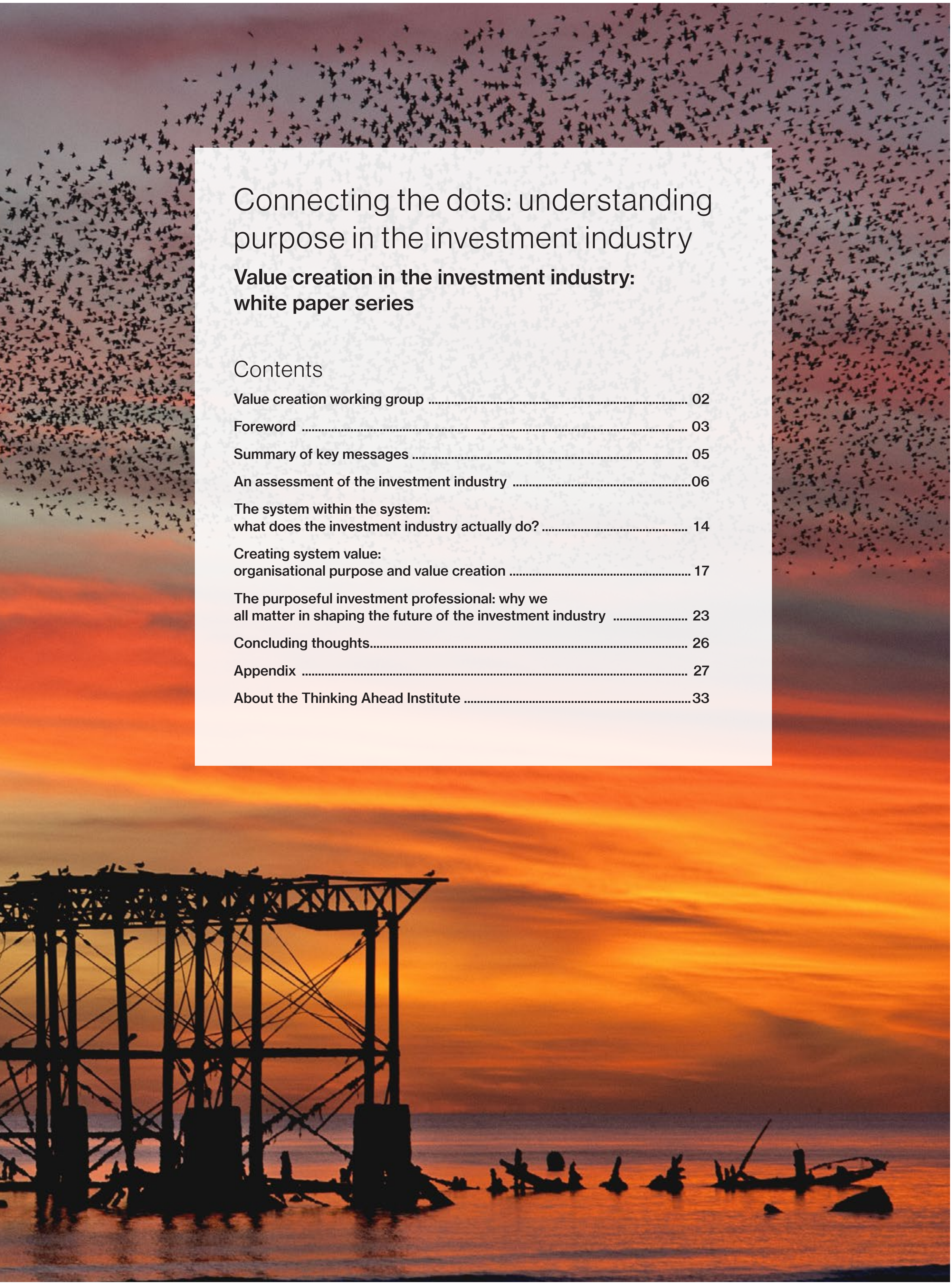
Thinking Ahead Institute

Connecting the dots: understanding purpose in the investment industry

Value creation in the investment industry: white paper series



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Contents

Value creation working group

This document has been written by members of the Thinking Ahead Group 2.0 (Marisa Hall, Tim Hodgson) following the research and discussion conducted by the Thinking Ahead Institute's value creation working group. The authors are very grateful to the members of the working group for their input and guidance but stress that the authors alone are responsible for any errors of omission or commission in this paper.

The aim of this white paper on purpose, and subsequent others in the value creation series, is threefold:
(1) to create a deeper understanding of the purpose of the investment industry and the agents within it,
(2) to consider what is value creation, how it evolves over multiple time horizons and the implications for stakeholders and (3) to consider how the industry's value proposition to end savers can be improved.

The mission of the working group is both altruistic (we believe that creating real value for the end saver is the right thing to do) and fulfils enlightened self-interest (by serving the interests of society and the end saver, our own organisations benefit too).

The members of this working group are as follows:

- Craig Horvath, Dimensional Fund Advisors
- Jeroen Rijk, PGB Pensioendiensten
- Marc Bautista, Willis Towers Watson
- Philip Palanza, State Street Centre for Applied Research
- Tracy Burton, Coronation Fund Managers
- Vishal Hindocha, MFS International
- Wynand Louw, Old Mutual Group

We hope that this paper provides the basis for a deeper understanding of how value is created in the investment industry, both for our members and for the wider industry.

Foreword

POSIWID: the purpose of a system is what it does

The history

In the Thinking Ahead Group we have spent well over a decade thinking about investment as a system. We are at least as interested in the macro behaviour of the industry, as we are about the micro behaviours of the various agents. We formed the Thinking Ahead Institute with the stated mission of changing the investment industry for the benefit of the end saver. In effect, we wanted to encourage the industry to (re)align itself to better serve a social purpose – to strengthen its licence to operate.

The painful recognition

In 2017 one of the Institute's research streams was 'investment as an ecosystem'. We held several topical days as part of the exploration. One of my personal goals was to understand whether an ecosystem could have a social purpose. Professor Mark Pagel, an external professor at Santa Fe Institute, was very clear that biological ecosystems had no intrinsic purpose. The fact that they happen to produce oxygen and tasty protein, and recycle waste (amongst other ecosystem services), is very convenient for us humans. However, nothing in a biological ecosystem is aiming toward those goals. He therefore suggested that this, an absence of over-arching purpose, was the starting point for considering human-made ecosystems, such as the investment industry.

Even with this helpful guidance, I still didn't get it. It has only been in pursuing our research this year into value creation that I have run into the acronym POSIWID – the purpose of a system is what it does. I think I get it now. But the realisation that I am a slow learner has been painful.

What does it mean?

The essence of POSIWID is to counter the notion that we can infer the purpose of a system from the intentions of those who design, operate, or regulate it. The originator of the phrase, Stafford Beer, stated that it gave a better starting point for understanding (rather than attributing good intentions, moral judgements or even knowledge to the system).

In turn, for the investment industry, this means two things:

1. It is beyond the power of any agent, even a regulator or a government, to impose a social purpose on the industry, and
2. If we want the investment industry to change, then we need to focus on what the industry does.

Where to from here?

I believe that POSIWID was a powerful insight for us and the value creation working group to consider. For example, in response to the first point above, we are forced to accept that no single agent can impose a purpose – but that doesn't mean an absence of influence. Could a sufficient number of purposeful investment professionals influence a sufficient number of investment organisations to change the industry? How large might that coalition need to be, to be successful? How much effort should be spent persuading regulators or governments to add their influence?

And the second point above is potentially deep, and throws off a number of questions, such as: what do we think our industry does? What does our industry actually do? If these answers are different, why is that? What should our industry be doing? And what would we need to change to accomplish that?

This paper attempts to answer some of these questions through a challenging analysis of the purpose of the industry and how this is connected to the organisations and the investment professionals within it. We see this paper as a foundational piece on which our exploration into a deeper understanding of the value created by the industry will be built.

Tim Hodgson
Head of the Thinking Ahead Group

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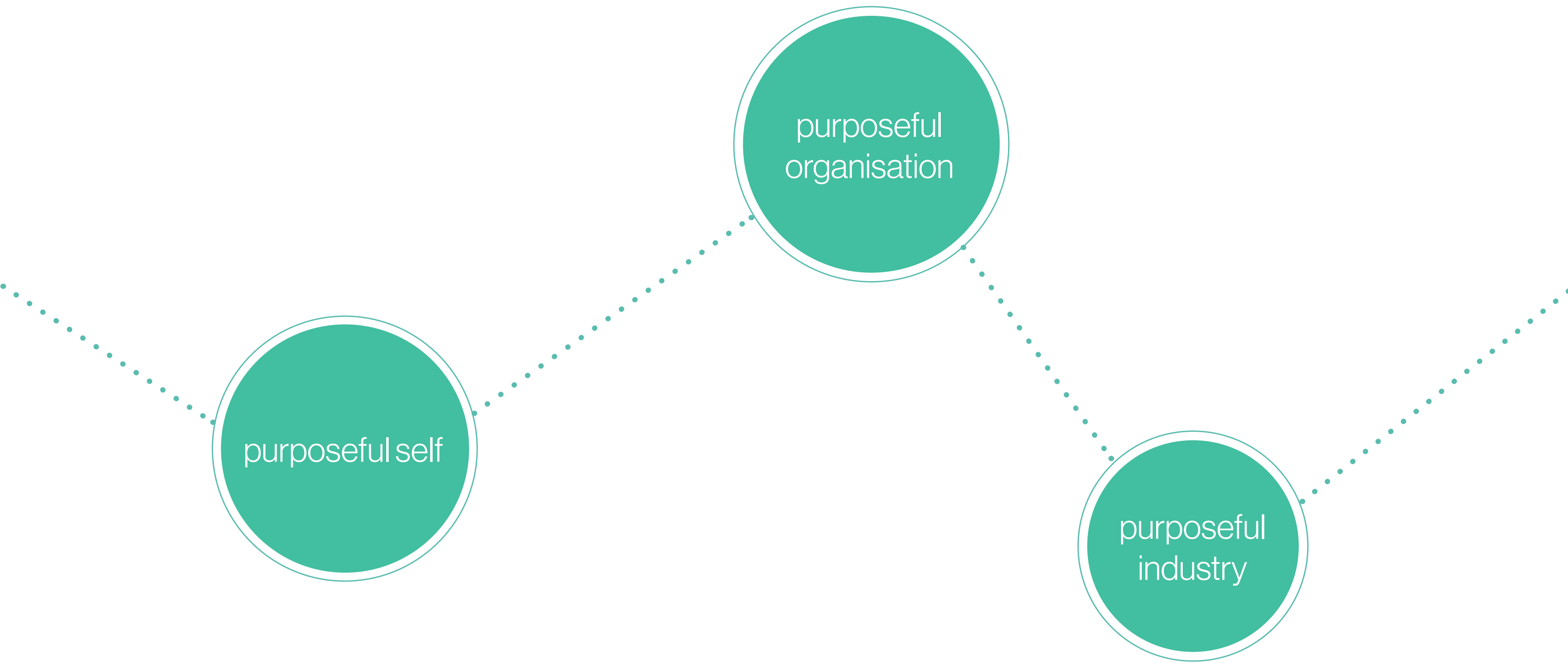
Summary of key messages

- The investment industry has contributed positively to society through the creation of wealth, providing risk management services and increasingly ensuring that capital allocated to companies are effectively stewarded.
- However, there is substantial room for improvement, particularly in the articulation of the industry's purpose and in understanding how value created is distributed among stakeholders. The industry also continues to suffer low levels of trust, asymmetries of information between end savers and itself and, in many cases, misaligned incentive structures and mandates.
- We can better understand the emergent purpose of the investment industry by looking at what it does. Two of the most commonly observed functions of the industry are risk management (specifically the construction of portfolios to an asset owner's risk budget) and stewardship activity. Risk management is primarily focused on managing cross-sectional, or point-in-time risk, and stewardship is gaining traction.
- Investment firms need to challenge their objectives to better understand how they create value, not just for their shareholders and clients, but for wider society and the planet. Whereas previously, profit maximisation was seen as the dominant purpose of an organisation, increasingly social licence regards this as an outcome of a company's broader purpose. A business cannot be considered as independent from either society or the environment. It will affect (and be affected by) both of them – for better or for worse.
- If we are to improve the value proposition of the industry, we need to be the drivers of that change. This can be achieved through a better understanding of our own purpose-driven motivations as investment professionals and how they collectively contribute to the well-functioning of our firms and the wider industry. It is the aggregation of individual purposes that forms strong team culture and drives to a common objective in our organisations.



An assessment of the investment industry

The investment industry ecosystem

The investment industry as a whole should be viewed as a complex, adaptive ecosystem[1]. In short, this implies that while the industry is made up of a number of interconnected organisations, which on some levels compete and on other levels rely on each other, these organisations are a product of, and an influence on, wider society.

[1] For further details on investment as an ecosystem, see the Thinking Ahead Institute paper, System thinking and investment, including some relevant investment case studies.

Taxonomy of some key institutional investment organisations

Asset owners: *work directly for a defined group of beneficiaries/savers/investors as the manager (and often the legal owner) of their assets in a fiduciary capacity (upholding loyalty and prudence) under delegated responsibility*

1. Asset owners (AOs) work with a sponsoring entity, usually a government, part of government, a company or a not-for-profit
2. Generally, delegated asset managers (such as OCIOs and other fiduciary managers) are broadly considered to be asset owners, even if rarely the legal owners. These fiduciaries deliver mission-specific outcomes to beneficiaries and stakeholders in the form of various payments or benefits into the future.

Further details on the defining characteristics of asset owners can be found in our paper, *The asset owner of tomorrow.*

Asset managers (listed securities): *safeguard financial assets on behalf of clients and through aggregation deploy them into portfolios constructed to pool and manage risk*

1. Asset managers can influence the return received by asset owners through portfolio construction techniques but are not directly responsible for the generation of return (this is done by the investee companies[2] themselves)
2. Asset managers can also influence the use of retained earnings by companies through stewardship and corporate governance

Asset managers (private securities): *allocate capital directly into private investments with the aim of creating growth to increase the wealth of asset owners and stakeholders*

1. Private asset managers aim to create growth through primary investments. As such, arguably, private asset managers have greater influence over the return received by asset owners – using financial and/or operational leverage
2. Private asset managers can often control the use of investee company earnings, typically having representatives on the board of directors.

Consultants: *provide domain specific investment knowledge*

1. Aim is to have an understanding of the client context so as to advise on investment strategies to meet AO / fiduciary objectives
2. Able to provide research to help meet needs eg manager products
3. Consultancies are able to influence some decisions made by asset owners / fiduciaries as in some markets sign-off is required by regulators (eg UK).

[2] The role of investee companies is to allocate capital provided by stakeholders to generate wealth and improved well-being. These companies fund new assets from retained earnings or the sale of securities to raise cash. Earnings are generated as a result of the transformation of both financial and non-financial capital inputs.

Undeniably, the investment industry performs a number of 'meta' functions through its role in providing value to the wider society. For example, the industry contributes (indirectly) to the wider economy through supporting jobs, communities, product innovation and capital and infrastructure spending. However, the fulfilment of the industry's purpose should be judged by its impact, which is a function of how aligned its participants are to the end saver, how much they cost the system relative to their value and how effectively they operate.

Perspectives on net value: the investment industry scorecard

There is no doubt that there is much activity by asset owners, asset managers, and intermediaries (such as consultants and custodians). But does all of this activity translate into net value as perceived by key stakeholders within it?

In March 2018 the Thinking Ahead Institute conducted a joint investment industry expert survey with the International Integrated Reporting Council (IIRC) to better understand how the investment industry delivered its value proposition across three key areas.

1. Alignment: how well do the interests, and consequently the efforts, of industry organisations align with the interests of the end investors (customers) and the wider society?
2. Cost: are costs fair (relative to the value the industry provides) and transparent?
3. Efficiency: how effectively do industry organisations transform those costs into portfolio outcomes?

This global survey of experts across asset owner and asset manager organisations followed a similar survey conducted in 2015 by the Thinking Ahead Institute in its three-part study on the state of the industry.

The results are shown below. Further details on the survey can be found in the appendix.

Table 1 – **The Thinking Ahead Institute investment industry scorecard**

	Balance score-card-system assessment factors	2015 score	2018 score
Alignment	1. Trust measures	4.4 - Moderate	4.0 - Moderate
	2. Transparency	4.2 - Moderate	4.3 - Moderate
	3. Ethical condition	5.0 - Moderate	5.2 - Moderate
	4. Incentives structuring	3.5 - Poor	3.7 - Poor
	5. Cultural condition	4.0 - Moderate	4.6 - Moderate
	6. Society		3.9 - Poor
Costs	7. Aggregate costs	2.8 - Poor	2.8 - Poor
	8. Cost structure and transparency	3.0 - Poor	3.7 - Poor
Efficiency	9. AO organisational effectiveness	3.9 - Poor	4.4 - Moderate
	10. AM organisational effectiveness	5.8 - Moderate	5.8 - Moderate
	11. Longer-term effectiveness/sustainability	3.8 - Poor	3.9 - Poor
	12. Value chain effectiveness	3.5 - Poor	3.8 - Poor
	13. Effective regulation	4.4 - Moderate	5.0 - Moderate
	Overall	4.0 - Moderate	4.2 - Moderate

Selected free-form responses[3]

- "The industry is improving following various initiatives and so we have reason to be positive. But there is still too much emphasis on value creation for the industry itself with too much focus on short-term value creation by corporates rather than long term. The organization of the system and personal biases/interests of those within it (or influencing it) leads to potential misalignment at various stages which need to be tackled, or at least recognised."

- "The industry has been highly effective in creating value for itself as evidenced by the growth witnessed. The picture is more mixed for society where there has been significant cost reduction possible through cheap capturing of equity beta through passive investments but the proliferation of investment products that fail to generate value for money is a potential drain on society. The transfer of investment risk from plan sponsor to the end saver has probably significantly undermined the efficiency of long-term savings from the end saver perspective."

- "On a relative value add basis the industry has created most value for itself. It generally destroys value for the end saver. Value add to society is questionable given the prevalence of short time investment horizons."

- "Financial value has been created for most employees in the industry, but not for many end investors. [It is] unclear that there has been any social, intellectual or other value creation."

- "I think it has created very limited value at huge cost and complexity in general."

- "...while there is more of a focus on transformation and responsible investing there's a long road ahead with low levels of trust."

- "The savings and investment industry has done a very poor job of creating value for clients. If we have created wealth, we have kept most of it for ourselves. We have failed to describe what our core purpose is and allowed ourselves to become distracted by trying to outsmart each other in the secondary markets instead of making fundamental investment decisions. We talk in riddles and we foist short-termism on clients and then blame them. We have created distrust of our motives and brought heavy-handed and destructive regulation upon ourselves."

- "It has been very good at attracting intellectual resources but this intellectual capital has been deployed to enhancing its own financial value ahead of customers. The social implications of this intellectual capital being deployed to the finance industry as opposed to other [areas] of greater social value has been significant. For example, society would be better served by more engineers as opposed to financial engineers."

- "The focus of the majority of the industry is heavily on creating value for itself. Value for society and the end saver are largely secondary in practice."

- "The industry is improving following various initiatives so we have reason to be positive. But there is still too much emphasis on value creation for industry itself with too much focus on short term value creation by corporates rather than long term. The organisation of the system and personal biases/interests of those within it (or influencing it) leads to potential misalignment at various stages which need to be tackled, or at least recognised."

- "The industry provides a valuable service to investors and the community at large. It has shown the ability to meet many and varied needs and to deliver outcomes. On the negative side the industry needs to use technology to drive efficiencies and reduce the overall cost of delivery of outcomes. As well as maintain a high ethical standard consistent with the industry's fiduciary obligations."

[3] While we received a range of responses to the survey, in general we note that the view of respondents were largely focussed on improvements the industry could make to increase its value proposition.

- "At an overall industry level it is hard to say that it has been successful in creating value for society and the end saver. So much of the investment industry is a relative competition against other investors, and so for every winner there is a loser. That said, there are clearly parts of the industry which have benefitted society and the end saver, through for example directing investment to essential areas (eg infrastructure), opening up capital markets and providing credit to help businesses grow and invest."

- "The focus in my view has historically only focused on financial performance with a lack of understanding of the impact ESG factors have on the long term outcomes of investments. With a deeper understanding of the role ESG factors play, financial, social and other value may be enhanced."

- "Overall the industry has done a mediocre job at creating value. Areas of strength are providing access to capital markets for all types of investors. The industry is fairly democratic. Areas of significant weakness are that the industry is so prone to misalignment because of the asymmetry of information and the size of the rewards available. The industry has created a lot of value for itself."

- "There are varying business models active in the investment industry and, therefore, varying levels of value created for itself, society and the end user. For investors operating on a not-for-profit or all-profit-to-members basis, it could be argued that significant value in financial and social outcomes are derived through long-term investment in infrastructure and the built environment, attention to sustainability and strong long-term returns. The profit-to-shareholder model may not deliver such levels of value owing to a conflicted model of needing to return some profit to shareholders as well as the end-saver. It has been economically modelled that the underperformance and productivity of the profit sector is causing a drag on the value creation of the investment system. Financial business models centred on volume-based percentage bonuses (typically associated with Fund Managers) could also be argued to be destroying value particularly in a compulsory savings system where volume growth is mandated."

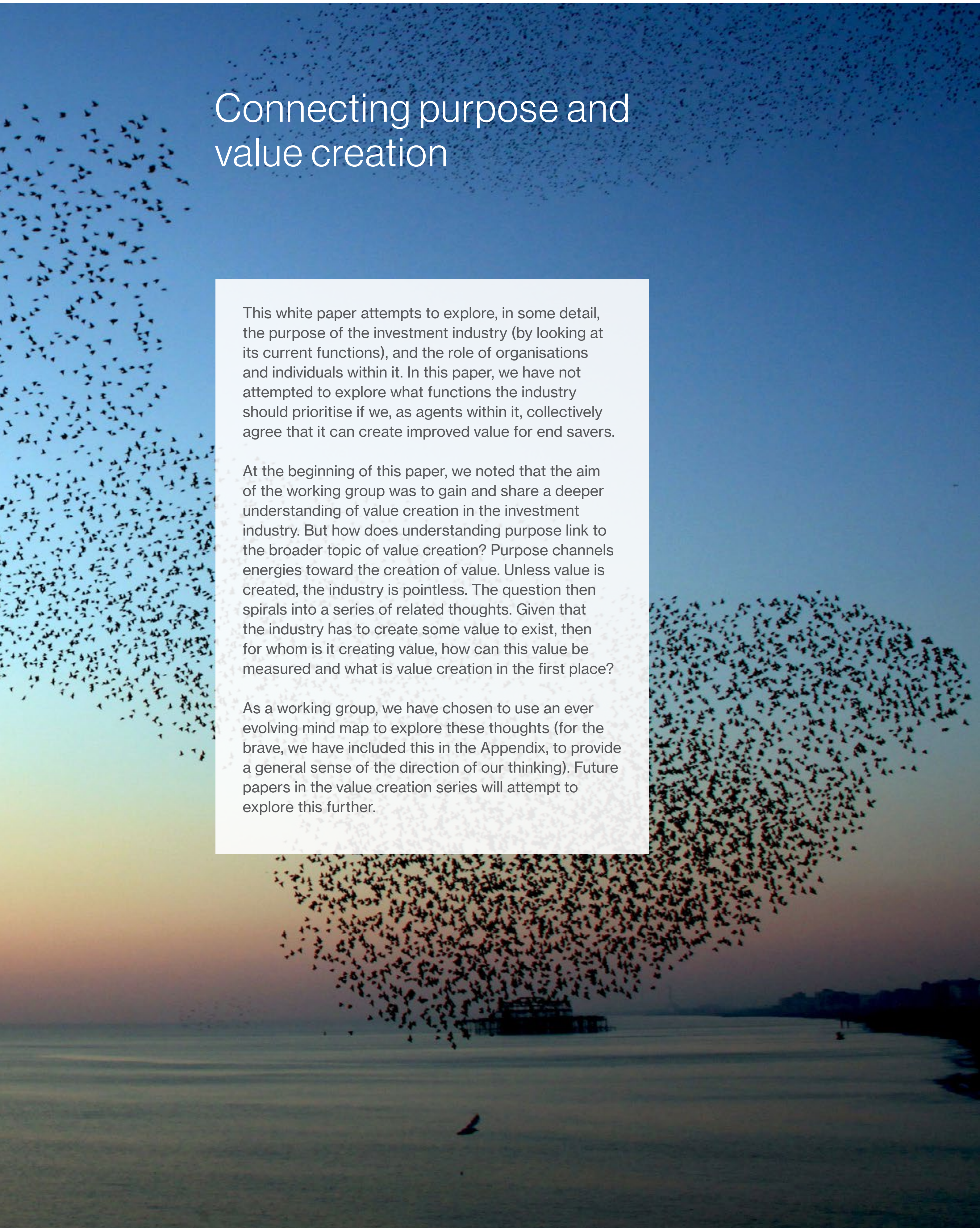
- "The industry is very effective in creating value for itself. Salaries, margins and profits are generally high. In creating value for the end saver it is doing ok. Finance is complex and the industry does add value through creating accessibility and providing information. Socially there is limited value creating. ESG is gaining traction, but only slowly and systemic risk is still abundant without any self-regulation or control within the industry."

These scores and free-form responses suggest that the industry still has substantial room for improvement, particularly in the areas of how value is distributed among stakeholders and articulation of its purpose. Although the assessments of respondents were subjective, given that all participants are part of the industry, there remains a widely-held belief that the industry falls short on its value proposition to the end investor. This is supported by the fact that, despite recent rises, the 2018 Edelman trust barometer[4] continues to report financial services as the least trusted industry.

So we know that perceptions (both internally and externally) of the investment industry can be improved. We suggest an appropriate question is: what should the industry be doing? The response to this question is likely to be driven by underlying beliefs and values and the notion of a licence to operate. We will therefore explore this separately as we continue our study on value creation in the industry.

First, we will look at the observed functions of the industry currently and conduct a broader study of how the purpose of individuals, organisations and the industry can be aligned.

[4] Further details can be found in the 2018 Edelman Trust Barometer report: http://cms.edelman.com/sites/default/files/2018-02/2018_Edelman_Trust_Barometer_Global_Report_FEB.pdf

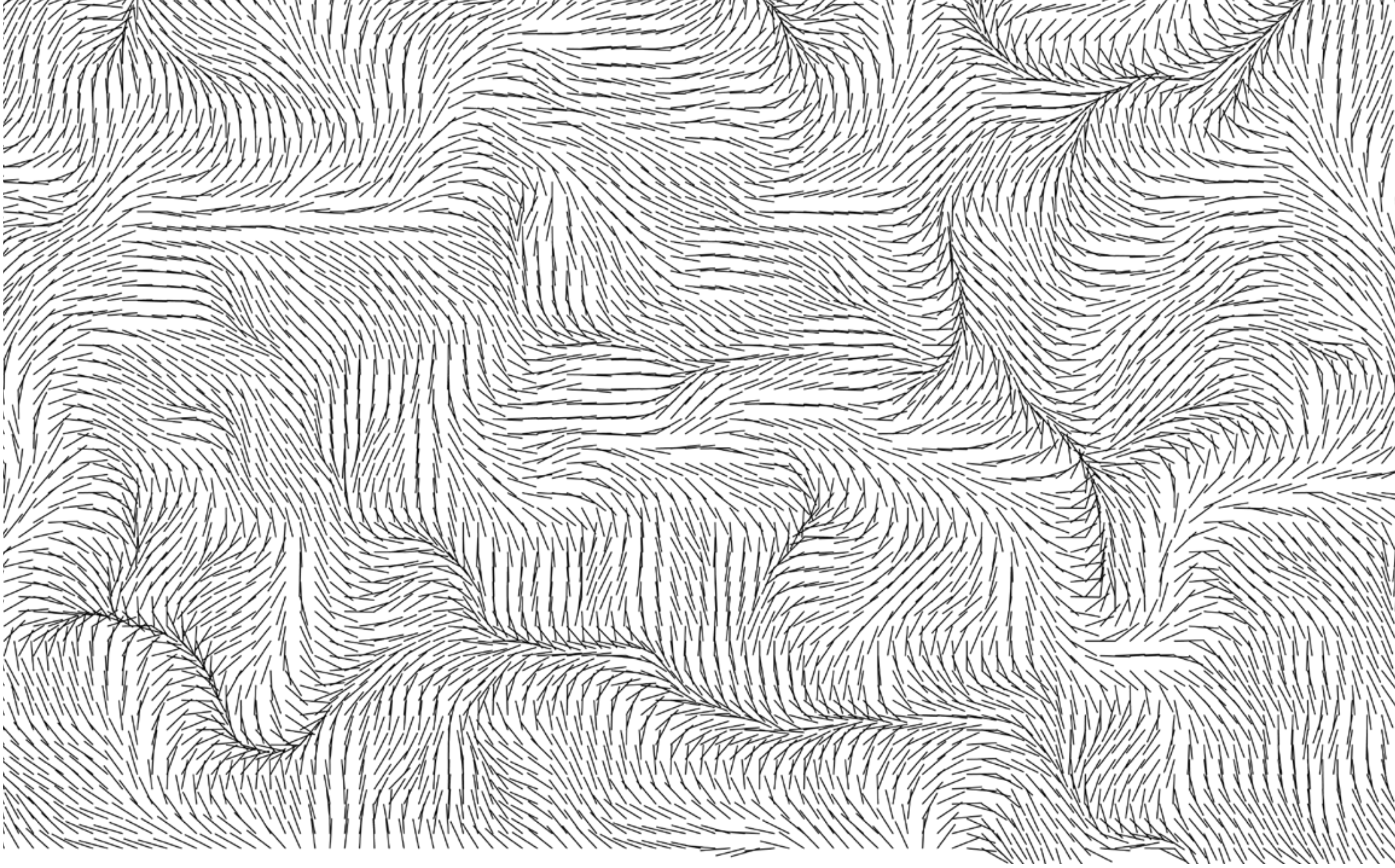


Connecting purpose and value creation

This white paper attempts to explore, in some detail, the purpose of the investment industry (by looking at its current functions), and the role of organisations and individuals within it. In this paper, we have not attempted to explore what functions the industry should prioritise if we, as agents within it, collectively agree that it can create improved value for end savers.

At the beginning of this paper, we noted that the aim of the working group was to gain and share a deeper understanding of value creation in the investment industry. But how does understanding purpose link to the broader topic of value creation? Purpose channels energies toward the creation of value. Unless value is created, the industry is pointless. The question then spirals into a series of related thoughts. Given that the industry has to create some value to exist, then for whom is it creating value, how can this value be measured and what is value creation in the first place?

As a working group, we have chosen to use an ever evolving mind map to explore these thoughts (for the brave, we have included this in the Appendix, to provide a general sense of the direction of our thinking). Future papers in the value creation series will attempt to explore this further.



The system within the system: what does the investment industry actually do?

So what useful function does the industry actually serve? Below, we discuss two of the most commonly observed functions of the investment industry, risk management and stewardship.

We're actually doing more risk management than capital allocation

Commentators often describe the core function of the investment industry as "the efficient allocation of capital", but as we, and many, have argued, adaptation by the system means that the focus of what the industry does now[5] looks very different. Below, we look at the role played by equities, bonds and private markets as a source of capital allocation.

Equities

The Bank for International Settlements (BIS) notes that since the early 2000s, there has been a reduction in the amount of equity capital raised by corporations.[6] This follows a global trend in developed countries where funds withdrawn from the market through acquisitions for cash and share buybacks have routinely and considerably exceeded the amounts raised in rights issues and IPOs. Many large firms quoted on the stock exchange no longer rely on the equity markets to raise cash to fund capital expenditure and indeed, over the 20-year period to 2016, the number of listed equities in the US has fallen by almost 50%[7] and in the UK by 26% (or by 57% if you include the AIM market)[8].

[5] By asserting that the investment industry is a complex, adaptive ecosystem it is only fair to note here that the trends which we observe now in the industry may not hold true in the future, particularly over longer time horizons.

[6] "Equity issuance and share buybacks", Adrian Van Rixtel and Alan Villegas, BIS quarterly review, 2015

[7] "The incredible shrinking universe of stocks", Michael Mauboussin et all, Credit Suisse, 2017

[8] "The shrinking public markets and why this matters", Helen Steers, Pensions Age, 2017

A powerful case study of this shift is the capital expenditure of four of the world's largest tech companies: Alphabet's Google, Amazon, Facebook and Microsoft. Over the 12-month period to March 2018, Bloomberg reported that these companies collectively spent $60bn on capital expenditure and capital leasing – up by 48% on the equivalent figure from 2017. The bulk of this was directed towards so-called hyperscale computing, which enables rapid access to heavy duty processing power on demand, and is vital to the tech behemoths' pursuit of dominance of the cloud. From a financial point of view, the remarkable aspect of this vignette is that the firms were able to deploy this amount without tapping equity markets. According to John Kay "as a source of capital for business, equity markets no longer register on the radar screen".

Bonds

Over the past two years, S&P 500 companies have spent $1.1tn on share repurchase programmes. Proposed changes to the US tax regime expected to trigger a repatriation of offshore funds are likely to increase this number significantly. The BIS argues that "share buyback booms in the US have typically coincided with surges in net bond issuance, suggesting that the former have been financed, at least in part, through the latter"[9]. Professor Mihir Desai, in his article Capitalism the Apple way vs capitalism the Google way, points to the corporate trend of using borrowed funds to distribute cash to investors. This has been fuelled by ultra-low interest rates and difficulties in repatriating offshore capital due to tax reasons[10].

In response to shareholder pressure to distribute more earnings, Apple began to issue debt. Over the 4-year period to March 2017, Apple released $200bn via dividends and buybacks, partially financed by $99bn in new debt. Apple has not been alone in this approach. According to Desai, "the dominant corporate-finance pattern for the last decade has been Apple's. Companies have been distributing cash via share buybacks and have borrowed money to finance these distributions at a rapid rate. As American stalwarts such as Deere, IBM, Amgen, and 3M cede power to investors, it's like watching leveraged buyouts unfold in slow motion".

According to a Fitch ratings report, share buybacks have exceeded free cash flow after dividends since 2014, "with most companies using debt to cover the shortfall, underscoring a more aggressive stance across the sector".[11] In other words, the managements of listed companies have inflicted financial engineering on themselves in the same way that private equity firms inflict it on non-listed companies.[12]

Private markets

While it is true that asset managers can influence the use of retained earnings by companies through stewardship and governance, it is difficult to suggest that they are directly responsible for the generation of return as this is done by the investee companies themselves[13]. Arguably, the business model of asset managers of private securities means that they have a greater influence over the return received by investors. These managers are often able to control the use of investee company earnings, typically by having representatives on the board of directors. However, given that private equity assets under management hovered at around $2.5trn[14] compared to the approximately $69.1trn[15] total run by the asset manager universe, even if this was all used for primary investment, this would represent only a small fraction of total activity.

So what exactly is going on?

There was a time where the purpose of the investment industry was acknowledged to be the efficient allocation of capital. Money directed to an equity portfolio is predominantly applied to buy ownership rights in the secondary market[16]. Given current low interest rates, bonds that are issued are increasingly being used for financial engineering versus investment in real growth. If we discount the activity of capital allocation, we must go back to our first question, what does the investment industry do?

We would suggest that the most significant observed activity within the industry is risk management – specifically the construction of portfolios to suit an asset owner's risk budget, or risk tolerance.

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9 "Highlights of global financing flows", BIS quarterly reviews, 2015

10 The significant size of the US market distorts this issue – large US companies with massive international operations historically have found it difficult to bring money back to the US without paying taxes. This coupled with limited scope for additional investment domestically meant that companies raised money at ultra-low interest rates (thanks to QE) and used the proceeds to buy back shares.

11 "US corporate share buybacks ongoing risk for bondholders", Fitch ratings report, 2017

12 These actions are often deemed to be 'efficient' as bond interest is paid before tax but equity dividends are paid after tax. However, borrowing necessarily reduces the resiliency of the organisation and the system. Managements and shareholders are therefore changing the shape of the return distribution (increasing returns a little in most outcomes; massively increasing losses in tail outcomes) rather than creating value in aggregate. The call by some for interest and dividends to be treated equally appears to have merit.

13 The role of investee companies is to allocate capital provided by stakeholders to generate wealth and improved well-being. These companies fund new assets from retained earnings or the sale of securities to raise cash.

14 "2017 Prequin global private equity and venture capital report", Preqin, 2017

15 "The innovator's advantage", Global Asset Management 2017, The Boston Consulting Group, 2017

16 As a brief aside, the accumulation of large pools of internal capital seems to be an evolutionary phenomenon, and is far more noticeable in developed than emerging markets, where equity is still a major source of financing for new capital projects.

Pitt-Watson and Mann describe the management of risk as one of the core functions of finance, whether it be to provide us with a pension until we die or to control the risk of failure to meet an investment return objective[17]. One of the key roles of the industry is to manage investors' risk through time, an activity conducted to a greater or lesser extent by asset owners, fiduciaries, asset managers and consultants within the industry. We would suggest, however, that the incentive structures and mandates prevalent in the industry mean that the vast majority of effort goes into managing cross-sectional, or point-in-time, risk – rather than through-time risk. Capital allocation does occur at the margin, but this is subservient to the behemoth of risk management.

Stewardship is gaining traction but can be done better

As John Kay argues in his book, Other people's money, even if there were no new investment in capital stock, there would still be a need for the investment industry to nurture and maintain the existing stock of assets through a stewardship function. Society needs mechanisms for transferring wealth over time, and trade in securities is one such mechanism. If large quoted companies such as Apple are self-financing, then the relationship between these companies and the long-term investor must be one of stewardship. In other words, one of the key roles of the investment industry should be to engage with company management on the best ways to generate sustainable long-term growth, and manage the risks and agency issues that might impair a company's prospects.

So how does the investment industry fare against this objective?

While difficult to measure, there is increasing empirical evidence to support the value of stewardship[18].This has led to a growing number of investors creating active ownership policies, fuelled by the growing adoption of stewardship codes in many countries such as the US, UK, Switzerland, Japan and the EU[19]. At the same time, the number of signatories to the UN Principles for Responsible Investment (UN PRI) continues to rise. However, while a number of asset owners integrate stewardship into their investment practices, more work needs to be done.

According to the 2017 Future Fund and Willis Towers Watson global research of the 'top 15' asset owners, opportunities are being missed by asset owners in the overlapping areas of sustainability, ESG, stewardship and long-horizon investing. Additionally, the UK's Investment Association notes that while most asset managers and asset owners consider influencing business strategy as a key priority for engagement, most engagements with companies are around executive remuneration. Although executive remuneration is an important topic, it can crowd out other significant issues.

Grewal et al, in their 2016 working paper on Shareholder activism on sustainability issues, note that while a growing number of investors are engaging with companies, 58% of the shareholder proposals studied were filed on ESG issues that are categorised as immaterial under the SASB Materiality Map™ (Sustainability Accounting Standards Board). This suggests that a significant number of shareholders were unaware of the materiality or were pursing objectives other than enhancing firm value. The paper argues that pressure on companies to address ESG issues that are not financially material destroys financial value. While the rise in stewardship and engagement activity is welcome, investment firms need to distinguish between material and immaterial sustainability factors to avoid destroying value.

A short word on price discovery

It is worth pausing here to observe Pitt-Watson and Mann's warning against the conflation of 'enabling functions' in finance (such as successful innovation, or the management of asymmetric information) with the ultimate services it provides for the outside world (eg risk management). Relatedly, there is a danger that some of the positive externalities in undertaking the functions of finance, are themselves viewed as purposes. A popular example of this is price discovery where "knowing market prices may have positive (and negative) side effects, but price discovery is not a primary purpose of finance"[20].

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[17] "The purpose of finance", David Pitt-Watson and Hari Mann, PIC, 2017

[18] See "Active ownership", Dimson, Karakas, Li, Review of Financial Studies, 2015. Also, "ESG engagement in extractive industries: return and risk", Hoepner, Oikonomou, Zhou, 2015

[19] "Passive fund providers take an active approach to investment stewardship", Morningstar, 2017

[20] "The purpose of finance", Pitt-Watson and Mann, Pension Insurance Corporation, 2017

Creating system value: organisational purpose and value creation

The returns we need can only come from a system that works; the benefits we pay are worth more in a world worth living in.[21]

There is a fundamental shift occurring in the relationship between companies and society. Whereas previously, profit maximisation was seen as the dominant purpose of a business, increasingly it is coming to be regarded as an outcome of a company's broader purpose. The idea behind 'creating shared value' was discussed in Porter and Kramer's 2011 work where it was argued that the competitiveness of a company and the health of the community around it are mutually dependent. This bridged the gap between the dichotomy of creating value for shareholders and creating value for stakeholders. Robert Eccles also tackles this idea by noting that companies have two basic objectives: to survive and to thrive. He argues that shareholder value should not be the objective of a company but the outcome of the company's activities. In other words, rather than profit being the purpose, profit comes from pursuing a purpose that benefits society.

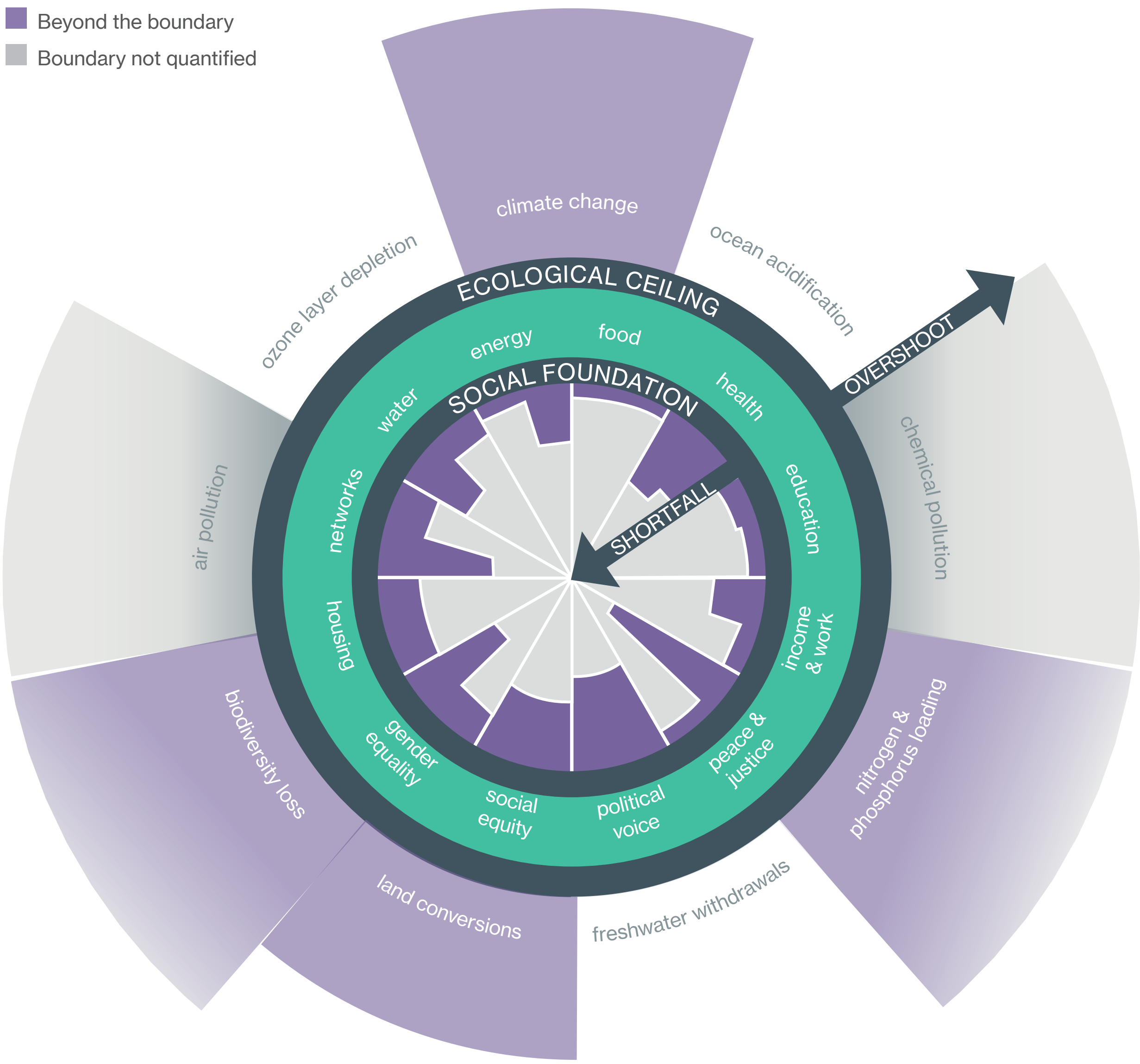
These considerations are shockingly important when you consider the size and impact of some companies. In 2016, 69 of the world's 100 largest economic entities were corporations rather than countries and the world's top 10 corporations had a combined revenue greater than the 180 poorest countries combined (a list which includes Ireland, Israel, South Africa and Greece) These 69 corporations clearly help shape the social foundation of our societies. The investment industry has an immense opportunity to influence how these corporations are run.

Building a better social foundation for societies

In 2009, Johan Rockström, executive director of the Stockholm Resilience centre, outlined nine planetary boundaries that are critical for keeping the earth in a stable state beneficial to life as we know it and attempted to quantify how much further we can go before there is a risk of "irreversible and abrupt environmental change". Human survival clearly requires the sustainable use of these planetary resources and complementing the planetary boundaries are social foundations below which there is unacceptable human deprivation. Kate Raworth picks up this idea in her book, Doughnut Economics, and sets out a visual framework for sustainable development by combining the complementary concepts of planetary and social boundaries. The 'doughnut' (shaded green) represents the safe operating space for humanity: a social foundation of wellbeing that no one should fall below, and an ecological ceiling of planetary pressure that we should not go beyond.

[21] Dutch pension fund. Source: Roger Urwin, Thinking Ahead Institute roundtable

Figure 1 – **Doughnut economics – balancing planetary and social boundaries**



Source: Doughnut Economics, Kate Raworth, 2017

For a clear statement of what societal wealth and well-being includes, a good place to look is at the UN's sustainable development goals (SDGs). This set of goals, targets and indicators has been agreed by 193 member states, and covers a broad range of social and economic development issues expected to frame government agendas and political policies until at least 2030.[22] The SDGs address the most pressing social, economic and environmental challenges in our world today and, in our opinion, represent the most objective reference point for determining what is good for society. With goals such as ending poverty, and hunger, achieving gender equality and improving access to clean water and sanitation, the SDGs point to a common language which the great majority of economies (and hence industries and organisations) can rally around.

However, the UN estimates that meeting the SDGs will require $5trn to $7trn in investment each year from 2015 to 2030[22]. The UN has put out a strong call to action for the private sector to play a fundamental role in achieving these SDGs. While government spending and development assistance will contribute, they are expected to make up no more than $1trn per year and so "new flows of private sector capital will be key, either through new allocations or by re-routing existing cashflows".

In their 2017 report, The SDG investment case, the UN PRI argues that investment organisations should consider the SDGs when making strategy, policy and active ownership decisions. It lays out five key arguments on the relevance of SDGs to investors:

Table 2 – **the SDG investment case**

1. The SDGs are a critical part of investors' fiduciary duty

Fiduciary duty requires investors to act in the best interests of beneficiaries, and in doing so to take into account environmental, social and governance (ESG) factors, as these factors can be financially significant over the short and long term. The globally agreed SDGs are an articulation of the world's most pressing environmental, social and economic issues and as such act as a definitive list of the material ESG factors that should be taken into account as part of an investor's fiduciary duty.

	Risks	Opportunities
Macro	**2. Macro risks: the SDGs are an unavoidable consideration for universal owners** By the nature of their investments, asset owners that choose to hold a diversified portfolio, investing in a wide range of asset classes and geographies, will be exposed to the global challenges that the SDGs represent. Failure to achieve the SDGs will impact all countries and sectors to some degree, and as such create macro financial risks.	**3. Macro opportunities: the SDGs will drive global economic growth** Achieving the SDGs will be a key driver of global economic growth, which any long-term investor will acknowledge as the main ultimate structural source of financial return.
Micro	**4. Micro risks: the SDGs as a risk framework** The challenges put forward by the SDGs reflect that there are very specific regulatory, ethical and operational risks which can be financially material across industries, companies, regions and countries.	**5. Micro opportunities: the SDGs as a capital allocation guide** Companies moving towards more sustainable business practices, products and services provide new investment opportunities.

Source: The SDG investment case, UN PRI, 2017 (marginally adapted)

[22] https://www.unpri.org/infrastructure/primer-on-responsible-investment-in-infrastructure-/2700.article

In short, the SDGs can be used as a framework through which investment decisions can be made. This is in keeping with an investor's primary fiduciary duty of creating financial value for the end saver.

Figure 2 – **The UN sustainable development goals**

https://www.un.org/sustainabledevelopment/news/communications-material

Creating system value

It is possible to move beyond the concept of shared value and extend it to the concept of creating 'system value', a term first introduced by the Future-Fit foundation[23]. A system value perspective places a business within society – it is a subcomponent – and places society within the environment. This perspective shows that a business cannot be considered as independent from either society or the environment. It will affect (and be affected by) both of them – for better or for worse.

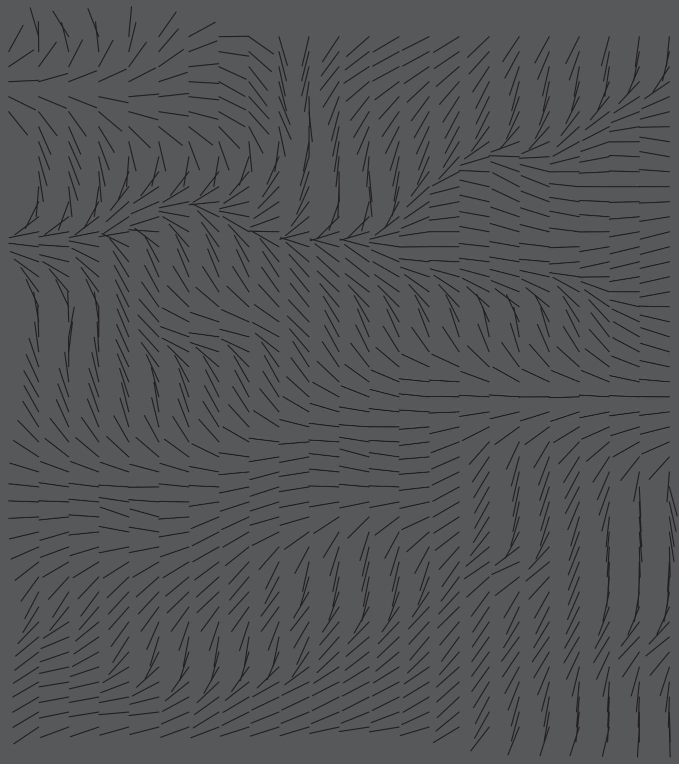


Figure 3 – **from shareholder value to system value**

Shareholder Value

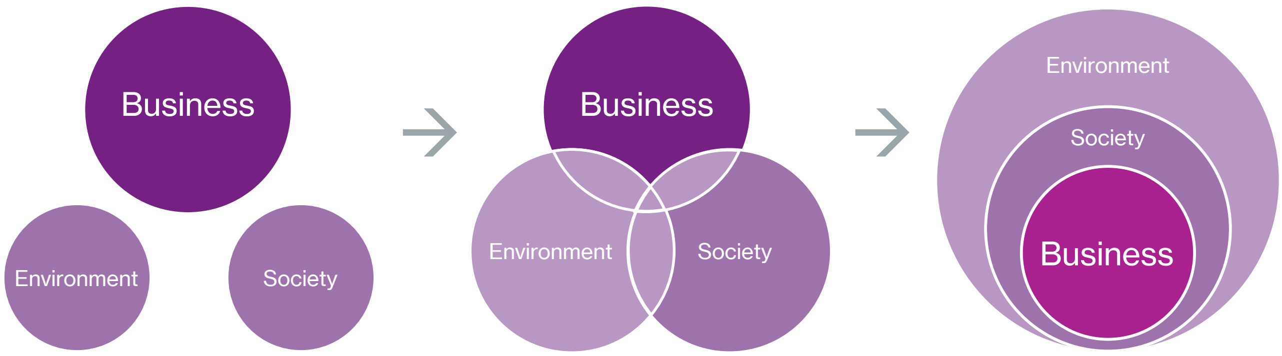
Financial returns are all that matters: companies privatise gains and externalise losses

Shared Value

Business comes first: negative impacts are often not sufficiently internalised, or are justified by 'doing good' elsewhere

System Value

Business addresses societal challenges in a holistic way, while not hindering progress toward a flourishing future



Source: Future-Fit Foundation

To understand how an organisation creates system value, one has to look no further than how it designs its business strategy and executes its operations to benefit its stakeholders, using its various sources of capital[24]. Admittedly the bar for achieving true system value is high, however, we believe that organisations can meet this target by pursuing activities which help create better societies and a more sustainable environment. We provide an example on the following page.

[23] For further information, see paper, Creating system value: concept note, Future-Fit Foundation, April 2017

[24] The International Integrated Reporting Council (IIRC), for example, categorises capital under the following headings: financial, human, social and relationship, manufactured, intellectual and natural.

Figure 4 – **an example of achieving system value within the investment industry**

System conditions	System value principles		
The conditions that must be met for society to flourish	*Principles an investment firm can follow to create system value (increasing levels of impact)*		
People are treated fairly	The firm ensures that all stakeholders are treated fairly (eg diversity and inclusion policies, treating customers fairly, regular board agenda item)	The firm helps others ensure that stakeholders are being treated fairly (eg collaboration with other firms to promote diversity, ethics and active affirmative policies)	The firm acts to increase social inclusion by overcoming barriers to unfair treatment (eg policies that support and deliver outcomes to address social inclusion)

Source: Based on Future-Fit Foundation

Table 3 – **a (non-comprehensive) list of an organisation's stakeholders and the value proposition for each of them**

Stakeholders	Value proposition: policies and actions that...
Shareholders	Improve the wealth of owners through capital growth and/or cashflows
Employees	Attract, retain and develop employees and teams
Customers	Deliver value to clients in all services and products
Suppliers	Create mutually beneficial relationships with suppliers
Government	Adhere to, or improve on, regulations/guidance and pay the fair amount of tax
Society	Contribute to the development of a progressive social contract (licence to operate) and healthy cross industry relationships
Planet	Do no harm to, or improve, the natural and human resources of our planet

The purposeful investment professional: why we all matter in shaping the future of the investment industry

In the previous section, we argued that organisations are inextricably linked to wider society and the environment in which they exist. In short, if businesses are to flourish they need to ensure the good health of the wider ecosystem. But organisations have no separate existence (except in a legal sense) – they consist of individuals, just like us, who are responsible for setting missions and objectives, driving culture and behaviours, and generally making decisions on how much our businesses contribute (or not) to various stakeholders in society and to the planet as a whole. To borrow generously from POSIWID[25], if we want to drive change in our organisations, and hence the industry, we need to change what we, as individuals, do. We need to examine our own motivations and behaviours and how they collectively contribute to the well-functioning of our firms and the wider industry.

The purposeful self

Intrinsic and extrinsic motivations

Deci and Ryan's self-determination theory points to the fact that we are all influenced by both intrinsic and extrinsic motivations. The former (intrinsic) describes something that is inherently interesting or rewarding while the latter (extrinsic) leads to some separable positive outcome such as high pay or avoidance of punishment.

Table 4 – **Intrinsic vs extrinsic motivations**

Intrinsic motivations	Autonomy	▪ Have control over self, freedom to seek interesting, rewarding work ▪ Adaptability and resilience
	Mastery	▪ Desire mastery in their field and focus on building competency skill sets - go deeper into issues
	Relatedness/purpose	▪ Have belief that they are contributing to something greater than themselves - connections to the 'nobility' of the profession ▪ Goals are aligned with their organisation, clients and wider society
Extrinsic motivations	Explicit incentives - promoting 'good' behaviours	▪ Work environment provides clear signals to good behaviours ▪ The greater the degree of socialisation and self-integration the more autonomous the motivation

[25] Recap: POSIWID (purpose of a system is what is does), refers to purpose at a system level and asserts that purpose is revealed by what the system does. Clearly for individuals this is different. As individuals, it is clear that we may deem ourselves to have a purpose beyond what we actually do. And we have the ability to choose a purpose, and adjust what we do accordingly.

While much debated, several bodies of research question the effectiveness of extrinsic motivations on producing positive long-term results. Princeton academics, Bénabou and Tirole note: “in well-known contributions, Etzioni (1971) argues that workers find control of their behaviour via incentives ‘alienating’ and ‘dehumanising’”, and Deci and Ryan (1985) devote a chapter of their book to a criticism of the use of performance-contingent rewards in the work setting. And, without condemning contingent compensation, Baron and Kreps (1999) conclude that: “there is no doubt that the benefits of [piece-rate systems or pay-for-performance incentive devices] can be considerably compromised when the systems undermine workers’ intrinsic motivation”[26]. In short, being driven by intrinsic considerations is a vital ingredient in achieving positive long-term results.

Purpose-driven motivations

At our March 2018 Sydney roundtable event, the top three responses to the question “what motivates you to perform in your current role?” were: (i) interesting and enjoyable work, (ii) helping clients and (iii) helping to do something meaningful with societal purpose. Interestingly, the lowest ranked categories were ‘pay’ and ‘helping my organisation to achieve its financial goals’. Second, attendees were asked to choose between which of two options they valued more: 94% of attendees chose “my organisation produces more societal wealth and well-being” compared to only 6% choosing “my organisation produces more profits”. These results suggest that intrinsic motivations that are linked to a positive purpose (such as improving societal wealth and helping clients) are highly valued.

Having purpose-driven motivation is important, as demonstrated in State Street Centre for Applied Research and the CFA Institute’s 2016 study, Discovering phi: motivation as a hidden variable of performance. Individuals that are driven by purpose, have positive habits and appropriate incentives (‘phi’) contribute to better organisation performance, client satisfaction and are better engaged. These results suggest that connecting the mission, values and culture of an organisation with an individual’s sense of purpose is vital.

What are the traits of a purpose driven investment professional?

According to the CFA Institute’s survey on the Future State of the Investment Profession, respondents ranked the top three skills required for the future as (i) the ability to articulate vision; (ii) relationship-building; and (iii) the ability to instil a culture of ethical decision making. The report notes “these results confirm the view…that investment organisations need to recruit and develop employees along new dimensions, such as creativity, empathy and judgement in complex situations”. Relevant here is the concept of T-shaped individuals who have both the depth of skills in a particular field and the breadth of knowledge across disciplines (along with the ability make connections between these disciplines and one’s own). We have previously argued that our investment industry is a dynamic, evolving and non-linear ecosystem with many disparate connections. Increased T-shapedness along with the capacity to adopt new skills (such as resilience and adaptability) should allow individuals to fare well in an uncertain future.

[26] See “Modern organisations”, A Etzioni, 1971; “Intrinsic motivation and self-determination in human behaviours”, E Deci and R Ryan, 1985; and “Strategic human resources”, J Baron and D Kreps, 1999.

The purposeful self → the purposeful organisation

Institutional investment is a team game. Through teams, strategic investment decisions are made, value is added to portfolios (or destroyed) and a progressive (or regressive) culture is built. In our paper, How to choose: a primer on decision-making in institutional investing, we note that collective judgement can be superior to that of any individual within a group subject to three conditions applying: diversity, independence and an effective means of aggregating views[27].

There is a reflexive relationship between individual purpose-driven motivations and the motivations of a collective team – individual purpose is validated by a strong team culture and a strong team culture emerges from the aggregation of individual purposes that drive to a common objective. Effective aggregation requires a careful awareness of social dynamics – perceptiveness by leadership and group members are key. In short, investment professionals need to be not just be T-shaped and technically capable but also emotionally so.

The purposeful self → the purposeful organisation → the purposeful industry

Connecting the dots

A purposeful industry can only emerge if there are sufficient organisations which are aligned in their individual purposes. And an organisation is only as good as the people within it. If the dials on the compasses (purposeful people, organisations and industry) do not align then the system will be suboptimal at best and, at worst, parts of the industry ecosystem can break down (sometimes to systemic proportions – think the global financial crisis).

We believe that change can only be effected through a coalition of individuals with a common mission to ensure that the investment industry drives positive social value.

The investment industry will not achieve its full potential without the trust of wider society. We, as the building blocks of the industry, are empowered to create change through our actions. By better understanding how our actions connect to social impact, we can shift the balance to improve the value proposition to society. Without that, we are in danger of losing our social licence to operate.

Connecting the dots: a brief side bar on culture and diversity

Culture is the collective influence from shared values and beliefs on the way our organisations think and behave. We have also previously written about the value of cognitive diversity[28]. As an industry we need more diversity, not just for better decision-making, but also for improved relatedness to our customer base and for inclusiveness. These are important ingredients for the sustainability of our industry.

We believe that there is a link between individuals, their organisations and the emergent purpose and functioning of the industry. This link is multi-directional: from the bottom-up where we as individuals and organisations effectively define what the industry actually does, and from the top-down where the culture of the industry and our organisations affect how we as individuals behave.

[27] While group interaction can reduce overconfidence and make better decisions in uncertain environments, we note that groups introduce biases of their own. James Surowiecki's three conditions, expressed in his 2004 book "The wisdom of crowds", are critical to the intelligent design of groups.

[28] "A cognitive take on diversity", Thinking Ahead Institute, 2017

Concluding thoughts

At the beginning of this paper, we noted that POSIWID (purpose of a system is what is does) continues to be a powerful insight for us in our consideration of how value is created in the investment industry. If we want to improve outcomes for stakeholders then we as the organisations and investment professionals within it need to be drivers of that change.

To be clear, we are not suggesting that the industry does not create any value. The investment industry has contributed positively to society though the creation of wealth, providing risk management services and, increasingly, through stewardship. Investment organisations within that system (such as asset owners, asset managers and intermediaries) have contributed to these services. But as much as we can recognise the benefits of the industry we must also acknowledge the issues: low levels of trust, asymmetries of information, and in many cases, misaligned incentive structures and mandates.

We have set out our thoughts on purpose in this white paper with the aim of deepening our own understanding of the industry and the agents within it. However, our work is not yet complete. To determine whether the investment industry is creating value for end savers, requires us to have a deeper understanding of what value creation is. Can we differentiate between value creating, destroying and re-distributing activities? Is net value creation a simple aggregation of positive and negative pursuits or is there failure when some boundary or threshold condition is breached? Which stakeholders are we trying to create value for? And at what point can value be declared given that end savers have multiple time horizons? We look to study these issues in more detail in future publications in our value creation series.

Appendix

Investment industry scorecard questions

A selected group of 46 investment industry professionals were asked to score the following questions against the following ratings: very poor, poor, moderate, good and very good.

Alignment

1. **Trust:** Trust will be evident where alignment is present and there are strong incentives for agents to do their absolute best for the end investor. Trust supports the well-being of the system, and is also a source of wealth generation; directly through a less costly system (less need for expensive regulation and intermediation) and indirectly through a more effective engagement process. In my opinion, the level of trust within the industry is…
2. **Transparency:** The attribute of transparency and clarity of communication supports the opportunity for end investors and other interested parties to assess products fairly. In my opinion, the level of transparency within the industry is…
3. **Ethical condition:** The ethical condition of industry practice can be judged by reference to the principles set out in the CFA Asset Manager Code (while developed for asset managers we believe the principles apply equally-well for asset owners): (i) act in a professional and ethical manner at all times, (ii) act for the benefit of clients, (iii) act with independence and objectivity (iv) act with skill, competence, and diligence, (v) communicate with clients in a timely and accurate manner, (vi) uphold the applicable rules governing capital markets. In my opinion, the ethical condition within the industry is…
4. **Incentives structuring:** The industry's alignment with the end investor is heavily influenced by how its participants are incentivised. Compensation design is one of the key components of incentive structuring and is particularly important for the leaders that set the tone at the top of the organisation. Other incentives follow from cultural influences in the organisation. In my opinion, the incentives structuring within the industry is…
5. **Cultural condition:** Culture is inextricably linked to (i) the purpose and drive of an organisation and (ii) the people ethos - how the team is treated and behaves. The ability to effectively meet the needs of customers (the end investor) is embedded in the culture of asset managers and asset owners. In my opinion, the cultural strength within the industry is…
6. **Society:** Increasingly investors are being asked to expand their focus beyond risk and return to also consider real-world impacts through the lens of the UN's sustainable development goals. The financial services industry has a significant impact on how capital is allocated in society and hence its effect on people and natural capital. In my opinion, the effectiveness of the industry as a steward of society's well-being is…

Costs

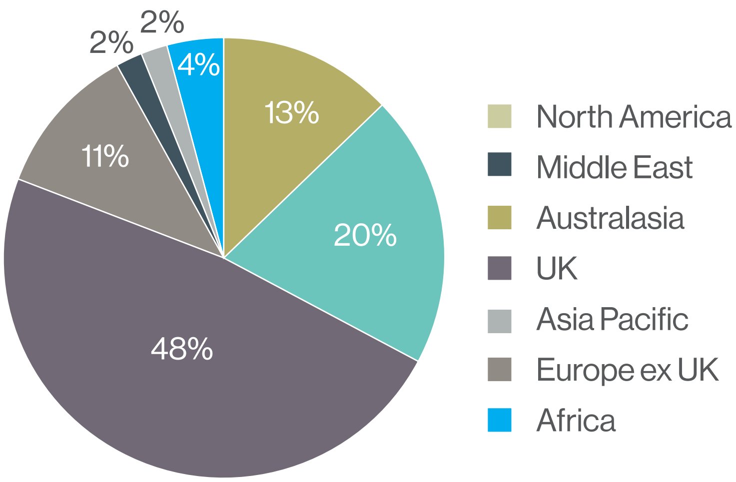
7. **Aggregate costs:** The following are examples of costs embedded in asset owner funds: (i) internal costs; (ii) external manager fees; (iii) performance fee and loaded expenses costs; (iv) transaction costs and (v) other provider costs. In my opinion, the aggregate cost within the industry is…
8. **Cost structure and transparency:** For full assessment of costs to be possible we must have appropriate fee transparency. Transparency is affected by the fee structuring in the industry and often the full cost to customers is not known until the end of lifetime of an investment. In my opinion, the cost structure and transparency within the industry are…

Efficiency

9. **Asset owner organisational effectiveness:** An asset owner's organisational effectiveness can be assessed by the coherence of its mission, governance, culture and strategy. The results of its structures, resources and processes are decision outputs and subsequent investment outcomes. In my opinion, asset owner organisational effectiveness is…
10. **Asset manager organisational effectiveness:** In this case the assessment is around the coherence of the mission, culture and leadership, and strategy. In my opinion, asset manager organisational effectiveness is…
11. **Longer-term effectiveness/sustainability:** Do we see evidence that long horizon thinking is embedded in the investment processes of investing institutions, or instead are the focal points of activities relatively short-term? In my opinion, longer-term effectiveness is…
12. **Value chain effectiveness:** Some market commentators have noted that chasing relative-to-benchmark returns has resulted in an inefficient investment industry and captures too much attention from market participants. Arguably, this negative-sum relative return activity is at the expense of not enough attention being spent on positive-sum efforts to improve absolute returns. In my opinion, the effectiveness of the value chain is…
13. **Effective regulation:** Effective regulation is a critical contributor to the maintenance of a healthy investment ecosystem. The regulator must ensure a mix of trust, fairness and inclusiveness are present. The costs of regulation must be borne by the users of the system. In my opinion, the regulatory effectiveness is…

Investment industry scorecard: survey statistics

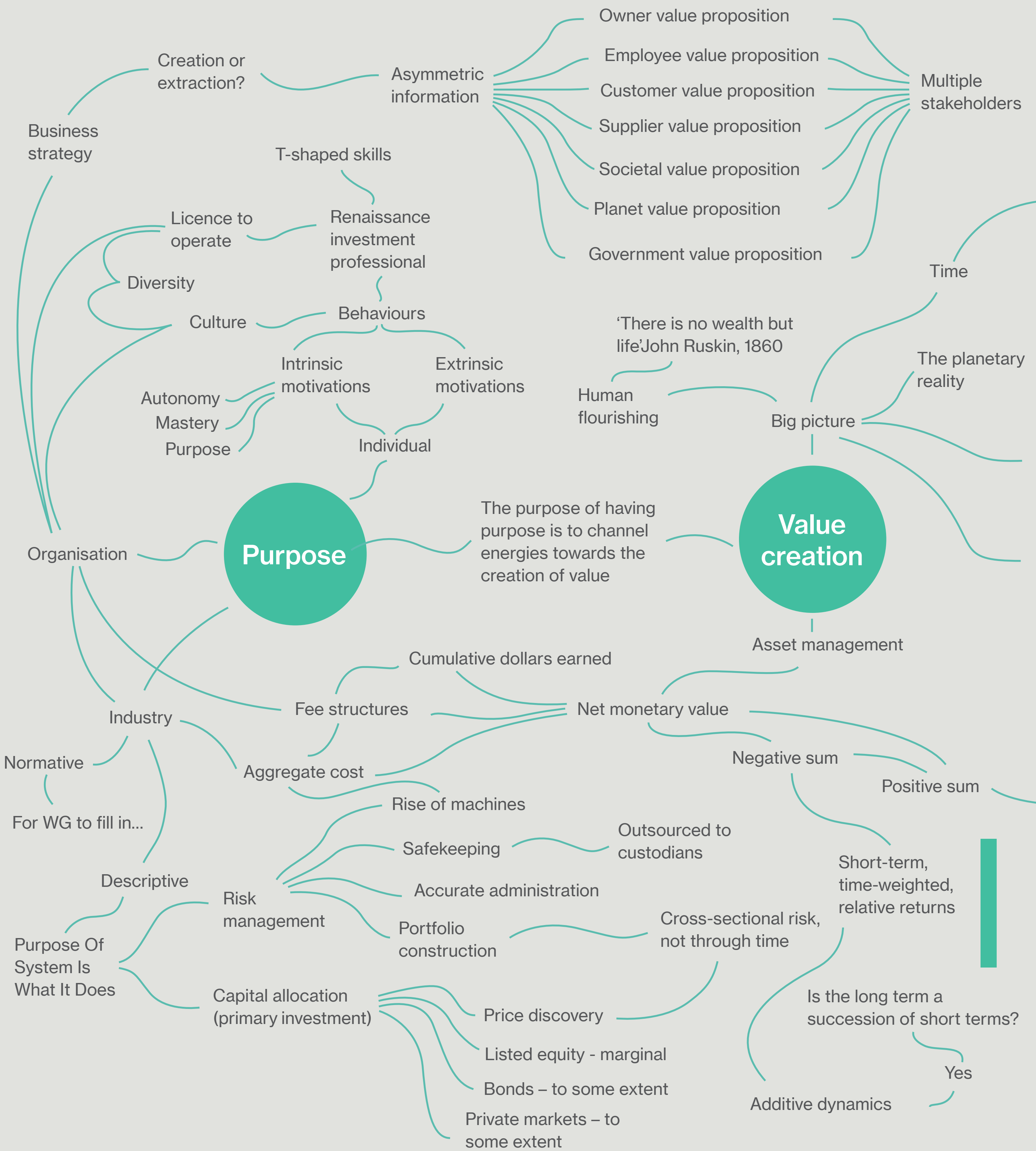
Which region do you operate in?



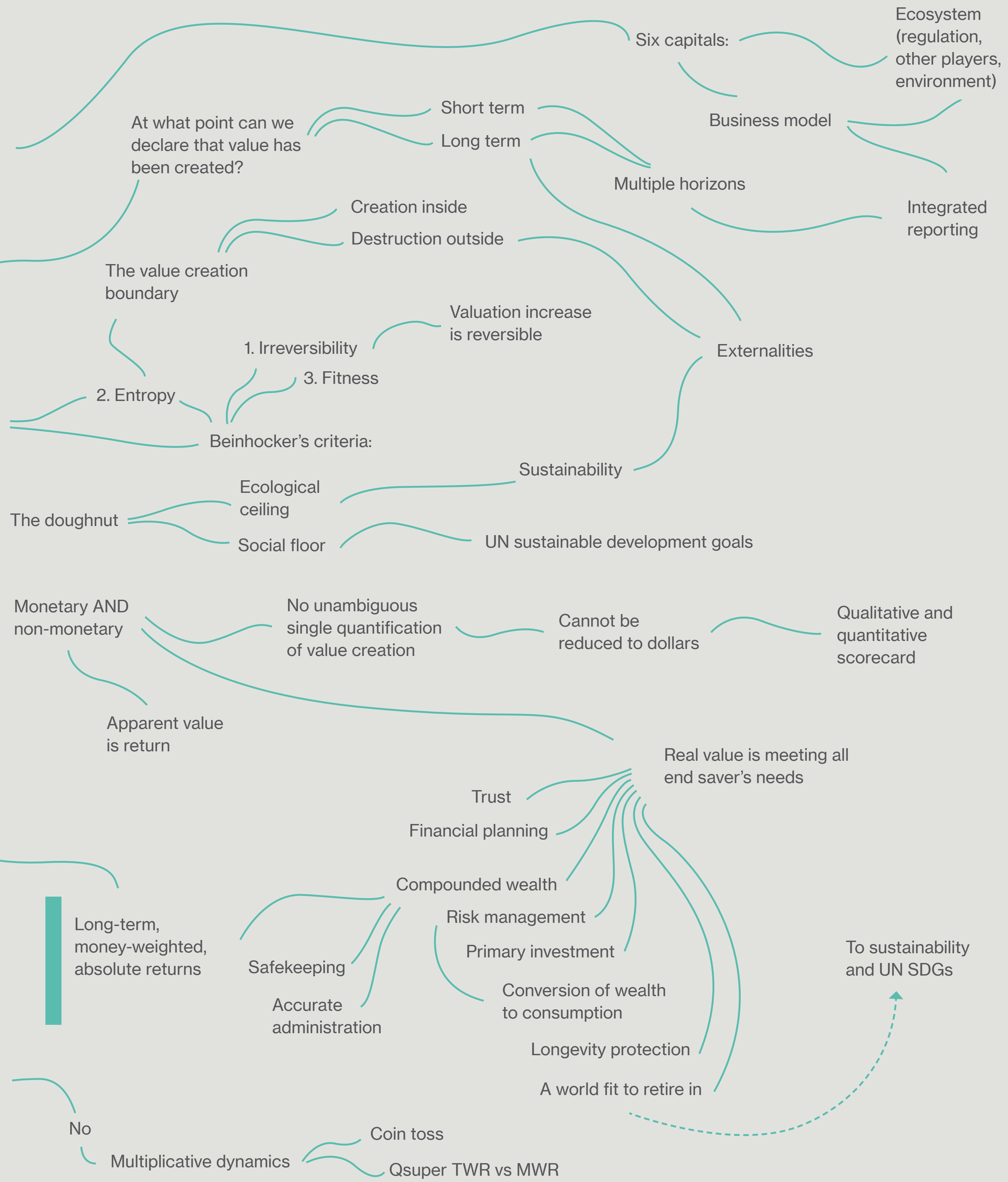
What type of organisation do you work for?

Connecting purpose and value creation: working group mind map[29]

Value creation and the asset management industry



[29] As at date of publication


Six capitals:
Ecosystem (regulation, other players, environment)
Business model
At what point can we declare that value has been created?
Short term
Long term
Multiple horizons
Integrated reporting
Creation inside
Destruction outside
The value creation boundary
Valuation increase is reversible
1. Irreversibility
3. Fitness
2. Entropy
Externalities
Beinhocker's criteria:
Sustainability
Ecological ceiling
The doughnut
Social floor
UN sustainable development goals
Monetary AND non-monetary
No unambiguous single quantification of value creation
Cannot be reduced to dollars
Qualitative and quantitative scorecard
Apparent value is return
Real value is meeting all end saver's needs
Trust
Financial planning
Compounded wealth
Long-term, money-weighted, absolute returns
Risk management
Primary investment
Safekeeping
Conversion of wealth to consumption
Accurate administration
To sustainability and UN SDGs
Longevity protection
A world fit to retire in
No
Coin toss
Multiplicative dynamics
Qsuper TWR vs MWR

Limitations of reliance

Limitations of reliance – Thinking Ahead Group 2.0

This document has been written by members of the Thinking Ahead Group 2.0. Their role is to identify and develop new investment thinking and opportunities not naturally covered under mainstream research. They seek to encourage new ways of seeing the investment environment in ways that add value to our clients.

The contents of individual documents are therefore more likely to be the opinions of the respective authors rather than representing the formal view of the firm.

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The Thinking Ahead Institute

The Thinking Ahead Institute seeks collaboration and change in the investment industry for the benefit of savers.

It was established by Tim Hodgson and Roger Urwin, who have dedicated large parts of their careers to advocating and implementing positive investment industry change. Hodgson and Urwin co-founded the Thinking Ahead Group, an independent research team in Willis Towers Watson in 2012 to challenge the status quo in investment and identify solutions to tomorrow's problems.

What does the Thinking Ahead Institute stand for?

- Belief in the value and power of thought leadership to create positive investment industry change
- Finding and connecting people from all corners of the investment industry and harnessing their ideas
- Using those ideas for the benefit of the end investor.

The membership comprises asset owners and asset managers and we are open to including membership of service providers from other parts of the industry. The Thinking Ahead Institute provides four main areas for collaboration and idea generation:

- Belief in the value and power of thought leadership to create positive investment industry change
- Working groups, drawn from the membership, and focused on priorities areas of the research agenda
- Global roundtable meetings
- One-to-one meetings with senior members of the Institute.

About the Thinking Ahead Institute

The Thinking Ahead Institute seeks to bring together the world's major investment organisations to be at the forefront of improving the industry for the benefit of the end saver. Arising out of Willis Towers Watson's Thinking Ahead Group, formed in 2002 by Tim Hodgson and Roger Urwin, the Institute was established in January 2015 as a global not-for-profit group comprising asset owners, investment managers and service providers. Currently it has over 40 members with combined responsibility for over US$12 trillion.

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