires a reallocation of capital that covers both investor funds and the deployment of corporate capital towards the long-term projects that are needed to make business, society and the environment resilient and sustainable. The scale of the investment needed means that passive funds will have a major role to play to meet investor demand and appropriate benchmarks will need to be created. With this responsibility, passive funds will have to play a full stewardship and active ownership role to fulfil their purpose.

The success of the investment management industry in backing sustainable wealth creation delivers not just great outcomes for investors, but more and better jobs, greater innovation and higher tax revenues to support education, health and infrastructure.

If the investment management industry was to optimise the full might of the $100trn+ that it speaks for to drive sustainable wealth creation it would be transformational for investors, society and the environment.

That's why it's important.

Situation report

We argue that the current overall business model of the industry is not fit for purpose. Objectively, the biggest incentives in the industry are offered for scale, alpha and control of index-relative returns and short-term absolute volatility.

None of these are obviously correlated to success in delivering wealth sustainably. At best, it can be argued that since markets tend to rise over time, persistent alpha generation will help to deliver long-term financial returns.

However, most index-relative funds underperform their benchmarks over the long-term and as it is particularly hard to tell in advance which will outperform (and when they do whether this is due to skill or luck) even the pursuit of alpha is hardly well-aligned to investors' true needs.

In addition, the current model creates a stewardship deficit that in turn may lead to corporate underperformance with potentially negative effects on the environment and society.

Investment managers who are underweight in a company (to control their tracking error) face a self-imposed conflict of interest. If they engage with the company effectively and it subsequently outperforms the index, it improves their investors' absolute returns, but harms the managers' relative performance.
How has the industry created a business model that voluntarily pits investment managers' interests against those of investors in this way?

But perhaps the greatest detriment to investors and society of the short-term, relative return focus is caused by its corrosive impact on business. If investors are demanding short term earnings-per-share gains, it's hardly surprising that CEOs and Boards set their objectives accordingly with a corresponding price to be paid from the future – financially, socially and environmentally.

It is as though we are demanding the apple grower chop down the trees in the orchard because the value of the wood is worth more than the value of this year's apple harvest.

The "How" for the industry – Stewardship

The key Investment Industry participants, asset owners and asset managers are always either fiduciaries or agents. This requires them to understand the needs of investors and act to the very best of their ability to deliver the returns that meet those needs. In doing so, they are entitled to be paid and make profit, but once they have agreed the terms, they must put the interests of investors first and ahead of their own. This is fundamental to the concept both of agency and fiduciary responsibility and why we regard the activity as being one of "Stewardship."

In our view the concept (as opposed to a local legal definition) of a fiduciary is no different from that of an agent when related to financial matters. The client hires and expects them to act in their place, on their behalf as though they **were** the beneficiary. But better at it. This is because agents and fiduciaries are expected to use all their knowledge, experience, skill and scale to understand their clients' objective needs and capacity for risk and to do their very best to deliver. In fact, for modest portfolios in particular, the costs of asset management can offer spectacular value including as they may, advice, portfolio management, diversification, safe custody and trading where the scale of professional firms means that the service can be provided at a fraction of the cost that would be borne by a D-I-Y investor if they were to try to replicate it all for themselves.

Action for the future – what needs to change

The means to achieving the goal of Sustainable Wealth Creation is the careful stewardship of investors' capital in the way it is allocated and active stewardship of those investments once they are made.

The investment industry needs to find a better way of defining unsustainable business activities that goes beyond accounting for long-term ESG risks to the business itself. It needs to develop a way of pricing externalities that are **unbilled** to the business because these externalities will ultimately destroy our investors' wealth. Where a business is "net negative" on this basis, it should be incumbent on those who engage and vote to target harm reduction, mitigation or elimination and to divest if they realise that they will never succeed.

Portfolio objectives need to be redefined so that they focus on long-term absolute returns (generally seven years or more) with levels of absolute risk to capital and time-horizons being set according to the particular needs of the investors being served.

The duration of contracts for active investment managers will need to be aligned to the longer-term objectives of mandates.

To exercise good stewardship over capital allocation, active Portfolio Managers need to cover smaller numbers of securities that they know and understand intimately. With that smaller number, they will also be able to exercise good stewardship of investees through engagement and voting. This will enable them to mitigate or eliminate ESG risks and to support or require that investees focus on and incentivise sustainable wealth creation.

Passive managers can play a vital role. They need to exercise their stewardship responsibilities, if necessary, by working collectively. If any link in the investment chain has a responsibility to their clients to "raise all ships" though stewardship and engagement, it is passive managers.

Fees and manager incentives need to be re-engineered to promote the objectives of Sustainable Wealth Creation. This would be measured by long-term absolute return and control of absolute risk and reported Stewardship outcomes against objectives.

Driving change

The investment chain is long and complex and resistant to change. This is hardly surprising when one considers how well the current structure of the industry serves participants. And yet, in quiet moments, most people recognise that a system which prizes relative returns against index benchmarks and control of relative short-term volatility is deeply dysfunctional for the people who we are supposed to serve.

And yet reform is difficult. It's really hard when each link in the chain is accountable to another link that is today judging them by inappropriate measures. This means that no single firm or link has the agency to change on its own. The lack of change is not a consequence of venality, but of this lack of agency.

The 300 Club's ambition is to facilitate a process that allows every link to recognise and to be safe in organising its own necessary reforms to mandates and incentives in a co-ordinated process along the entire length of the chain from the providers of capital to issuers.

Yes, there are regulatory and legislative changes that would help. These include a re-articulation of the legal definition of fiduciary responsibility such that it incorporates time horizon.

It is odd that the current definition is silent on the question "over what time period do we judge whether a fiduciary has acted reasonably in fulfilling her obligations?" If we assume that we review fiduciary conduct through a twelve-month lens, it will lead to perverse behaviours.

Really, we should consider the time-lens through the objective needs of a typical beneficiary, which is likely to be decades. Suddenly, significant attention to the potential adverse impacts on wealth (with collateral damage to health and happiness) caused by environmental and social risks loom large.

There are also regulatory changes that could be made in many jurisdictions to bring an end to the promotion of pro-cyclical investment approaches and the use of debt in comparison to equity or to support better stewardship. An end to the favourable treatment of debt versus equity would help too.

Whilst these and other changes would be welcome and helpful, the investment industry cannot rely on them just happening and needs to take control of its destiny into its own hands. The reality is that there is little that the industry cannot do to support sustainable wealth creation through stewardship.

The 300 Club calls on all links in the investment chain to work together and give permission to those who they hold accountable to deliver these changes with profoundly positive consequences for long-term investor returns and for society as a whole. At this time of global reflection on the role of the state and business in society, if not now, when?

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The 300 Club

The 300 Club is a group of leading investment professionals from across the globe who have joined together to respond to an urgent need to raise uncomfortable and fundamental questions about the very foundations of the investment industry and investing. The mission of the 300 Club is to raise awareness about the potential impact of current market thinking and behaviours, and to call for immediate action.

Current economic and investment trends will change the investing landscape over the next two decades and we are at a crisis point which presents huge risks to investors, according to the 300 Club. Moreover, the 300 Club believes that current financial and investment theory and practice run the risk of failing investors at their time of greatest need.

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