UNIGESTION

Investing for the greater good: how asset managers can make a difference in our society

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There has been considerable scepticism among the general public about the role of the financial system since the 2008 financial crisis. But against a challenging backdrop, we believe finance companies – and asset managers in particular – have a major role to play in helping solve the range of problems the world is facing. In this paper, Fiona Frick, CEO of Unigestion, explains how she believes asset managers can invest for the greater good.

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In brief

1. The financial crisis and the problems the world is currently facing have resulted in a change in outlook for companies and investors: it's no longer all about making money
2. Thanks to their role in channelling long-term capital throughout the economy, asset managers are in a privileged position to be able to help solve some of the issues that society is currently facing
3. We see four key areas in which asset managers can play a part: helping people fund their retirement, ensuring financial markets function efficiently, financing the long-term needs of the economy, and helping solve certain environmental and social problems

Background

Looking to capitalism to solve the problems the world is facing

The limits of capitalism have been exposed in recent years. In 2008 the global financial system was close to collapse, forcing governments to support it with huge injections of money that will take decades to pay off. In the eyes of many, capitalism is in crisis.

But the good news is that capitalism is an evolutionary system that remains a work in progress, gradually improving as a result of constant discovery and experimentation. Over the past few centuries, capitalism has brought about a huge overall increase in human prosperity, lifting hundreds of millions of people out of poverty. This process continues to this day.

Today, the world is faced with new problems, including the stagnation of the middle class in developed countries, rising income inequality across the globe and a raft of environmental concerns. Can capitalism adapt to help solve these problems?

A change in outlook for companies and investors

As recently as the 1990s, most companies essentially had one main goal: to create value through the management team's ability to grow earnings, dividends and the share price and deliver it to their shareholders.

Elevating the creation of shareholder value to the status of prime objective led to a myopic focus on quarterly earnings and short-term share performance. But as a result of the financial crisis, we acknowledged that there is a fine line between growing shareholder value in a sustainable manner and doing whatever is needed to generate a profit.

But should growing shareholders' assets be the main purpose of a company? We are now living in a world in which companies want to serve a purpose other than just making their shareholders richer. For example, Google's overarching aim is to organise the world's information, while Nike's corporate mission is to bring inspiration and innovation to every athlete in the world.

The financial crisis created a considerable sense of wariness about the contribution the financial industry makes to the economy. In previous decades, the financial system was there to provide the flow of capital necessary for the economy to grow. Our aim now must

be to ensure the financial system is once more the means rather than the end in itself. In this paper we argue that asset managers, one of the most important components of the financial system, have an important role to play not just in terms of providing returns for their clients, but helping solve some of the world's most pressing problems.

Institutional investors also have an important part to play in this respect: according to a study by EFAMA in 2014, they account for around three-quarters of European asset managers' client base, so they have considerable influence. There is a clear trend emerging in how institutional investors see their responsibility not just in terms of a fiduciary duty to achieve the returns their beneficiaries need, but also more and more as long-term investors engaging with the companies they invest in so that they can produce a positive impact on society.

Asset managers need to think about their role in society

Against this new backdrop, asset managers need to ask themselves what their purpose should be in addition to generating returns for their clients. We believe that from now on they won't just be assessed by the financial returns they deliver on behalf of their clients: they will also be judged on the values they uphold, the ethics they promote, and the wider role they play in improving the society we all live in.

As vital components in the financial system as well as investors in companies operating throughout the economy and the world's governments, asset managers are in a privileged position to be able to make a difference. We believe they can play four key roles in helping society, which we discuss in turn in the following sections.

1. Helping the world's aging population fund its retirement
2. Ensuring financial markets function as an efficient transmission mechanism
3. Financing the long-term needs of the real economy rather than seeking short-term gain
4. Creating the necessary architecture to solve social and environmental problems

1. Helping the world's aging population fund its retirement

Providing the right retirement solutions

The world's population is growing older, and how to pay for people's retirement has already become a pressing issue. Individuals will have to save more and retire later if they are to be able to live comfortably in their old age, as the public system can no longer cope. This retirement problem became all the more acute when we moved from defined-benefit to defined-contribution pension plans.

So how can asset managers help? On the surface, asset management is about promising clients a certain return on their portfolio, but the deeper implicit purpose is to ensure their future financial security.

Helping fund people in their retirement has long been one of the purposes of asset managers, but against this new backdrop we need to work harder than ever before to deal with increased life expectancies and longer periods of retirement. If we are able to demonstrate our capacity to design investment solutions that can meet these challenges by providing financial security for a longer retirement, we will be clearly showing how our industry is able to help broader society.

The most important factor for a retirement investment solution should be the safety of the

future income it provides rather than the market value of the portfolio or its capital gain. Risk management and limiting drawdowns will play a vital process in achieving this goal – it won't be good enough to lose 40% one year and make 40% the next as the fall in income in the initial loss could have dire consequences for end-investors. So rather than only thinking about increasing a portfolio's value, asset managers need to concentrate on ensuring stable cash-flows and developing solutions that provide their ultimate beneficiaries with annuity-like income streams. In this respect, running the assets of private investors will become much more like managing money on behalf of institutions that have long-term liabilities to meet.

Part of this process will involve a shift away from simply selling products towards implementing a solutions-based approach to meet individual clients' needs. It will be the responsibility of the asset manager to sell the right products to the right people with the appropriate risk level to ensure financial security.

The importance of investor education

Another vital role for asset managers will be their ability to educate the wider public about investment, risk management and making the right choices as they save for their retirement.

With the shift away from defined benefit to defined contribution pension schemes, investment risk is being transferred away from companies to employees. While this arguably reduces the liabilities of companies, it puts what can be quite complex decisions in the hands of people who do not necessarily have the financial expertise to make the best choices. If people don't invest appropriately during their working life to safeguard their retirement, they run the risk of falling into financial disarray in their later years. Asset managers must be sure to provide comprehensive, but easy-to-understand, information about the investment solutions people have available to them and how they fit their needs.

2. Ensuring financial markets function as an efficient transmission mechanism

It is the finance industry that provides the flow of capital necessary for the economy to grow.

Within this system, asset management companies have a vital role to play – European asset managers alone hold equities equivalent to around 40% of the free float of European listed companies. One of the key jobs of the asset management industry is to make sure that the financial markets function as smoothly as possible. How exactly do we do this?

Ensuring appropriate liquidity

First, we must ensure that there is no mismatch between the liquidity of the securities we hold in our investment solutions and the redemption conditions we promise to investors – in other words, our investment funds must not provide more attractive liquidity terms than that of the underlying investments those vehicles allocate to.

If there is a liquidity mismatch and a fund cannot meet redemption demand in a down market, there can be major implications for the markets as prices will diverge from the value of the underlying assets. This was strikingly the case in 2008 when hedge funds could not cope with the redemptions that investors were trying to make.

More recently the rapid rise in flows into and out of exchange-traded funds (ETFs) has also

raised some concerns, with two worrying incidents taking place in 2015. First, US shares were sold off sharply at the opening of the market on August 24, and US equity ETFs saw their prices plunge far below the values of the indices they were designed to track. Second, a gradual sell-off in high-yield bonds in December turned into a rout for ETFs investing in this asset class. In short, ETFs are an untested market force that may increase selling pressure in a market downturn.

Focusing on the long term to prevent excessive market volatility

Second, asset managers need to play the role of long-term buy-and-hold investors, basing their decisions on their confidence in a company's valuation and growth potential. Today, an alarming proportion of financial market participants do not invest for the long term, but trade in the hope that they can jump off a profitable bandwagon in as little time as possible.

The danger of this short-termism is that it creates volatility in the stock price, which represents a risk for investors. What's more, it doesn't incentivise asset managers or the companies they invest in to adopt long-term strategies as they will not be judged on their success. Instead of encouraging our institutions and leaders to overcome complex, long-term challenges, we're actually rewarding them to do the opposite. Often, there seems to be a great deal more upside to placing a simple bet for a quick win than in staying the course through difficult times with the aim of creating sustainable gains that can be widely shared across society.

So asset manager incentives should be based on long-term return metrics that incorporate measures of risk. Investors, for their part, must act as the long-term owner of a stock and not as a mere renter who will trade the stock as soon as they can pocket a quick gain – or sooner if there's no such gain to be made.

In fact, there is far too much short-termism throughout the economy. Companies are judged based not on their long-term financial performance and future potential, but on what happened over the last quarter. Asset managers are assessed by their clients in large part on their year-to-date performance rather than their long-term returns.

But it doesn't have to be this way, and indeed it wasn't in the past. It is only in the last ten years or so that this focus on the short term has become so prevalent – previously, a 3–5-year horizon was much more common. And going further back in time to the very beginnings of the stock market, the whole idea of investing in a share was to benefit from the issuing company's long-term growth.

So it is important that asset managers invest with the long term in mind and do not pay too much attention to short-term noise. Institutional investors also have a role to play in this respect, as they have long-term liabilities and must move towards assessing their asset managers over a similar horizon, not just on the last few months. We elaborate on this point later on.

Contributing to price discovery and avoiding bubbles

A third way in which asset managers ensure that the markets are efficient is their role in price discovery. But it is only active managers that can perform this role, and it is one of their most important functions.

A decade ago, passive funds accounted for around 5% of global assets invested in public equity. Today, this figure is around 20%. Passive investments provide a great service in

terms of keeping a lid on management fees and ensuring liquidity in the markets, but they cannot match the role of active managers in terms of price discovery.

What does this mean in practice? In simple terms, active managers aim to uncover as much information as possible about a stock and these details are incorporated in the share price, which represents the sum of all of their views. Without active managers, no one would have an accurate idea of what the price of a security should be.

Passive investors, in contrast, act as free riders in that they only have to pay the marginal cost of participating in the markets rather than the high costs of a research process whose aim is to accurately assess prices.

What's more, in general they allocate capital based on the composition of a market index rather than in the belief that a company will grow or that it is an attractive investment. This means a passive approach is like investing by looking in the rear-view mirror. If a company is in the index, passive investors are forced to continue investing even when a company's valuation has become disconnected from its fundamentals. The result is that the greater the proportion of capital invested in passive strategies, the more likely it is that bubbles will form and that investors will be exposed to sharp reversals in performance.

The purpose of passive investment is not in question but its rapid growth raises the question of whether it has come to lead the market rather than follow it. The cost to society of passive management is a more volatile and less efficient stock market. If all investments were managed passively, the main function of the market – to provide pricing – would cease to exist. Passive investments can also expose investors to undue risk: an investor allocating to a passive fund in 2008 would have been taking exposure to some very risky sectors (such as financials) that were about to collapse and that many active managers avoided entirely. Active management based on exposure to a set of proven risk factors provides the most scope for producing attractive long-term risk-adjusted returns.

3. Long-term financing of the economy

Asset managers are ideally placed to provide long-term funding

Asset managers should increase their involvement in the long-term financing of the economy, and there could be some considerable advantages to them doing so. Unlike banks, which use short-term funding to allocate capital, asset managers use the long-term funding provided by institutional investors (with the caveat that those investors must remain invested), so they provide a crucial link between investors and the financing needs of the real economy. What's more, history shows that very few of them have gone bust or needed state bail-outs in order to survive. Active asset managers allocate capital among competing uses so, if they do so properly, economic growth will be enhanced as those activities that generate the best risk-adjusted returns should attract the most investment.

So asset managers have an important role to play in society in terms of channelling capital to finance growth. But not any kind of growth. The real end goal should be sustainable economic expansion that minimises the risk of another major financial crisis.

How can we achieve this goal? Again, institutional investors and asset managers must work together to allocate to companies with a sustainable growth model rather than looking for a short-term jump in price. Institutional investors (mainly pension funds and insurance companies) account for around 75% of the asset management client base in Europe, so they have a major role to play in ensuring the companies they invest in act responsibly and implement good corporate governance practices.

Given that the liabilities of our biggest clients – pension funds and insurance companies – are rather long term in nature, asset managers are well placed to act as a source of long-term finance to the economy, mainly by investing in equity and debt securities issued by companies and governments.

This holds true for investments in private as well as public equity. The idea of private equity is to inject working capital into a promising business and help refine its products, operations or management, while suitably compensating shareholders for the risk this involves. As private equity investments are long term in nature, investors have even more time to make sure the strategy of the underlying companies meet a relevant societal purpose.

A change in mind-set

But at the moment, adopting a long-term approach is easier said than done because of the current focus on short-termism, which we discussed above. For example, the average holding period of a stock has fallen from eight years in the 1960s to around one year today. Meanwhile, the tenure of the average CEO is just three years. Under these circumstances, what kind of motivation do company managers have to put forward a long-term strategy? As it stands, they will just be judged on day-to-day events.

We see evidence of this in the financial news on a regular basis. Short-term financial engineering efforts, such as buybacks, dividends, spin-offs and sales, are increasing in frequency, and they generally cause shares to spike in the short term. But such activities can have unwanted effects over the longer term, leaving a company's finances more vulnerable, especially if it uses borrowed money to buy its own shares. This is harming the long-term creation of value and may ultimately be doing companies and their investors a disservice, even if stock prices rise impressively temporarily.

We can see this in a 2015 report published by McKinsey Global Institute, which showed that the average variance in return on capital for North American companies is over 60% higher today than it was between 1965–1980. What's more, a focus on short-termism could see public companies lose ground to other kinds of firm, compelling some to move back to private ownership so they can implement a long-term strategy without worrying too much about quarterly earnings. In the US, the number of listed shares has fallen from 8000 in 1996 to half that number now.

To avoid this kind of situation, asset managers must act as long-term investors who make sure that companies do not focus too much on the daily fluctuations of their stock prices and that they plan for and invest enough in their long-term futures. Meanwhile, company CEOs must be incentivised to invest in research, innovation, and training their staff, and to make the capital expenditure that is vital to ensure long-term growth and ongoing relevance of the company as the needs of its customers evolve.

Investors need to be on board

The caveat of all this is that institutional investors must also take a long-term view when they choose their asset managers and evaluate their investment performance. This could be achieved by setting out a fee structure based on long-term performance objectives – we believe that a horizon of five years is appropriate given that this is approximately the length of an investment cycle.

Internal managers working at institutional investors must also be judged over the long

term. If they are assessed on their one-year performance, even though the goal of the pension fund is to meet its long-term liabilities, there is no way they will judge their asset manager based on long-term returns.

While a shift to a long-term focus would represent a big change from much current practice, it would be in the interests of investors themselves. As most institutional investors themselves have long-term horizons, ensuring the sustainable long-term growth of the companies they invest in is clearly in their benefit.

4. Creating the necessary architecture to solve social and environmental problems

Allocating money to solve long-term problems

In his book *Finance and the Good Society*, US economist Robert Shiller tried to define what makes a "good" society and how the finance industry could contribute to improving the world we live in. In short, as the financial system acts as a transmission mechanism to facilitate human activity, it can be used for purposes that go beyond just funding the economy. It can help us reach wider goals that our society needs to achieve, such as increasing the prosperity of all citizens or helping to preserve the environment.

Finance is not just about making money, but about bigger goals, such as promoting prosperity, equality and financial security. There should be no conflict between having a deeper purpose and making profit: making a profit can be a consequence of having a deeper purpose. Profits are vital for a business to survive, but they do not have to be the company's purpose, just like drinking water is vital for a human being, but life is not just about drinking water.

Prosperity can be defined not just in reference to monetary values such as income or wealth, but as the accumulation of solutions that answer problems that we as humans all face. In these terms, asset management is not only about allocating capital, but about helping to channel investments to help solve society's issues.

So as well as increasing the value of their clients' assets, asset management companies can make a positive impact on society. For example, in the past, mutual funds were developed to enable private individuals to diversify their assets, helping more people – not just the rich – to increase their wealth. More recently, the emergence of robo-advisors has been an attempt to provide asset management tools to a wider clientele.

There are already around 1400 signatories – including asset owners and managers – to the United Nations-backed Principles for Responsible Investment. These principles encourage asset managers to act as stewards of the corporate landscape, and have brought about considerable improvement in companies' corporate governance through proxy voting by asset managers and their engagement processes to improve corporate behaviour.

And this trend is apparent among our client base too. More and more of our investors have to show to their stakeholders that their investments are having a positive impact beyond rising in value. For example, they may ask us to provide evidence of the number of jobs created or loans made to finance economic growth as a result of their investments, in addition to maximising their return potential and controlling volatility. In that context the relationship between asset owners and managers is evolving, with investors making increasing societal demands of their asset managers.

Helping to counter climate change

Interest in low-carbon investments has gathered momentum in recent years. With concern about climate change increasing and pressure from governments, universities, religious groups, and non-governmental organisations mounting, the focus has shifted to carbon risk in investment portfolios. This is particularly the case for long-term investors such as pension schemes, insurance companies and sovereign wealth funds.

There is now growing pressure on investors, and in particular asset owners, to meet their fiduciary responsibility in terms of carbon emission reporting and reduction. In terms of regulation and reputation, carbon risk is not rewarded, and as such needs to be identified and minimised.

Asset managers could have an important role to play in facilitating the transition to a low-carbon economy. They could help achieve this in a number of ways, from controlling their exposure to companies involved in fossil fuel extraction and processing and avoiding firms with high CO_2 emissions, to financing projects in the renewable energy sector. In fact, there has been a clear trend in recent years of asset managers deliberately investing in companies developing alternative energy sources, both for their strong return potential and their ability to reduce the world's dependence on carbon-based fuels.

In conclusion

With the fallout from the 2008 crisis still affecting the lives of millions of people across the world, it is unsurprising that the financial industry is still viewed with considerable suspicion by much of the general public. But we believe it can be a powerful force for good.
Asset managers in particular have a major role to play in helping solve some of the most pressing problems that the world currently faces, and we must demonstrate our capacity to develop meaningful investment solutions that meet today's challenges and help finance sustainable economic growth.

We are in a privileged position in terms of our position as a link between the providers of and those who need funding, and we must make the most of the opportunity we have to improve the world we live in as well as grow the value of our clients' assets. If we do so successfully, we will once more be able to justify our existence as an industry to a sceptical public.

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