Thinking Ahead Institute

Willis Towers Watson

Mission critical: understanding value creation

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 value creation, and others in the Institute's 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 and wider stakeholders 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 Center 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 Institute members and for the wider industry.

Summary of pre-launch checks

This paper has four key messages:

1. We define what value creation is
2. We propose a normative vision of what the investment industry should be, and the duty it should take on
3. We add our voice to the call that more stakeholders must be brought within the value creation boundary – in particular the planet, and ideally wider society too
4. We suggest three possible tools to help move us from concept to execution.

- In this paper, we propose a new definition of value creation:

Value creation is an increase in the stock of monetary and non-monetary resources used to create future wealth and well-being for stakeholders, as judged by observers, mindful of the passage of time.

This definition can be broken down into five key components:

i. An increase in the stock of monetary and non-monetary resources....

- Organisations depend on various monetary and non-monetary resources as inputs into their business models. These resources are either increased or decreased through the organisation's activities. With respect to the monetary and non-monetary resources we would tend to opt for the International Integrated Reporting Council's (IIRC) six-capitals framework – financial, manufactured, intellectual, human, social and relationship, and natural – but any comprehensive taxonomy would work equally well.

ii. ...used to create future wealth and well-being...

- The outcome of resource transformation must be handed over to stakeholders. Value is only added to stakeholders if the result of this transformation is an increase in wealth and well-being. Organisations therefore need to (i) develop their understanding of what stakeholders value and (ii) develop policies and actions to meet those expectations in line with their stated vision.

iii. ...for stakeholders...

- An organisation's purpose and resultant activities, either implicitly or explicitly, create a boundary between those stakeholder groups which benefit from the value created, and those for whom value is destroyed.

iv. ...as judged by observers...

- There is necessary subjectivity in the determination of whether value has been created – individuals will have their own perspectives on how an organisation's resources should be used and transformed. This signals the need for organisations to develop strategies that focus on anticipating, understanding and responding to stakeholder needs and the development of long-term relationships.

v. ...mindful of the passage of time.

- Value creation emerges over time and so its assessment should comprise a current/backward-looking element (such as a scorecard) and a forward-looking component (such as an integrated story explaining how resources are used to create value).

- As a working group we set out a bold vision for the industry:

The investment industry should aim to provide whole-of-life, whole-of-balance-sheet management for end savers. At a minimum, this activity should cause no harm, and will be truly valuable if it contributes to a world more fit to live in. As such, the industry has a duty to ensure its provision of new capital, and its stewardship of existing assets add value to the end saver, wider society and the planet both now and, as far as it is able, into the future.

Achieving this vision is likely to involve a broader interpretation of fiduciary duty than is currently practiced. It involves moving fiduciary duty from its current framing of risk and return to a broader interpretation that also includes impact.

- There is increasing demand for organisations to provide positive social contributions to maintain their social licence to operate – it is not enough for organisations to narrowly focus on creating financial value. Understanding what stakeholders value is a critical input into determining an organisation's vision, strategy, culture and its monitoring of outcomes – these invariably require feedback loops to improve organisational policies and practices.
- We outline three practical tools which organisations can use to better define, measure and monitor the value created.

1. *Guidelines for reporting on value creation:* this 'code' can be adopted by organisations that would like to issue statements on their value creation
2. *A self-assessment framework:* allows an organisation to identify its beliefs/value system as it relates to value creation. This framework can identify differences between the organisation's current and desired states, and facilitate a strategy to fill the gaps
3. *Monitoring scorecard:* provides a framework for organisations to monitor their value creation activities.

Our lofty ambition: understanding value creation in the investment industry

A bold statement

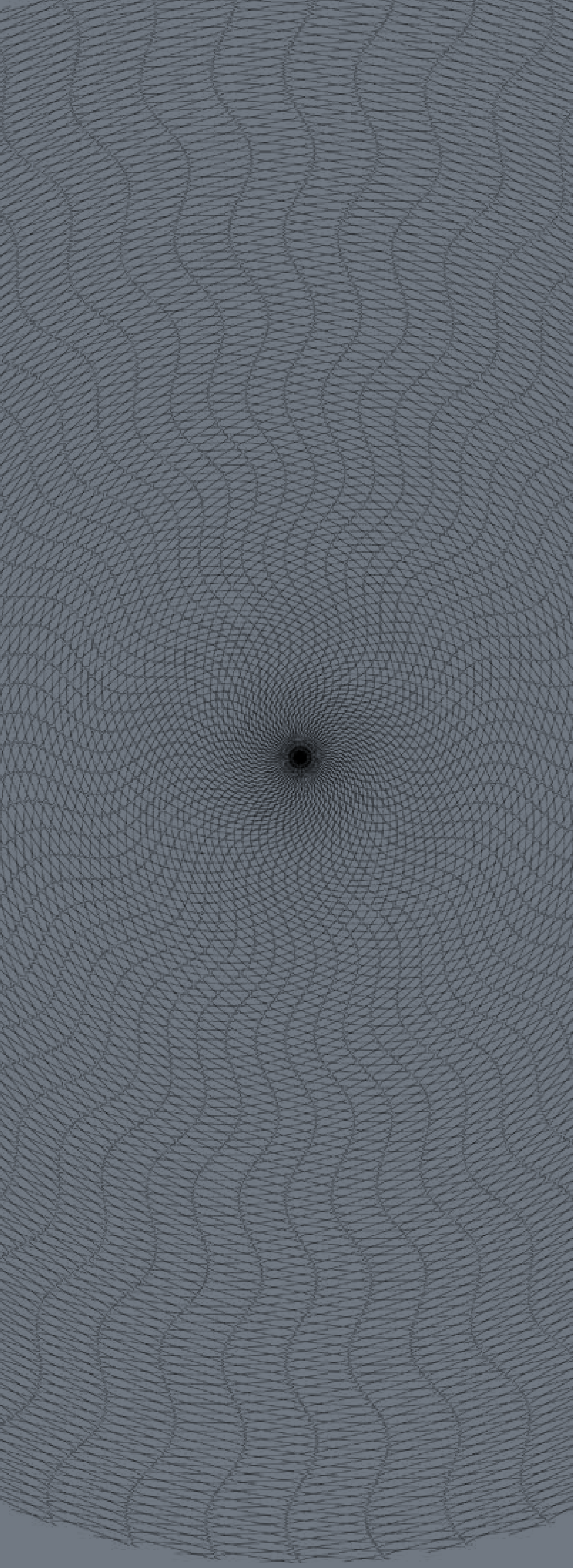
How ***does*** the investment industry create value? As a working group we have spent much of the last year exploring the purpose of the investment industry[1]. Why? Because purpose sets the direction for value creating activity. By looking at what the industry does (its de facto purpose), we can gain insight into which functions the industry prioritises and understand where its focus of value creating activity lies. Our findings were mixed. We found an industry that has contributed positively to society through participation in the wealth creation chain, providing risk management services and starting to increase its stewardship of investee companies. However, there was much room for improvement. Our industry scorecard, conducted in collaboration with the International Integrated Reporting Council (IIRC), pointed to continued concerns by investment professionals that we need greater clarity in the articulation of the industry's purpose, in understanding the value created and how this value is distributed among stakeholders.

And that is where this paper starts: how ***should*** the investment industry create value? If we, as many commentators before us, would like to assert that the industry does create some value, then for whom is this value being created, how can this value be assessed, and what is value creation in the first place?

These questions are fundamental to improving the value proposition of the industry and squarely fit into our mission at the Thinking Ahead Institute (TAI) to influence the industry for the benefit of the end saver. However, we recognise that any response to the above questions is likely to invoke a strong set of underlying beliefs and values and disparate thoughts on the notion of a licence to operate.

And so here we lay our cards on the table. As a working group, we believe that **the investment industry has a duty to ensure its provision of new capital, and its stewardship of existing assets adds value to the end saver, wider society and the planet.** This is a powerful statement. It moves the goal from a singular focus on creating financial value for investors to a broader conscientiousness that includes looking at the impacts of investments on both the wealth and well-being of society and the planet. It states that the industry shoulders some responsibility for ensuring that current and future end savers are left in a world fit to retire in – and this world involves broader social and planetary considerations. We recognise that this is a bold position (and perhaps foolhardy as we have yet to make our case) but necessary to set out up front so as not to mislead the reader. We must support our position and so we will be conscious to present our arguments in this paper objectively.

[1] See our paper *Connecting the dots: understanding purpose in the investment industry*, Thinking Ahead Institute, 2018



Balancing the planetary reality with society's needs

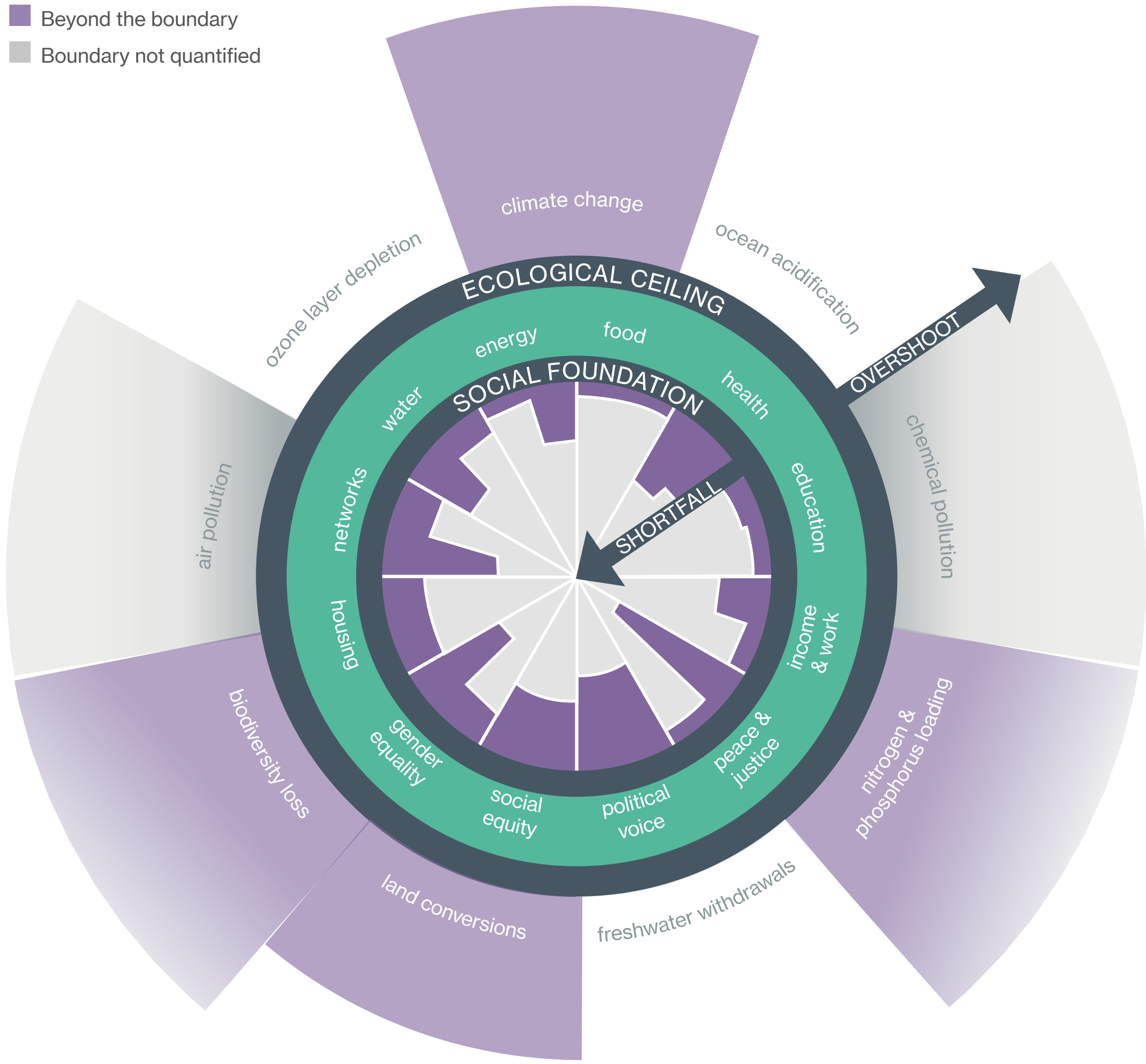
In October 2018, the Intergovernmental Panel on Climate Change (IPCC) issued a "final call to save the world from a climate catastrophe". Limiting global warming to the preferred target of 1.5 degree Celsius above pre-industrial levels would require "rapid, far-reaching and unprecedented changes to all aspects of society"[2]. Without concerted action, humanity risks seeing more extreme weather, rising sea levels and a significant impact on our ability to grow crops such as rice, maize and wheat – which provide the bulk of humanity's daily calories.

This view is echoed by economist Kate Raworth in her book, *Doughnut Economics*[3]. In it she sets out a visual framework for sustainable development by combining the complementary concepts of planetary and social boundaries. She argues that the safe operating space for humanity lies between a social foundation of well-being no one should fall below, and an ecological ceiling of planetary pressure that we should not go beyond. While there is growing scientific acceptance of the concept of planetary boundaries that are critical for keeping the earth in its current stable state, the concept of a social floor is laden with subjective values. Does society have a duty to ensure that everyone receives an education, access to adequate healthcare, housing and a political voice? Does the investment industry have a role to play in this? Individuals will have their own beliefs on this and the argument in this paper does not require bringing these into a consensus. However, we appear to be increasingly demanding positive social contributions from organisations that operate in our societies – if only to pay a fair amount of tax. As we will show later in this paper, it is not enough for organisations to narrowly focus on creating financial value; any activity must be 'sanctioned' by wider society.

[2] See IPPC special report: *Global warming of 1.5 degree Celcius.* Also, article reported in BBC News online *(https://www.bbc.co.uk/news/science-environment-45775309)*. Accessed on 5 November 2018

[3] *Doughnut Economics: seven ways to think like a 21st-century economist*, Kate Raworth, Penguin Random House, 2017

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



Source: *Doughnut Economics*, Kate Raworth, 2017

Building a social licence to operate

In 1970, Milton Friedman famously argued that "the doctrine of social responsibility...is fundamentally subversive in a free society...In such a society, there is one and only one social responsibility of business: to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game..."[4]. Friedman's view – that the sole responsibility of a firm is to maximise profit – laid the intellectual foundations for the dominance of the shareholder value mindset of the 1980s onwards. The effects are still felt today in both finance and law.

But what does it mean to 'stay within the rules of the game'? To operate legitimately, the activities of organisations are subject to some form of licence (legal, regulatory etc), with the aim of protecting the interests of customers, employees and (in some cases) wider society. For a business to remain viable, these activities, at the most basic level, need to be seen to offer some benefit to customers. However, some organisations choose to sacrifice the pursuit of short-term profit, with the aim of building longer term relationships – presumably because they see higher value in this. Ongoing acceptance of the organisation's operations requires a must-needed shift from economic-legitimacy-only behaviours to obtaining a social licence to operate.

The usage of the term, social licence to operate, has grown significantly over the past 20 years. In their paper, *Social licence to operate: legitimacy by another name?*, professors Joel Gehman and Lianne Lefsrud note that "after mentioning the concept of social licence in less than 10 articles a year from 1997 through 2002, news media mentioned social licence in more than1,000 articles a year from 2013 to 2015, and more than 2,000 articles in 2016"[5]. One definition is "the ongoing acceptance or approval of an operation by those local community stakeholders who are affected by it and those stakeholders who can affect its profitability"[6]. But is having a social licence necessary?

Mining industry consultants, Boutilier and Thomson (2011)[7], were among the first to define social licence to operate in terms of legitimacy and trust and to also propose that it promotes reputational benefits for businesses. They envisaged the building up of a social licence as requiring organisations to move up from economic and socio-political legitimacy to interactional and institutionalised trust (see table below). This signalled the move from satisfying short-term stakeholder requirements to building long-term relationships for the benefit of both stakeholders and the organisation.

Table 1 – Four building blocks for developing a social licence to operate

Level & Label	Description
1. Economic legitimacy	The perception that the project/company offers a benefit to the perceiver.
2a. Socio-political legitimacy	The perception that the project/company contributes to the well-being of the region, respects the local way of life, meets expectations about its role in society, and acts according to stakeholders' views of fairness.
2b. Interactional trust	The perception that the company and its management listens, responds, keeps promises, engages in mutual dialogue, and exhibits reciprocity in its interactions.
3. Institutionalized trust	The perception that relations between the stakeholders' institutions (eg the community's representative organizations) and the project/company are based on an enduring regard for each other's interests.

Source: Boutilier and Thomson, 2011

[4] *The social responsibility of business is to increase its profits*, Milton Friedman, The New York Times Magazine, 13 September 1970

Society is increasingly asking the investment industry to play its part through investing sustainably – balancing time horizons and stakeholders. In his keynote address at OPTrust's 2018 Climate Change Symposium, Roger Urwin notes, "the social licence to operate for all asset owners and asset managers is the tacit social contract that gives legitimacy to asset owners depending on their actions and impacts"[8].

A brief sidestep to the UN sustainable development goals

It is perhaps useful to mention here the UN's sustainable development goals (SDGs) which provide a useful vision for organisations and governments that seek to contribute to wider society, strengthening their social licence to operate. This set of targets and indicators, agreed by 193 member states, provides a clear indicator of a range of social, economic and environmental challenges faced by our world today. With goals such as reducing inequality, ending poverty and hunger and making sustainable cities and communities, the SDGs point to a common language which organisations and the great majority of economies can rally around. The UN has put out a strong call to action for organisations to play a fundamental role in achieving the SDGs[9] – it will be up to individual organisations, perhaps with influence from stakeholder groups, to decide whether to take up the challenge of addressing some of the most pressing issues in our world today.

We know that social licence can persist for a long time before being lost based on changing perspectives in society (think the tobacco industry). This calls for organisations in the investment industry to become more attuned to the expectations of stakeholders and to be adaptable to changes.

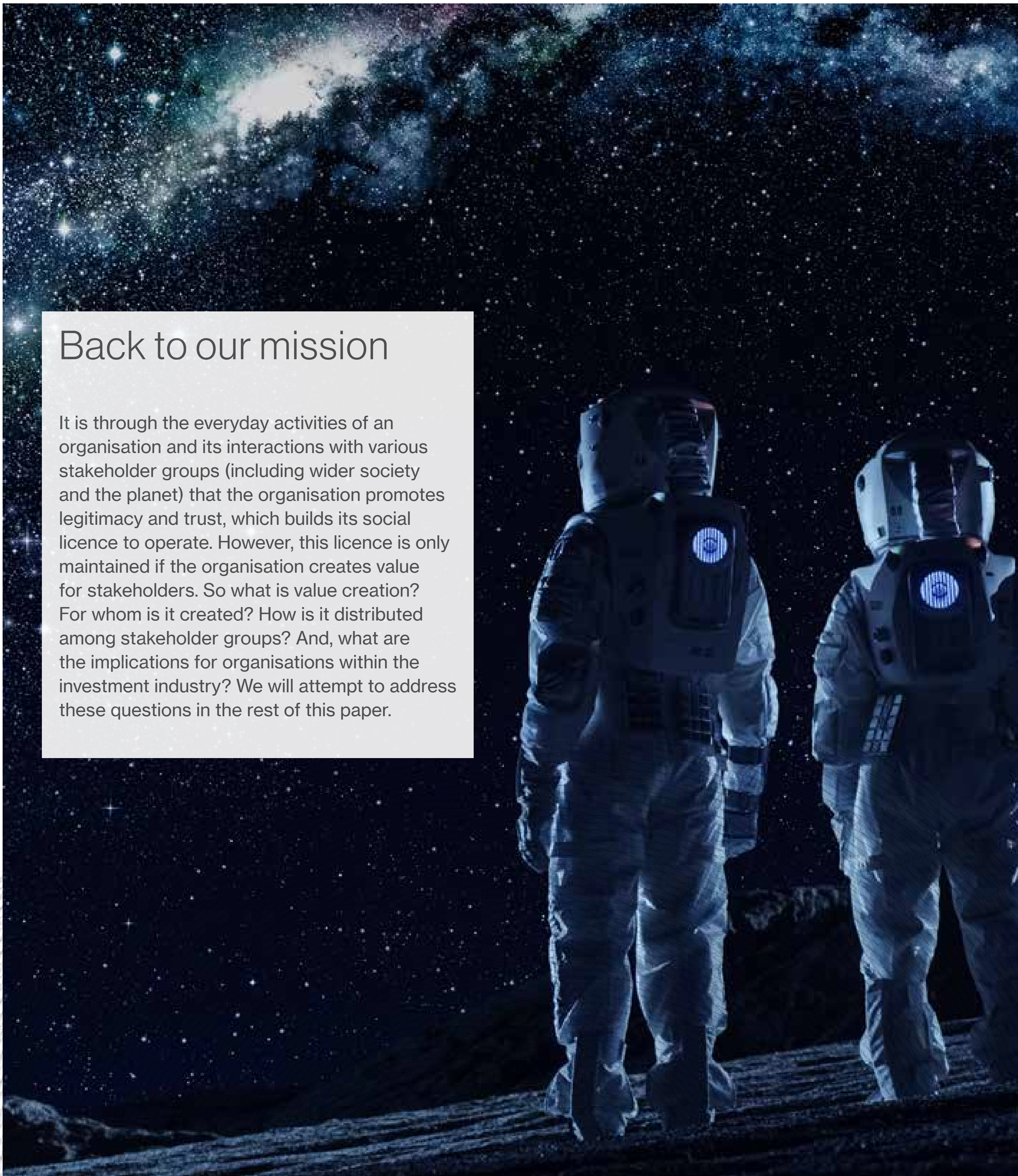
[5] *Social licence to operate: legitimacy by another name*, Gehman et al, 2017

[6] *The social licence to operate: a critical review*, Moffat et al. 2016

[7] *Modelling and measuring the social licence to operate: Fruits of a dialogue between theory and practice*, Boutilier and Thomson, 2011

[8] *The returns investors need can only come from a system that works*, Roger Urwin. Keynote address at OPTrust Climate Change Symposium, 19 November 2018

[9] *The SDG investment case*, UN PRI, 2017



Back to our mission

It is through the everyday activities of an organisation and its interactions with various stakeholder groups (including wider society and the planet) that the organisation promotes legitimacy and trust, which builds its social licence to operate. However, this licence is only maintained if the organisation creates value for stakeholders. So what is value creation? For whom is it created? How is it distributed among stakeholder groups? And, what are the implications for organisations within the investment industry? We will attempt to address these questions in the rest of this paper.

The journey: exploring key concepts of value creation

What is value creation?

Milton Friedman's position on the dominance of shareholder financial value has since been attacked by many critics. In 1994, John Elkington, coined the phrase "the triple bottom line" to argue that corporations should not only focus on the economic value that they add, but also on the environmental and social value they add (and/or destroy). Porter and Kramer (2011) argued that the competitiveness of a company and the health of the community around it are mutually dependent, calling for shared value as necessary for reshaping capitalism and its relationship to society[10]. Robert Eccles and Tim Youmans (2015) also tackled the idea that shareholder value should not be the objective of a company but the outcome of the company's activities in keeping with its objective to survive and to thrive[11]. And Nobel Laureate Oliver Hart and Luigi Zingales (2017), although agreeing with Friedman's basic premise, argued that directors have a fiduciary duty to maximise shareholders' welfare, not value, which may also include "prosocial aims"[12]. In other words, value creation is a bigger concept than a financial return.

In the first paper of this series, we progressed the concept of the need for organisations to think about how they create "system value"[13]. A system value perspective places a business within society and places society within the environment. This perspective shows that a business cannot be considered as independent from society or the environment. It will affect (and be affected by) both of them – for better or for worse. As a working group, we see the investment industry as vital to the well-functioning of modern society and we recognise its interconnectedness in providing wider societal value. For example, the industry contributes (indirectly) to the wider economy through supporting jobs, communities, product innovation and capital and infrastructure spending. Yet, the fulfilment of the industry's purpose should be judged by its impact and by the value it creates. This brings us to the often asked question: what is value creation?

Our definition

We propose the following definition of value creation:

Value creation is an increase in the stock of monetary and non-monetary resources used to create future wealth and well-being for stakeholders, as judged by observers, mindful of the passage of time.

This seemingly simple definition requires some unpacking – it is laden with sub-text and it has taken us as a working group almost eight months to work through. We break down this definition into five key components:

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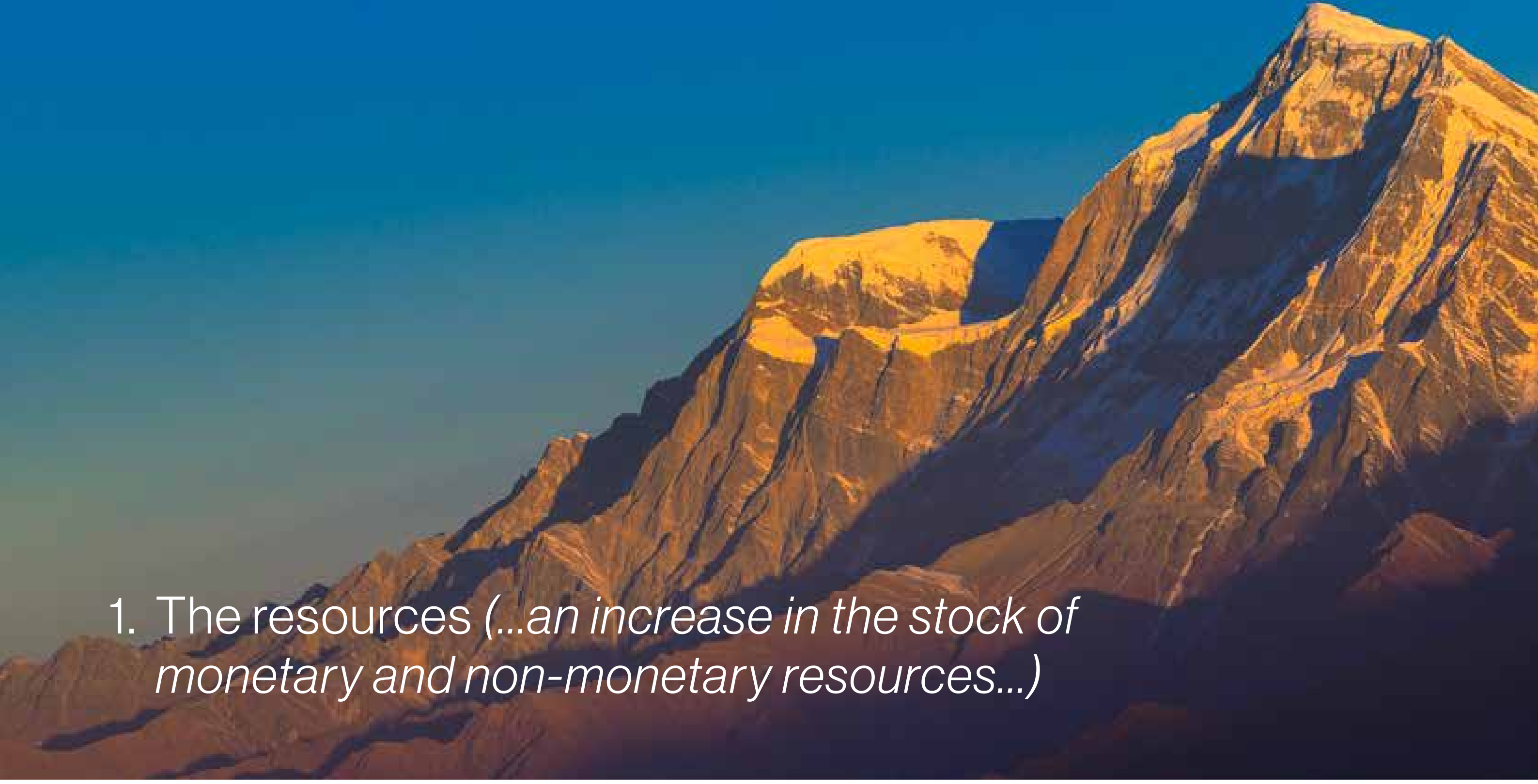
[10] Creating shared value, Michael Porter and Mark Kramer, Harvard Business Review, February 2011

[11] Why boards must look beyond shareholders, Robert Eccles and Tim Youmans, MIT Sloan Management Review, 2015

[12] Companies should maximize shareholder welfare not market value, Oliver Hart and Luigi Zingales, working paper, July 2017

[13] For further information see papers, *Connecting the dots: understanding purpose in the investment industry,* Thinking Ahead Institute, 2018 and Creating system value: concept note, Future-Fit Foundation, April 2017



1. The resources *(...an increase in the stock of monetary and non-monetary resources...)*

In December 2013, the International Integrated Reporting Council (IIRC) published its integrated reporting (<IR>) framework with the aim of "aligning capital allocation and corporate behaviour to the wider goals of financial stability and sustainable development". The framework allows organisations to communicate how their "strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term". Central to the concept of value creation is that organisations depend on various forms of resources or capitals – financial, manufactured, intellectual, human, social and relationship and natural – as inputs into their business models[14]. These monetary and non-monetary resources are stocks of value that are transformed, and either increased or decreased through the organisation's activities.

Table 2 — The IIRC six 'guideline' capitals

Capitals	Description
Financial	Pool of funds available to be used in the production of goods/services; obtained through financing or generated through operations and/or investments
Manufactured	Manufactured physical objects available for use in the production of goods/services (eg buildings, equipment, infrastructure etc)
Intellectual	Knowledge-based intangibles eg intellectual property, organisational capital (systems, protocols etc.)
Human	Individuals' competencies, capabilities, ecperience and their motivations to innovate. Includes individals' alignment with organisation's governance framework, understanding of strategies, ability to lead, manage and collaborate
Social and relationship	Organisation's relationships with communities, stakeholders and other networks; ability to share information to enhance organisation and collective well-being
Nautral	Environmental resources and processes that support prosperity of the organisation, eg land, water, biodiversity, health of the eco-system

[14] These are the six capitals suggested by the IIRC, but businesses are free to choose, and name, the capitals that are most relevant to their own context. The only point is that the capitals should be comprehensive.

2. A test of human fitness *(...used to create future wealth and well-being...)*

"There is no wealth but life",

John Ruskin, English social thinker, 1860

Harvard professors, Robin Greenwood and David Scharfstein note the significant expansion in the financial sector over the last 30 years. This growth is apparent whether one measures the sector by "its share of GDP, by the quantity of financial assets, by employment, or by average wages". At its peak in 2006, "financial services contributed 8.3% to US GDP, compared to 4.9% in 1980"[15] and financial services employees earned an average of 70% more than their counterparts in other industries. This suggests that both owners and employees have done very well – the industry has done a good job in creating wealth, if not well-being, for these stakeholder groups.

But has wider society benefited from the significant growth of the financial sector? Past chairman of the UK's financial regulatory body, Lord Adair Turner, notes "there is no clear evidence that the growth in the scale and complexity of the financial system in the rich developed world over the last 20 to 30 years has driven increased growth or stability, and it is possible for financial activity to extract rents from the real economy rather than to deliver economic value"[16]. Similarly French economist, Thomas Philippon, argues that despite a tenfold increase in productivity in the broader economy over the past 130 years (primarily due to technology), there was no improvement in the cost of financial intermediation even when adjusting for the greater complexity in lending today[17].

So the industry, and organisations within it, may provide considerable fitness for some stakeholder groups at the expense of others. It is difficult to argue that shareholders, as owners of the company, are not in the most privileged position. This is where companies tend to focus their value adding activities. But as previously argued organisations are a sub-component of the society and environment in which they operate – the success of a company cannot be separated from its wider surroundings. Shareholders' welfare is most sustainably looked after if due regard is paid to the well-functioning of (and value added to) wider stakeholder groups. To achieve this, organisations need to (i) develop their understanding of what stakeholders value with the aim of improving both wealth and well-being and (ii) develop policies and actions to meet these expectations in line with its stated vision.

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[15] *The growth of finance*, Robin Greenwood and David Scharfstein, Journal of Economic Perspectives, 2013

[16] *What do banks do? Why do credit booms and busts occur and what can public policy do about it?*, Chapter 1 in The Future of Finance, edited by Adair Turner et al. London School of Economics, 2010.

[17] *Has the US Finance Industry Become Less Efficient? On the Theory and Measurement of Financial Intermediation*, Thomas Philippon, 2012.

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

Stakeholders	What do stakeholders value? (Eg…)	Organisations should develop policies and actions that…
Shareholders	Financial reward (margin/growth); stewardship/influence; reliability of forecasts	Improve the wealth of owners through capital growth and/or cashflows
Employees	Salary and benefits; safe working conditions; training programmes to improve skills; collegiate atmosphere; development of a strong culture to improve sense of belonging	Attract, retain and develop employees and teams
Clients	Financial planning, risk management, compounded wealth, longevity protection, conversion of wealth to consumption; AO/AM: development of long-term relationships	Deliver value to clients in all services and products
Suppliers/intermediaries	Participation in networks to promote/improve the industry	Build integrity and trust with suppliers and intermediaries
Government	Viewed as a value-adding partner (regulation, apprentice schemes, social safety net); fines & taxes paid	Adhere to, or improve on, regulations/guidance and pay the fair amount of tax
Society	Internalisation of externalities; cross industry relationships which benefit society	Contribute to the development of a progressive social contract (licence to operate) and healthy cross industry relationships
Planet	Regenerative policies	Do no harm to, or improve, the natural and human resources of our planet

3. The value creation boundary: introducing the haves and the have-nots *(...for stakeholders...)*

"There are no side effects – just effects... [Side effects] are just a sign that the boundaries of our mental models are too narrow, our time horizons too short",

Professor John Sterman, Director of MIT System Dynamics Group

A thought experiment

It is worth stating up front that, for us, the value creation boundary is an abstract concept rather than an actual, discoverable thing. It is more of a thought experiment and so its value lies in how it might change our thinking and worldview.

We start by asserting that we value order in our lives. We will pay to have our homes cleaned, but not to have them messed up. It is similar for goods. We will pay up for the highly-ordered final product, but not for the raw materials it is made of. Next, we note that economics has long recognised the concept of externalities – costs or benefits that fall on people not directly involved in the economic activity. From here two things follow. First, that there is a value creation boundary which lies between these innocent bystanders, and the parties involved in the economic activity. Second, that value is created inside the boundary and destroyed outside it. In other words, the externalities are, in aggregate, negative. Several questions spring to mind: who are the insiders, and who are the outsiders, and do they tend to be the same people? Where should we draw the boundary, and are there consequences to that decision?

Where to draw the boundary?

The tightest local boundary we can draw is around a single individual, for a single good or a single service. So we derive value from our homes being cleaned but tend not to think about the impact outside our boundary. These impacts include, first, the production of chemicals used to clean our homes, and their escape as waste; second, our share of CO2 emissions from the electricity powering the vacuum cleaner; and, third, the fact that most of the vacuum cleaner will end up in land fill at the end of its life. Having considered our impact outside the boundary we have a choice to ignore it, or to adjust our cleaning mandate (only lemon juice and vinegar? More sweeping and less vacuuming?).

Switching to the widest pragmatic possibility, we could draw the boundary around the earth's atmosphere. Expanding the value creation boundary to this fullest practical extent echoes the logic of ecological boundary conditions and arguably is at the true heart of sustainability. In this framing, we recognise the earth as a largely-closed system (so a good idea to maintain the life-support systems) with the free input of solar energy, and the ability to costlessly dump excess heat into the universe[18].

[18] Given the size of earth relative to the universe this would appear to be a sustainable strategy for the 5 billion or so years before earth is consumed by the expanding sun. We also obey the second law of thermodynamics as the increase in entropy (our excess heat) is carried by the universe

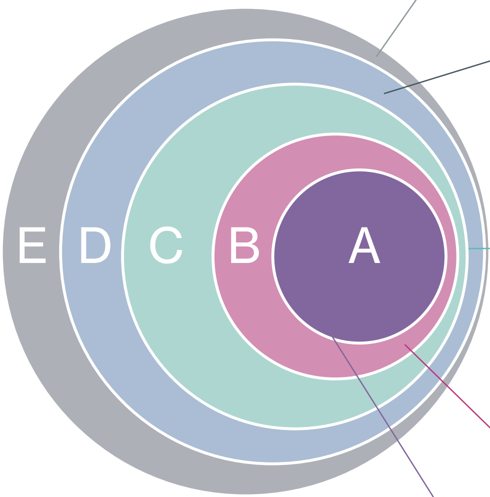
There is a growing recognition of the validity of ecological boundary conditions. The ecological ceiling representing the outer ring of Kate Raworth's 'doughnut' is based on the scientific paper published by Johan Rockström in 2009[19]. Due to the scientific foundation of these boundary conditions we do not need a values-based discussion to support them. We accept that beliefs may differ but, by definition, valid beliefs must be consistent with the available data, and so the range of disagreement is constrained.

The logic of the value creation boundary is that the more tightly we draw it (implicitly or explicitly), the larger the domain over which we are having a negative impact (this doesn't mean the negative impact gets bigger). Further, this engenders an adversarial, negative-sum environment. To create value for 'our' group, we need to be able to dump harm on some other group. However, the other groups know this, and have the same incentives. In case this is too abstract, think about the choice between divestment and engagement. Divestment is nothing other than the discovery of a value creating opportunity for a group by dumping the unattractive securities on another group. Not wrong, but not positive sum either. Engagement runs the risk of still holding securities with a collapsing value before business models can be adapted. But it can be a positive sum activity, and it signals a 'wider boundary' mindset.

The more we expand the boundary the more of humanity we include. This carries the advantage of reducing the antagonism between groups, but the substantial disadvantage of removing cheap dumping grounds for the waste of the economic activity we invest in. By drawing the value creation boundary around the atmosphere to include all of humanity, we are saying that value must be created for all humans, not just subsets. This is the social foundation, and inner ring, of Raworth's doughnut. It is also the UN's sustainable development goals. Accepting some degree of responsibility for these social goals is necessarily (but not exclusively) values-based. And values can legitimately vary widely. For our part (authors and working group), we believe that all investment organisations should develop the beliefs and values to support this social floor, as well as the ecological ceiling, in addition to having a stated vision which makes clear how much value flows to which stakeholders (and which are ignored).

[19] A safe operating space for humanity, Johan Rockström et al, September 2009

Defining value creation boundaries



E: Planet
Largely-closed system which maintains all life

D: Wider society
Society: shift of mindset to see 'the interconnectedness of all things' for example a greater focus on humanity's needs (eg SDGs) as a potential source of long-term value (larger market)

Government: shift of mindset from compliance only/no effort beyond legal duties to viewing government as a value-adding partner (regulation, apprentice schemes, social safety net)

C: The investment industry
Suppliers/other investment firms: shift of mindset from transactional relationships to mutually beneficial relationships with other investment firms/suppliers, perhaps with the aim of strengthening the influence of the industry

B: My organisation
Employees: recognition that employees contribute to the success of the company and need to be developed and nurtured; war for talent/increased costs

Clients: recognition that client focus is necessary for financial success: competition with others for clients/reduced margins

A: Shareholders: concentrated effort on financial outcomes, clients, employees and other outer rings are secondary activities. Consistent with Friedman's view that the social responsibility of a business is to increase its profits

Environmental damage as the ultimate externality

The term *externalities* has become deeply embedded in the jargon of business, but often escapes common understanding (which is ironic given that it is the everyperson that is often most affected). Externalities are the unpriced costs of production or consumption that fall on unrelated parties, which could be other companies or society more generally[20].

Arguably the most important externality is the environmental cost caused by climate change, resource depletion and pollution. In 2009, S&P Global's Trucost attempted to quantify the cost by looking at the financial risk of unpriced natural capital inputs to production. In its publication, *Natural capital at risk: the top 100 externalities of business*, Trucost estimated that primary production and processing centres had unpriced natural capital costs of approximately US$7.3trn, equivalent to 13% of global economic output[21]. The majority of this came from greenhouse gases, water use and land use. Shockingly, the report noted that "no high impact region-sectors generated sufficient profit to cover their environmental impacts" suggesting that these impacts are left to fall on other stakeholders by design. In a similar study, the UN Principles for Responsible Investing (UNPRI) estimated that the top 3,000 public companies caused over US$2.15trn in environmental damage, equivalent to one-third of global environmental costs.

The report notes that "in a hypothetical investor equity portfolio weighted according to the MSCI All Country World Index, externalities could equate to over 50% of companies' combined earnings"[22]. As the complexity and connectivity of the investment landscape increases, so also will the size and impact of its externalities.

In *Doughnut Economics*, Raworth points to the narrow focusing of modern day economics on labour and capital, subsuming the importance of the earth as "just another capital". She calls for a broader definition of the economy, to include not just households and markets but also the state and publicly shared resources (described as 'the commons'). This four-pronged economy is embedded within, and therefore dependent upon, society and the earth. As a result, the economy depends upon the earth as a source of resources and as a sink for its wastes. As noted by Raworth, "many economic effects that were treated as externalities...have turned into defining social and ecological crises". This is a critical point. If the earth is considered for the most part a closed system (materials only cycle within it), then any externalities by organisations and markets are absorbed by wider society and ultimately the planet. This implies that there are value creation boundaries, within which value is created and outside of which value is destroyed.

[20] Strictly speaking, externalities can have either positive or negative effects on unrelated parties. However, they are often associated with negative consequences, whereas the related term 'spill-overs' is often associated with positive benefits.

[21] *Natural capital at risk: the top 100 externalities of business*, Trucost, 2013

[22] Universal ownership: why environmental externalities matter to institutional investors, UNPRI, 2008

4. Necessary subjectivity *(...as judged by observers...)*

The assessment of whether value has been created has a quantitative component – the extent of increase or decrease of each individual capital/resource – and a qualitative component – a subjective weighting of the capitals and a view on how these capitals are valued. How much does a stakeholder group value the development of a company's human and intellectual capital? Presumably the answer will be different for different observers, with employees likely assigning a higher weight than customers would. At the most granular level, each individual will have their own unique set of weights for each of the capitals. One shareholder may see an increase in human capital as a necessary investment in the future of the business, while another may see it as an unnecessary dilution of current financial return. This suggests that value creation, to some extent, is 'in the eye of the beholder'.

For many organisations, this will be a challenging observation. For long, value creation in the financial services industry was viewed as the result of winning the competition on organisational efficiency and functional excellence. Better operations, better distribution networks, better servicing – all were seen as main factors in improving market share, creating value for customers and therefore creating shareholder value. Current metrics were often developed in relation to an organisaton's own financially driven objectives: how much return have we added above the benchmark? How many clients did we win? How much has our business grown? But, as argued in Melnick, Nayyar et al's 2000 paper, *Creating value in financial services*, customers do not care about functional excellence, nor do they care about whether an organisation has unique resources to take advantage of scale or networks. Customers care about whether the product or service is of utility to themselves and (in some cases) to wider society.

This observation leads us to a natural conclusion: understanding stakeholder needs[23] is a vital input to the determination of value and should be an integral part of developing an organisation's mission. This signals the need to develop organisational strategies that focus on anticipating, understanding and responding to stakeholder needs and developing long-term relationships with them. In effect, improving the social licence to operate. The verdict on whether value is created will be determined by how well organisations can narrow the gap between their functional activities and how these activities are perceived by stakeholders to add value.

5. Time *(...mindful of the passage of time)*

Value creation emerges over time. For immediate consumption goods/services (food, restaurant meal, experiences, etc) the time frame is relatively short. For durable goods and some services (such as DC pensions) the time frame can run into decades. Value creation is therefore linked to the stakeholder's experience over time relative to expectations. Only at the point of ultimate outcome (replacement of long-serving washing machine, or death of DC pensioner) can a definitive assessment of value creation be made. Before that point, value creation is a current and prospective concept.

We therefore suggest that any assessment of value creation should comprise a current/backward-looking element (such as a scorecard, an example of which we discuss later in this paper) and a forward-looking component (such as an "integrated story that explains how all of their resources are creating value" per the International Integrated Reporting Council's (IIRC) framework). In the next section, we introduce two possible tools which we believe will be useful to organisations to better understand the value they create and/or destroy: a self-assessment framework and a monitoring scorecard.

[23] In the widest possible sense, stakeholder needs also include those necessary to maintain a sustainable planet.

Does value creation survive the growth imperative?

"The day is not far off when the economic problem will take the back seat where it belongs, and the arena of the heart and the head will be occupied or reoccupied, by our real problems – the problems of life and of human relations, of creation and behaviour and religion"

John Maynard Keynes

"Global economic growth has peaked, says the World Bank". This was the stark warning issued by the Financial Times to readers based on the World Bank's 2018 report, *Global Economic Prospects*. The report highlights that "longer term, slowing potential growth...puts at risk gains in improving living standards and reducing poverty around the world". The solution? In the words of World Bank director, Ayhan Kose, "policymakers will need to consider new approaches to sustain the growth momentum...specifically productivity-enhancing reforms...". In other words, governments need to try harder to ensure the maintenance of growth.

However, common sense suggests two things:

i. Growth cannot go on forever: consider two options for growth – exponential (where the growth rate is consistently positive until the point of collapse) and sigmoidal/S-curve (where growth starts slowly, accelerates for a while before decelerating to a zero growth rate)[24]. Considering an exponential model, the current growth trajectory suggests that the global economy would be "three times bigger by 2050, over ten times bigger by 2100 and almost 240 times bigger by 2200"[25]. However we know growth stops when resources cannot be extracted from the environment fast enough. Therefore, one must conclude that over the very long term, the only sustainable growth rate is 0% per annum.

ii. A positive GDP growth does not always mean a more prosperous society. The global economy has quadrupled in size since the 1970s. Yet this has coincided with an increase in inequality. The statistics are familiar: as of 2017 the world's richest 1% owned 82% of new wealth created (0% went to the world's poorest 50%); around 56% of the global population lived on between $2 to $10 a day[26]; and the risk of a child dying before five years old was eight times higher in Africa than in Europe[27]. Donella Meadows, environmental scientist and lead author of the influential book, The Limits to Growth, asks some poignant questions: "growth for what, and why and for whom, and who pays the cost, and how long can it last, and what's the cost to the planet, and how much is enough?"[28]

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[24] A third growth dynamic that comes to mind is chaos – the classic example here is the growth in a rabbit population on an island, with unpredictable booms and crashes.

[25] *Doughnut Economics*, Seven Ways to Think Like a 21st-Century Economist, Kate Raworth, Penguin Random House, 2017

[26] *Reward work, not wealth*, Oxfam briefing paper, 2018

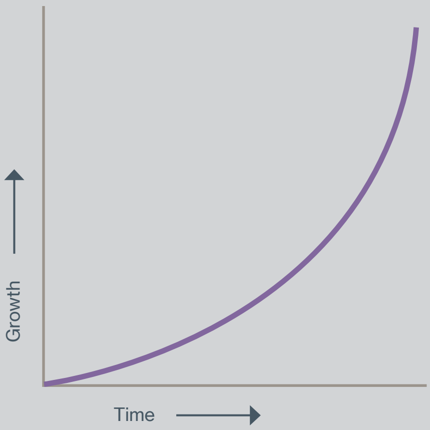
[27] *Under 5 mortality*, Global Health Observatory data, World Health Organisation. Accessed on 7 November 2018.

[28] *Sustainable systems*, Donella Meadows. Lecture at the University of Michigan, 1999

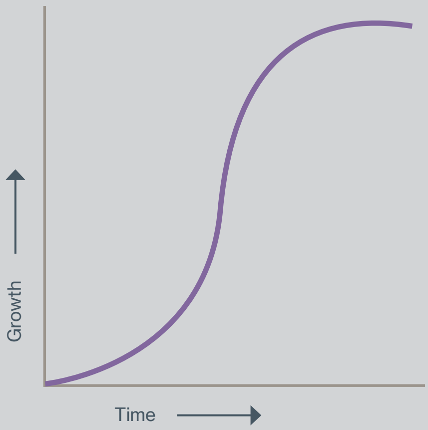
So if we establish that there are limits to growth, it begs the question, are there limits to value creation? Unlike growth which stresses resources available, value can be created time and time again through innovation, changing perspectives and beliefs and genuinely satisfying a human need (the fitness test). It does not mean that value creation requires no effort[29], but it suggests that we are able to continuously create value for individuals through improvements in knowledge. The indefinite increase of knowledge seems plausible, given that the more discoveries we make the more recombinations of them can be made, to yield yet further discoveries.

So we believe that value creation can survive the snares of the growth imperative. Growth must be considered as the means to an end; the primary focus should instead be to the improvement of the human and planetary condition. However, our point is perhaps better summarised by British philosopher John Stuart Mill who wrote in 1848 “a stationary condition of capital and population implies no stationary state of human improvement. There would be as much scope as ever for all kinds of mental culture, and moral and social progress; and much room for improving the art of living...when minds ceased to be engrossed by the art of getting on”.

Two pathways for GDP growth



Exponential (unsustainable)



Sigmoidal (sustainable)

[29] Indeed the 2nd law of thermodynamics states that total entropy (disorder) in an isolated system, will always increase over time. Put simply, without effort, value will eventually diminish. It is worth nothing that much of our thinking as a working group on value creation started off with Eric Beinhocker’s three conditions of value creation (irreversibility, entropy and fitness) expressed eloquently in his seminal book, *The Origin of Wealth*, 2017.

Absolute versus relative value creation

One of the questions we grappled with in the working group was whether there could be an absolute measure of value creation. Is it possible to objectively and unarguably declare that a business has created value, or must we take the more subjective viewpoint of a particular stakeholder or observer? This deep and perhaps philosophical question echoes the musings of English philosopher, George Berkeley, on whether a falling tree makes a sound if no one hears it.

We posit that there can be no unambiguous single determination of value as value creation will always be subject to the test of whether it is perceived as such by different observers. Value creation emerges over time and different stakeholder groups will have different time horizons and expectations, making it difficult for an organisation to declare value has been created for all groups at any given point in time. To clear this impasse, we believe that organisations need to:

i. *Be intentional:* an organisation's mission, policies and behaviours need to align with its intention to create value for stakeholder groups

ii. *Be transparent:* organisations should provide both objective and subjective metrics to stakeholders on how value is created. Transparency helps stakeholders to understand how value is created, and to narrow any gap between stakeholder expectations and the ultimate outcome they receive. This may require the use of both 'hard' and 'soft' data (see sidebar for further information).

In this paper, we set out some tools that organisations can use to better meet stakeholders' expectations, including some guidelines for organisations reporting on their value creating activities.

The use of hard and soft data

- 'Hard data' is information/quantifiable data that is generated from sensors, machines, and other devices that provide accurate measures of status or change.
- 'Soft data' is information/qualitative data that is generated from people's subjective assessment and is susceptible to interpretation and opinion.
- Soft data is potentially less valuable than hard data because of its adjacency to and approximation to the desired measure which qualifies its accuracy.
- That said, soft data may be more valuable in getting some (qualified) information on material factors that could never yield hard data because of unobservability or because the factor would change if you observed it.
- As access to data continues to grow, businesses will need to incorporate both hard and soft data into their solutions for improved, real-time decision support as a way to build the quality of their product or service offerings.

Back to Earth: implications for the investment industry

Understanding the disconnects

So what can investment organisations do? We have previously argued that investment organisations 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. For large assets owners (AOs), this may involve a shift to a more universal owner mindset and accompanying behaviour and for smaller AOs, it may involve strengthening their values and beliefs on environmental, social and corporate governance policies. For intermediaries, this may involve improved transparency of cost structures and for asset managers (and asset owners) changing incentives structures and mandates so that more effort goes into managing through-time risk and less in cross-sectional, or point-in-time risk. But in general, it involves organisations better defining, measuring and monitoring their value creating activity. This requires a redefinition of the industry's purpose and a critical look at an organisation's mission.

Redefining the industry's purpose

"End savers should be left in a world fit to retire in; they should enter the industry hopeful and exit satisfied".

TAI value creation working group, 2018

We have previously written about POSIWID (the purpose of a system is what it does) as a tool to better understanding the industry's purpose[30]. POSIWID counters the notion that we can infer the purpose of the industry from the intentions of those who design, operate, or regulate it. Instead, if we want the industry to change, we need to be the drivers of the change and we need to address what the industry actually does.

But does the industry need to change? According to the Financial Conduct Authority, the UK's regulatory body, yes it does[31].

And change has also been called for by the public and industry professionals alike. The general public, as represented by the Edelman Trust Barometer ranked financial services the least trusted industry for 2018[32]. And we know from a comparison of the Thinking Ahead Institute's 2018 and 2015 investment industry scorecards, there was very little change in how poorly viewed the industry was across the themes of alignment, costs and efficiency by investment professional themselves.

The industry is grappling with some key challenges: short-termism, misaligned interests, complex markets and weak decision-making by the end saver. The industry is also uniquely poised to invest capital and ensure the effective stewardship of businesses. We believe this mix creates the ideal conditions for the industry to reconsider its value proposition and what it actually does – or rather, should do – for the end saver. And it seems logical to start by developing a better understanding of what end savers need.

[30] See our paper *Connecting the dots: understanding purpose in the investment industry*, Thinking Ahead Institute, 2018

[31] The Financial Conduct Authority's June 2017 report, *Asset Management Market Study*, contains the results of its two-year long review. The report found "weak competition in a number of areas of the asset management industry...high levels of profitability, with average profit margins of 36% for [sampled] firms, no clear relationship between charges and the gross performance of retail active funds...concerns about how asset managers communicate their objectives...and investors' awareness and focus on charges is mixed and often poor". Of intermediaries they identified "concern in the investment consulting market... [including] relatively low switching levels and conflicts of interest".

[32] This was no improvement on the 2014 results which we featured in our paper, titled *Our industry has a problem*.

Understanding end savers' needs

In our paper titled, *DC: the movie*, we tried something different. We expressed the challenges faced by the end saver through the eyes of a fictional character, Todd, an everyman. Todd faced alternative futures in retirement: poverty or lifelong comfort. And the difference was all up to Alice. Alice, CEO of a DC mastertrust/multi-employer plan, wanted to restructure the trust with the aim of managing members' whole-of-life journey, rather than growing a pot of assets to the point of retirement.

Following Todd's narrative, we suggest that end savers needs can be placed into five primary categories: (i) financial planning, (ii) compounded wealth (which involves the supporting actions of safekeeping, accurate administration, risk management, investment); (iii) conversion of wealth to consumption, (iv) longevity protection, and (v) having a world fit to retire in. The last point is unconventional but important. It signals the contribution that the investment industry must make to wider society in exchange for the resources used. It also subscribes to the concept that 'the benefits we pay are worth more in a world worth living in'.

A bold vision for the investment industry: redefining fiduciary duty

As a working group, we propose a bold vision for the industry:

The investment industry should aim to provide whole-of-life, whole-of-balance-sheet management for end savers. At a minimum, this activity should cause no harm, and will be truly valuable if it contributes to a world more fit to live in. As such, the industry has a duty to ensure its provision of new capital, and its stewardship of existing assets add value to the end saver, wider society and the planet both now and, as far as it is able, into the future.

We recognise that we have a long journey ahead of us to achieve this vision and it is likely to involve a broader interpretation of fiduciary duty than is currently practiced.

Roger Urwin, in his article titled, *Pension fund fiduciary duty and its impacts on sustainable investment*[33], notes that fiduciary duty in the UK and US has "developed through common law origins to exert particular influences on pension fund practices". However, he points to four principal forms of obligations:

1. Loyalty: putting the interests of beneficiaries first when determining the investment strategy and avoiding conflicts of interest
2. Prudence: investing to the standard of a prudent expert
3. Diversification: diversify according to the principles of accepted investment theory[34]
4. Impartiality: avoid favouring the interests of a particular beneficiary or class of beneficiaries over others.

These forms of obligations present two particular challenges for asset owners. First, that they are subject to interpretation and expert opinion will differ on their correct application – this has led to peer practice as the dominant paradigm. And second, appropriate interpretation will change as investment principles, practices and circumstances evolve, and so "it is reasonable to anticipate some changing context to fiduciary duty. No strict interpretation of fiduciary duty would be expected to fix the concept in time".

These two points present a challenge for investors given the growing significance of sustainable investing. It is unrealistic to expect acceptable results from dealing with the future on a year-by-year basis while taking a narrow view of macro risk factors. To be successful, investors now need to incorporate longer time horizons and adapt to anticipate the structural changes coming from economic and environmental, social and corporate governance (ESG) factors.

However, there still remains great uncertainty over the extent of an investors' fiduciary duty in relation to ESG. Following the critical review of the UK equity market by Professor John Kay, the Law Commission was asked to investigate whether the current practice of fiduciary duty works in the interest of the ultimate beneficiaries. The report, *Fiduciary duties of investment intermediaries*, suggests that pension fund trustees often had a narrow interpretation of their fiduciary responsibilities, focusing on maximising financial returns over the short term. This was often to "hide behind risk-averse legal advice, designed to protect the adviser and client rather than to provide guidance as to the proper discharge of fiduciary duty"[35]. In March 2017, the Pensions Regulator issued strong guidance stating that financially material ESG factors should be taken into account in decision making for both DB and DC pension schemes. And indeed, in a follow up report by the Law Commission, *Pension funds and social investment*, it notes that "[fiduciary] law permits pension trustees to make investment decisions that are based on non-financial factors (such as environmental and social concerns), provided that (i) they have good reason to think that scheme members share the concern and (ii) there is no risk of significant financial detriment to the fund"[36].

In the US, interpretation of considering ESG factors in investment strategies is more varied. However, in a recent *Field Assistance Bulletin* published by the US Department of Labor it notes "if a fiduciary prudently determines that an investment is appropriate based solely on economic considerations, including those that may derive from environmental, social and governance factors, the fiduciary may make the investment without regard to any collateral benefits the investment may also promote…Fiduciaries must not too readily treat ESG factors as economically relevant…A fiduciary's evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons". This places a relatively heavy burden on fiduciaries to prove, in the short term, that often difficult to price ESG factors are financially relevant.

[33] See chapter 21 in Cambridge handbook of institutional investment and fiduciary duty. Edited by Hawley et al., Cambridge University Press, 2014.

[34] We would add that there is a difference between point-in-time (cross-sectional) diversification and through-time (valuation-sensitive, or risk budget) diversification. We would further argue that the first represents common practice, whereas fiduciary duty in most cases is more about the second.

[35] *Fiduciary duties of investment intermediaries*, Law Commission, 2014. See also the report, *Protecting our best interests: rediscovering fiduciary obligation*, FairPensions

[36] *Pension funds and social investment*, Law Commission, 2017

It is easy to understand from these two examples why fiduciaries struggle to effectively incorporate wider societal and environmental factors when carrying out their duties. However, we go back to one of the key roles of the fiduciary – to put the interests of the beneficiary first. In an increasingly complex and interconnected world, this must involve consideration of (i) less traditional risk factors, which would involve a range of ESG considerations impacting risk and return and (ii) increasing recognition that end savers and organisations are embedded within wider society and the planet. The latter point suggests that end savers are not only concerned about the return on their investments at a point in time but whole-of-life wealth management which contributes to their wealth and well-being.

It is our belief that, while investment and fiduciary duty has been framed as a two-dimensional problem (risk and return), it has always been a three-dimensional problem of risk, return and impact. The business models that are funded (the search for return) throw off externalities to a greater or lesser extent (they have an impact). The discussion regarding fiduciary duty is therefore whether the impact dimension should continue to have a zero weight in decision making, or whether beneficiaries' interests would be better served with a moderately positive weight.

Increased value or increased valuation – what's the difference?

What are the artefacts in investment? To clarify this question, Eric Beinhocker in his 2006 book, The Origin of Wealth, argues that value is only created if "economic transformations and transactions produce artefacts and/or actions that are fit for human purposes". So, what value do we deliver to stakeholders in the management of investment portfolios?

Arguably, beating a market benchmark in and of itself is not a value creating transaction. If the outperformance reverses in the next period then it would have been premature to declare that value had been created in the first period (and yet many fee and bonus structures require such a declaration at a point in time). There is a difference between an increase in the valuation of an investment portfolio and the broader consideration of whether the portfolio has added value to various stakeholder groups. For the end saver value is better thought of in money-weighted terms – are there more dollars in the account than would have been there under a different process? And in most cases, value for the end saver is about how much income the dollars in the account will purchase. If the price of buying an income stream is increasing faster than the portfolio valuation, the industry is not adding value for the end saver. The focus should instead be on maintaining, or preferably growing, a saver's income-purchasing-power.

Redefining your organisation's vision

Putting stakeholders at the heart

"The purpose of a great company is its reason for being. It defines its existence and contribution to society. It determines its goals and strategy. Underlying it is a set of values and beliefs that establish the way in which the company operates. Purpose is as fundamental to a corporation as our purposes, values and beliefs are to us as individuals"

Big Innovation Centre in The purposeful company, 2016.

Many organisations define their goals quite narrowly. Often business goals (eg to become a leading fiduciary manager) are created without connecting this to a broader purpose (eg how does this service benefit my clients/my employees/society?). Purpose addresses issues such as: why does our organisation exist? how do we contribute to society? what value do we add to our stakeholders? and what motivates us to perform?

However, purpose is hard to define as it must balance multiple dimensions at once. It must be:

- Broad enough to be recognised in an ever changing environment, but also sufficiently specific to allow differentiation from competitors
- Enduring enough over the long term to be a useful navigation aid, while allowing change when circumstances change or the organisation evolves
- Practical and achievable, but it must also be aspirational enough to appeal to individuals, teams, customers and other stakeholders[37].

Purpose channels energies towards the creation of value. If no value is created, then there is no rational reason for the organisation to exist – an organisation that does not create value is unsustainable. Our definition for value creation notes that value is judged by observers, it cannot be unilaterally declared by the company or entity undertaking the activity. A company can, of course, be an observer and self-assess its value creation – but we think the judgement is better done by stakeholders, or by an independent party such as an investment analyst. Therefore understanding what stakeholders, and other relevant observers, value ought to be a critical input for a corporation in determining its purpose, designing strategy, building culture and monitoring outcomes.

[37] See *The aligned organisation*, McKinsey, 2014

Dealing with your externalities

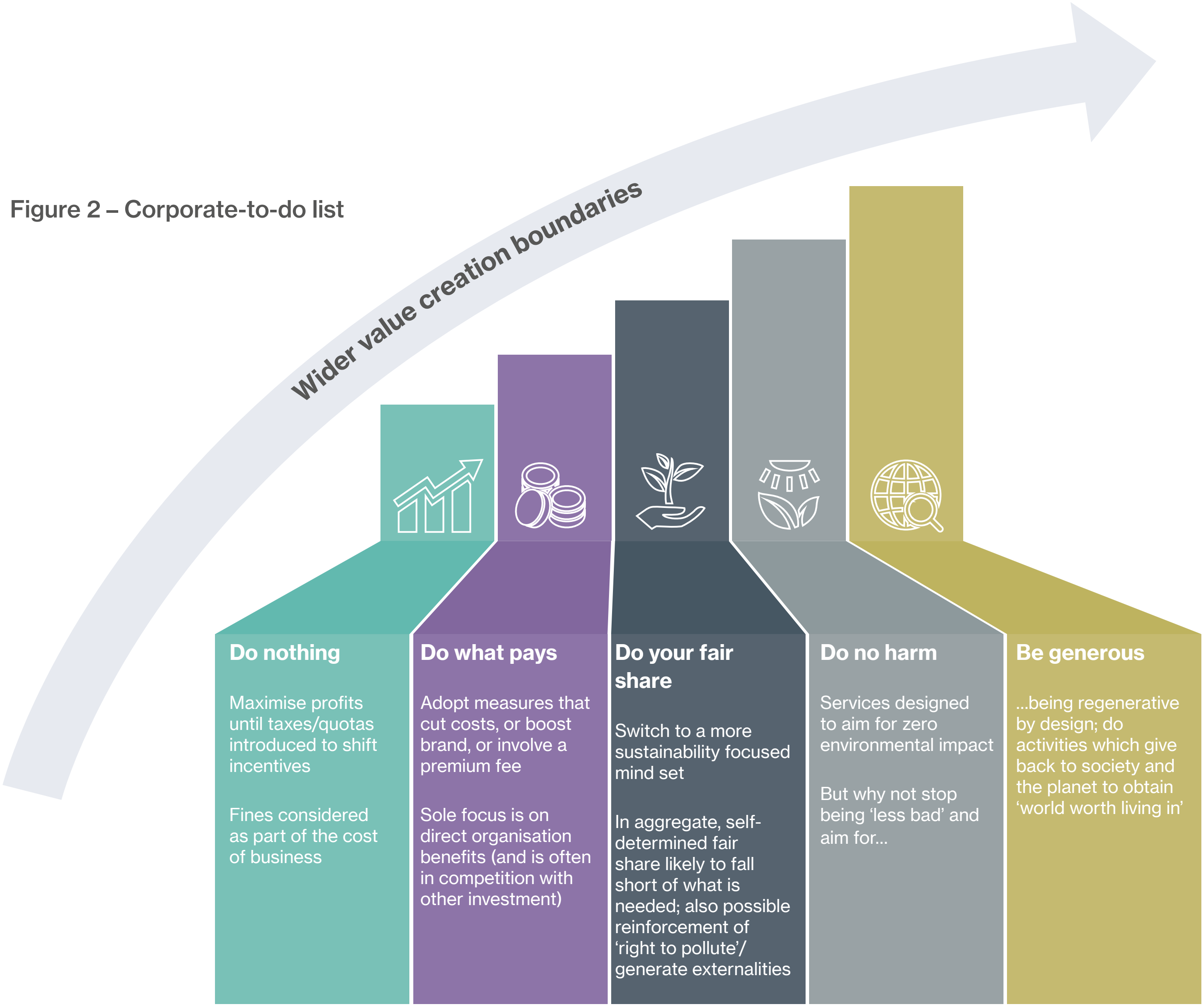
The dominant practice for dealing with negative externalities from industry has been to ignore them. This guarantees higher profits if the externalities are never priced, and gives the current generation of stakeholders higher returns if the eventual pricing-in falls on a future generation of stakeholders. To the extent that pressure been brought to address externalities, the pricing mechanism tends to use market-based tools such as quotas and taxes. Pay-as-you-use schemes and tariffs placed on the 'social cost' of pollution and environmental degradation have raised significant amounts of revenue for governments and, to some extent, limited the wholesale abuse of natural resources. But as noted by Kate Raworth, "in practice, [these] fall short because they are rarely set to the level required...and in theory, from a systems-thinking perspective, quotas and taxes to limit the stock and reduce the flow of pollution...are low points of leverage. Far greater leverage comes from changing the paradigm that gives rise to the system's goals" .

Negative externalities are most effectively dealt with by not being produced in the first place. This requires changing an organisation's behaviours, such as its business model or production process. The debate is then about the most effective way to change an organisation's behaviours – through external rules or penalties, or through changing the mindset of the board and executive. Organisations have a choice of mindset regarding their approach to externalities, which Raworth refers to as her 'corporate-to-do list':

1. *Do nothing:* maximise profits until taxes or quotas are introduced to shift incentives; fines are considered as the cost of business.
2. *Do what pays:* adopt eco-efficiency measures that cut cost, boost brand (eg reducing industrial water use) or adopt 'green' product branding to charge a premium fee. The primary focus is on direct organisation benefits and is often in competition with other firms.
3. *Do your fair share:* this signals a switch to a more sustainability focused mind set and can be seen as the call to action for universal owners. In aggregate, self-determined fair share is likely to fall short of what is needed. This may also encourage possible reinforcement of the 'right to pollute'.
4. *Do no harm:* design services and products that aim for zero environmental impact in resource-related aspects of a company's operation.
5. *Be generous:* extending beyond a 'do no harm' mission to creating an enterprise that is regenerative by design; do activities which give back to society and the planet in the pursuit of obtaining a 'world worth living in'.

[38] See also *Leverage points: places to intervene in a system*, Donella Meadows, 1997, for an excellent narrative on this.

Figure 2 – Corporate-to-do list



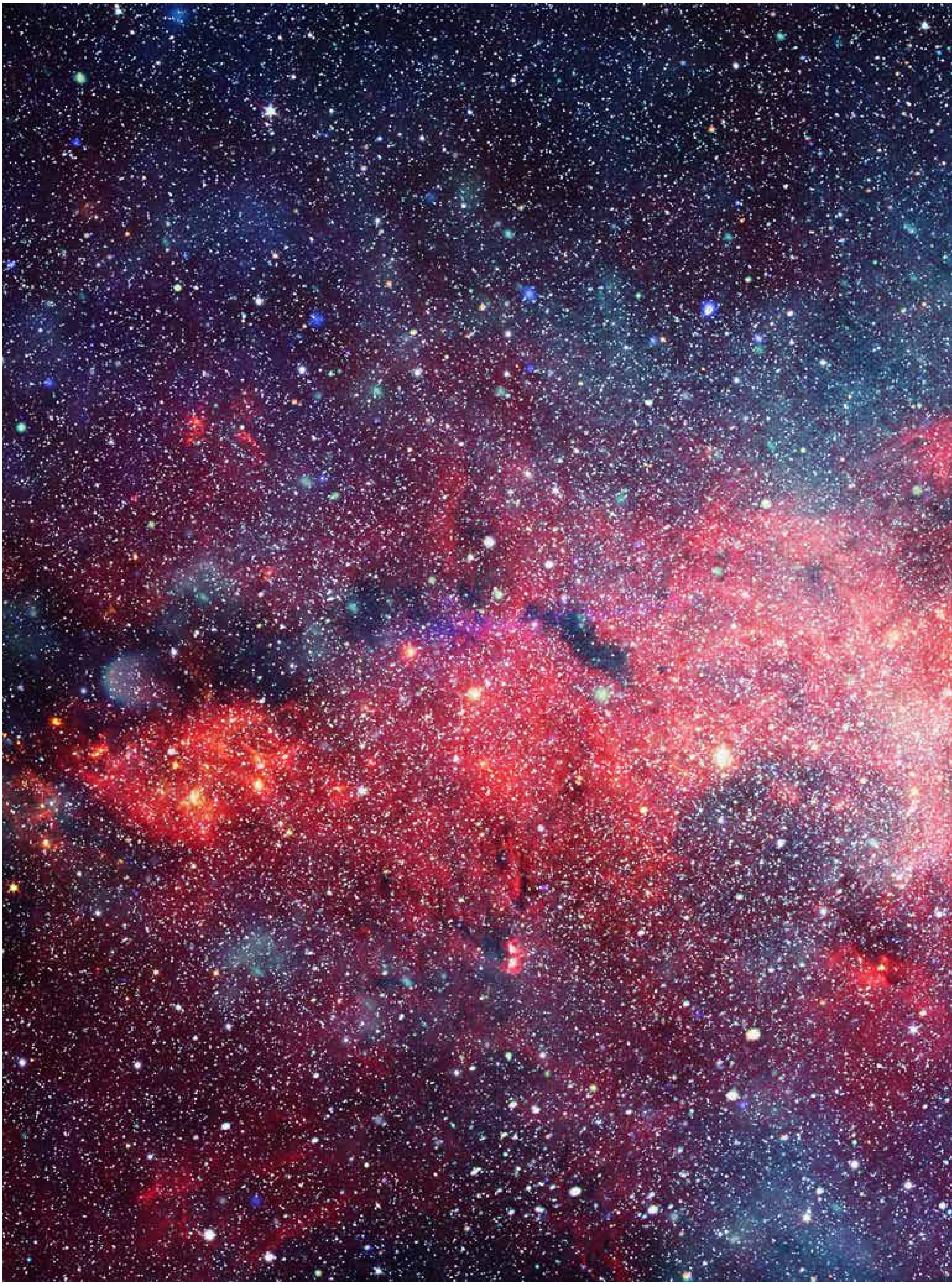
Source: Adapted from *Doughnut Economics*, Kate Raworth, 2017

The decisions made by investment firms as to how they deal with the negative impacts of investment portfolios is akin to deciding where to draw value creation boundaries – a choice between who we create value for and an implicit understanding of which wider stakeholders our activities negatively impact.

If we choose not to draw the value creation boundary beyond our own organisations, we are identifying that we hold one or more of the following beliefs or values:

- My investment time horizon is sufficiently short that I do not have to worry about potential negative consequences from investee company business models over the longer-term
- I am subject to fiduciary duty, which I interpret to mean my responsibility is solely to maximise the next period's risk-adjusted return
- I am powerless to influence externalities produced by investee companies so there is no point expending any such effort
- I recognise the importance of addressing externalities but prefer to be a free-rider on the efforts of others
- My ideology does not support widening my boundary. I believe unconstrained free markets produce the best outcomes, so if the externalities matter that much someone will create a profitable business to address them (and I might invest in it...)

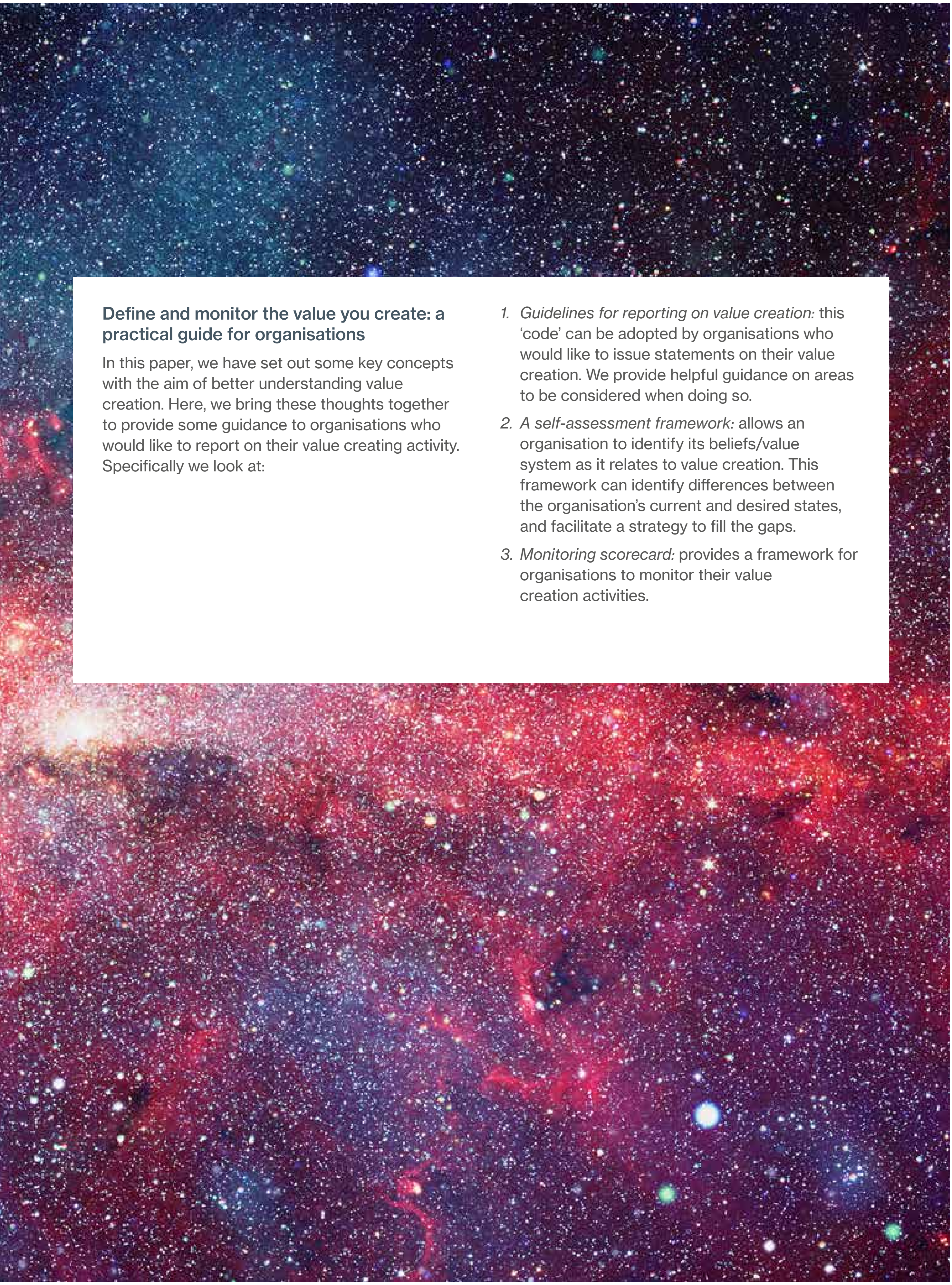
The above list is not our values and beliefs, but they are valid – at least somewhat. Each investment organisation, whether asset owner, asset manager or other service provider, will need to work out where to draw their own. Where we choose to draw the value creation boundary will clearly have implications for our subsequent actions. It will determine which business models are appropriate to be in the portfolio, and which should be excluded. It will influence decisions over the provision of new capital. And how seriously to take voting and engagement. It may influence new thinking over the structure of incentive arrangements. And quite possibly have other effects we haven't documented here. This is already a daunting list for investors but as a first step we urge all organisations to start considering these issues and how they influence current policies and practices.

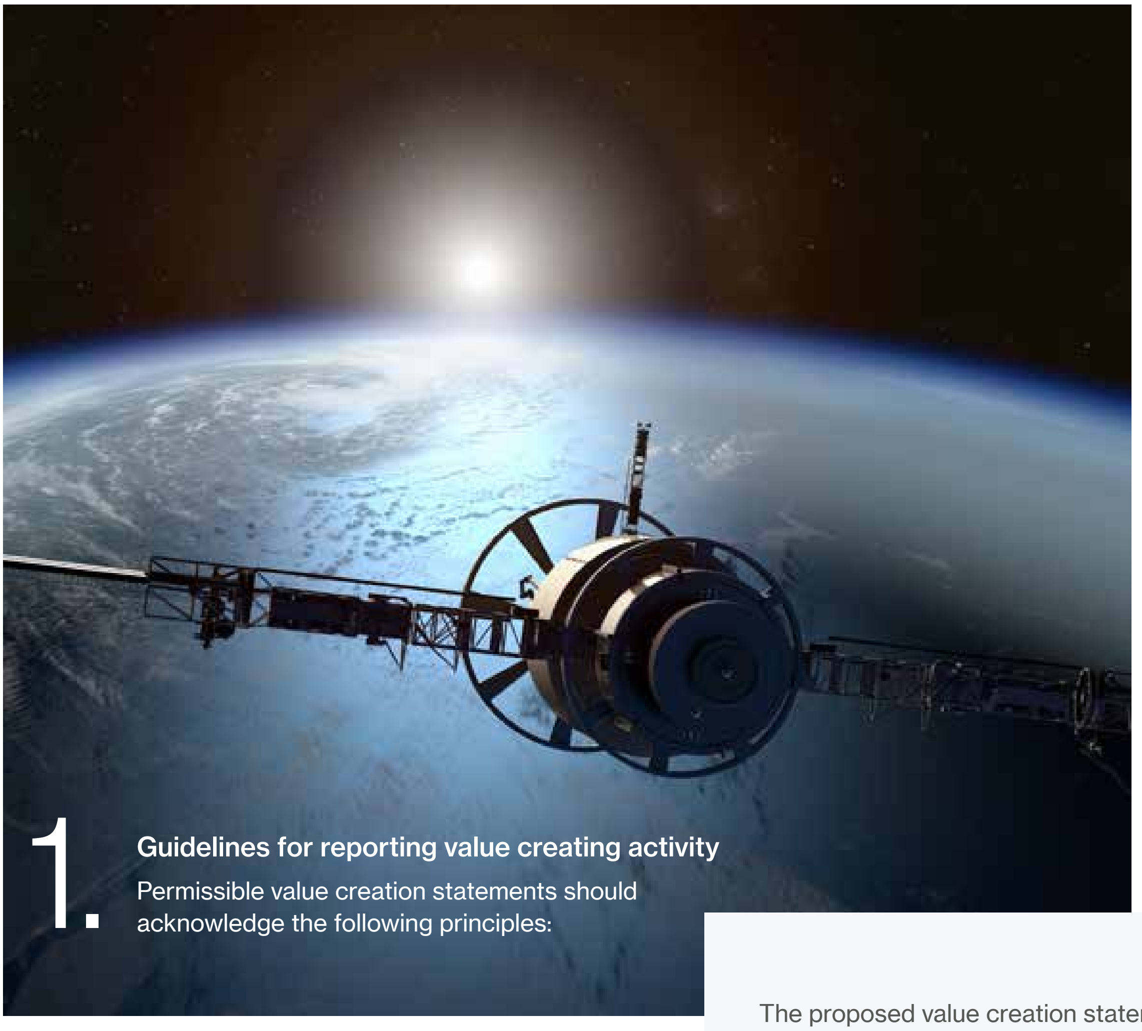


Define and monitor the value you create: a practical guide for organisations

In this paper, we have set out some key concepts with the aim of better understanding value creation. Here, we bring these thoughts together to provide some guidance to organisations who would like to report on their value creating activity. Specifically we look at:

1. *Guidelines for reporting on value creation:* this 'code' can be adopted by organisations who would like to issue statements on their value creation. We provide helpful guidance on areas to be considered when doing so.
2. *A self-assessment framework:* allows an organisation to identify its beliefs/value system as it relates to value creation. This framework can identify differences between the organisation's current and desired states, and facilitate a strategy to fill the gaps.
3. *Monitoring scorecard:* provides a framework for organisations to monitor their value creation activities.





1. Guidelines for reporting value creating activity

Permissible value creation statements should acknowledge the following principles:

1. **The value creation boundary:** describe where the organisation chooses to draw its value creation boundary ie which stakeholder groups the organisation intends to create value for. For stakeholders outside this boundary, the organisation's activities will, in aggregate, have a negative impact. The stakeholder groups discussed must include shareholders, employees, clients/customers and the planet. The discussion may also cover other stakeholders such as suppliers, collaborators, government, non-governmental organisations and society.
2. **Monetary and non-monetary value:** describe both the monetary and non-monetary value created. Full transparency would suggest also acknowledging areas of value destruction, whether monetary or non-monetary.
3. **Time:** describe how the value created in the current reporting period accrues to different stakeholders over different periods of time.
4. **Value creation at risk:** describe how much of the value created in the current period is at risk of being reversed in future (whether through error, product fault, fraud or other reason).
5. **[For investment or holding companies] Investee company value creation:** the principles 1-4 should also be applied to investment positions in investee companies.

The proposed value creation statement serves to provide much needed transparency to stakeholders, enabling them to judge the boundaries of an organisation's value creating activities and how value created evolves over time.

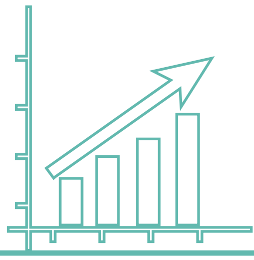
It is difficult to create value simultaneously for all stakeholders and this will often require a fundamental shift in the mind-set of the executive of many investment organisations. However, we believe that asset owners, asset managers and intermediaries alike need to be drivers of that change and so welcome efforts to move in the direction of improving organisations' understanding of how value is created.

2.

A self-assessment framework

Below, we outline a four-step process that could be used by organisations to self-assess their value creation activities and identify areas of desired improvement:

1. Identify stakeholders and understand their expectations and needs to determine what is valued



2. Align organisational purpose with desired outcomes:

a. Identify which stakeholders the organisation prioritises and agree value creation boundaries

b. Identify associated externalities and agree treatment of these

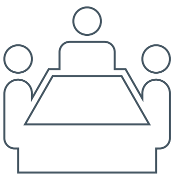
c. The vision/purpose of the organisation should be aligned with which stakeholders the organisation prioritises.

3. Norms development and evaluation process:

a. Identify the beliefs/value system necessary to align its purpose with what the organisation's stakeholders value (ie develop the 'norms'). Some examples of norms include: 'the organisation believes it is important to build trust in wider society', 'the organisation values strong client service which is practiced and measured', and 'the organisation views the government as a value-adding partner (regulation, apprentice schemes etc)'

b. Evaluate norms through a questionnaire, identifying gaps between current state and agreed norms.

c. Develop a scoring system. This could be based on a built up database of peers and applied experience.



4. The delivery process:

a. Discuss results/gaps and develop an internal action plan; consider linking to an integrated report

As a working group, we have identified this framework as potentially useful to organisations. We have not yet completed our work on this and we will look to develop this framework further in the near future.

3.

A monitoring scorecard

In this paper, we proposed a definition of value creation:

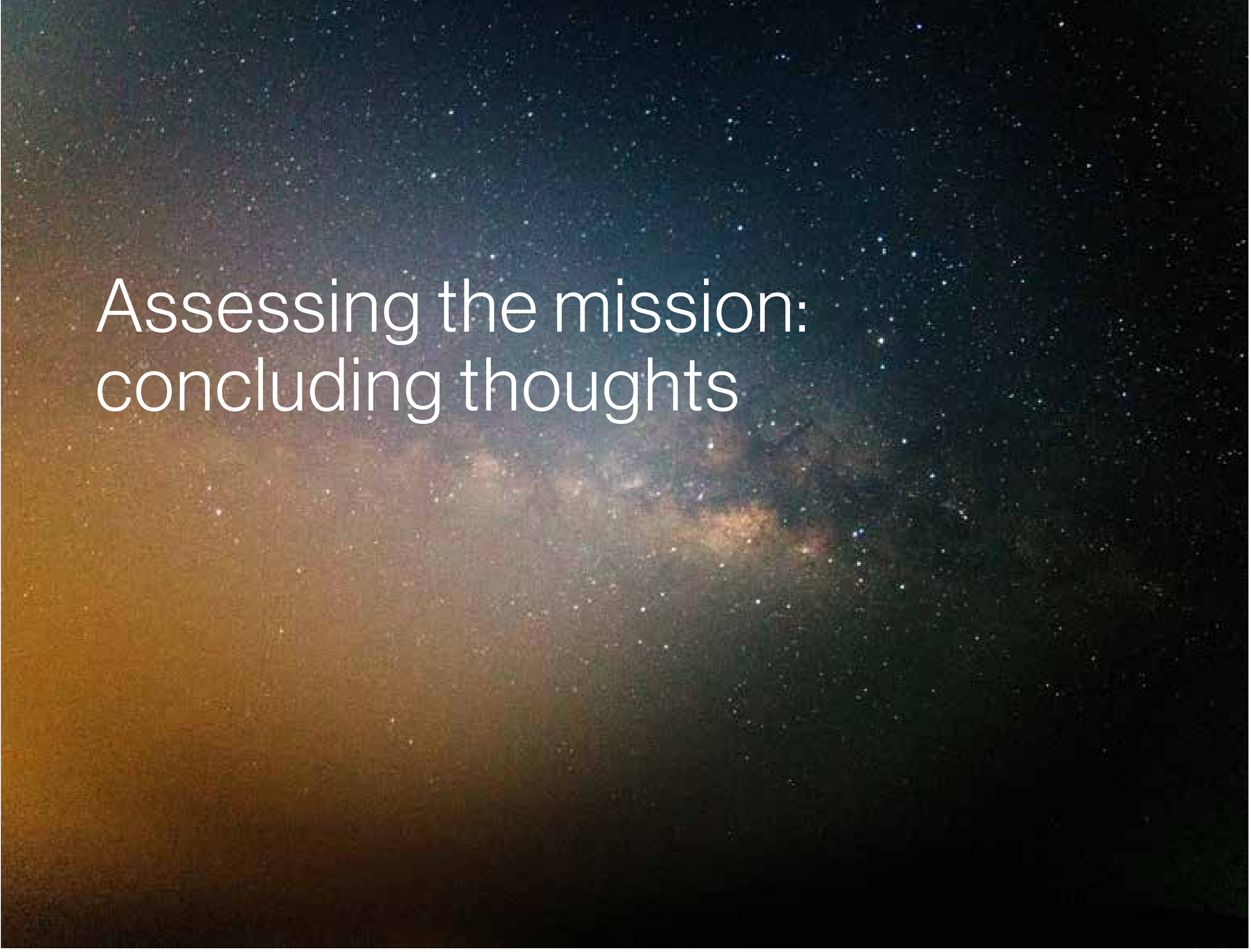
Value creation is an increase in the stock of monetary and non-monetary resources used to create future wealth and well-being for stakeholders, as judged by observers, mindful of the passage of time

This definition can be translated into a scorecard that organisations can use to monitor their value creation activities. We provide an example of how this can be used in the table below. Specific KPI's would need to be developed to meet these high level goals and should be determined by each organisation. These KPIs should be specific, measurable, attainable, relevant (SMART) and include the relevant time horizon over which they are measured.

Figure 3 – **Monitoring Scorecard**

	Financial metrics	Non-financial metrics
Value creation is an increase in the stock of monetary and non-monetary resources…		
Human		Improvements in employees' skills and motivations to innovate; increased alignment with company purpose
Intellectual		Improvements in knowledge-based intangibles such as intellectual property, protocols and systems
Social and relationship		Improvements in the organisation's relationships with other stakeholders; the ability to share information to enhance the organsation's and collective well-being
Natural		Improvements in environmental resources and processes that support the prosperity of the organisation (eg bio-diversity land, health of the investment ecosystem)
Manufactured		Improvements in physical objects used in the production of services (eg technological infrastructure, office space)
Financial	Margin/growth; return on capital/cashflows	
…used to create future wealth and well-being for stakeholders…		
Shareholders	Increased return on capital; continued authorisation to operation; minimisation of regulatory breaches	Improved trust and transparency
Employees	Fair and transparent pay; competitive benefits	Autonomy; sense of belonging/collegiate atmosphere; training to improve skills
Customers	Compounded wealth; longevity protection; conversion of wealth to consumption	Risk management; financial planning; trust built (enter hopeful/exist satisfied)
Other investment firms	Mutual financial benefits due to the development of long-term relationships (eg more efficient payment transfer systems)	Participation in networks to promote and improve industry improving social licence to operate
Government	Ability to pay taxes; adhere to, or improve on, regulations/guidance	Good citizenship: government viewed as a value-adding partner (regulation, apprentice schemes, social safety net)
Society	Minimisation or recovery of externalities	Maintenance of social licence to operate (may also lead to financial outcomes)
Planet	Minimisation or recovery of externalities	Improved environmental handprint
…as judged by observers, mindful of the passage of time.		

Specific KPIs to meet these high level goals should be determined by each organisation.



Assessing the mission: concluding thoughts

To date, it feels like mankind has not been that bad at value creation ...

If we each look out of our window, most of what we see is testimony to some form of value creation. For most of us, our basic needs such as food and shelter are met securely, and for an increasing number of us, we have access to high tech communications, transport systems, consumption and entertainment.

It is tempting to conclude that we humans are quite good at value creation – it might even be one of our strongest evolutionary traits. We are able to recognise value creation when we see it and are able to change our views over time. The counterfactual is hard to prove but one could argue that without these skills we would not be where we are today. The investment industry has been an enabler of this narrative, through its participation in the wealth creation chain, through the provision of risk management services and through increasing its stewardship of investee companies.

But this has been at the expense of the planet...

The above statements are loosely based on what we obviously see. However, we could also argue that all of this apparent value creation has simply been us spending our endowment – the endowment of natural resources gifted to the human race (and other species). It is easy to create wealth and well-being by running down an endowment, but it isn't sustainable. Value creation is increasing the stock of resources that create future wealth and well-being. That is sustainable.

We increasingly know that our activities have had a profound effect on the things that are not so readily observable. Due to the scientific foundation of ecological boundaries, we do not need a values-based discussion to support the fact that human activities have had a negative effect on the planet. We know that our economy depends on the Earth as a source of resources and as a sink for its wastes. We also know that, so far, society and the investment industry have not yet fully accounted for their costs to the planet.

And we should not leave the future to chance...

It is natural for organisations to prefer tighter value creation boundaries – this has the benefit of producing cheap dumping grounds for the wastes of our economic activities, while focussing on a narrow group of stakeholders that we truly value. For a couple of centuries during which the global population was less than one billion we could get away with that. But there are over seven billion of us now, and rising, and the costs of our activities are clearly building up momentum and becoming more visible. Unless we take deliberate and targeted action and change our behaviours, these externalities may overwhelm us in time. We should not leave the future to chance.

So it is our collective job to help shape a future fit for all of us to live in.

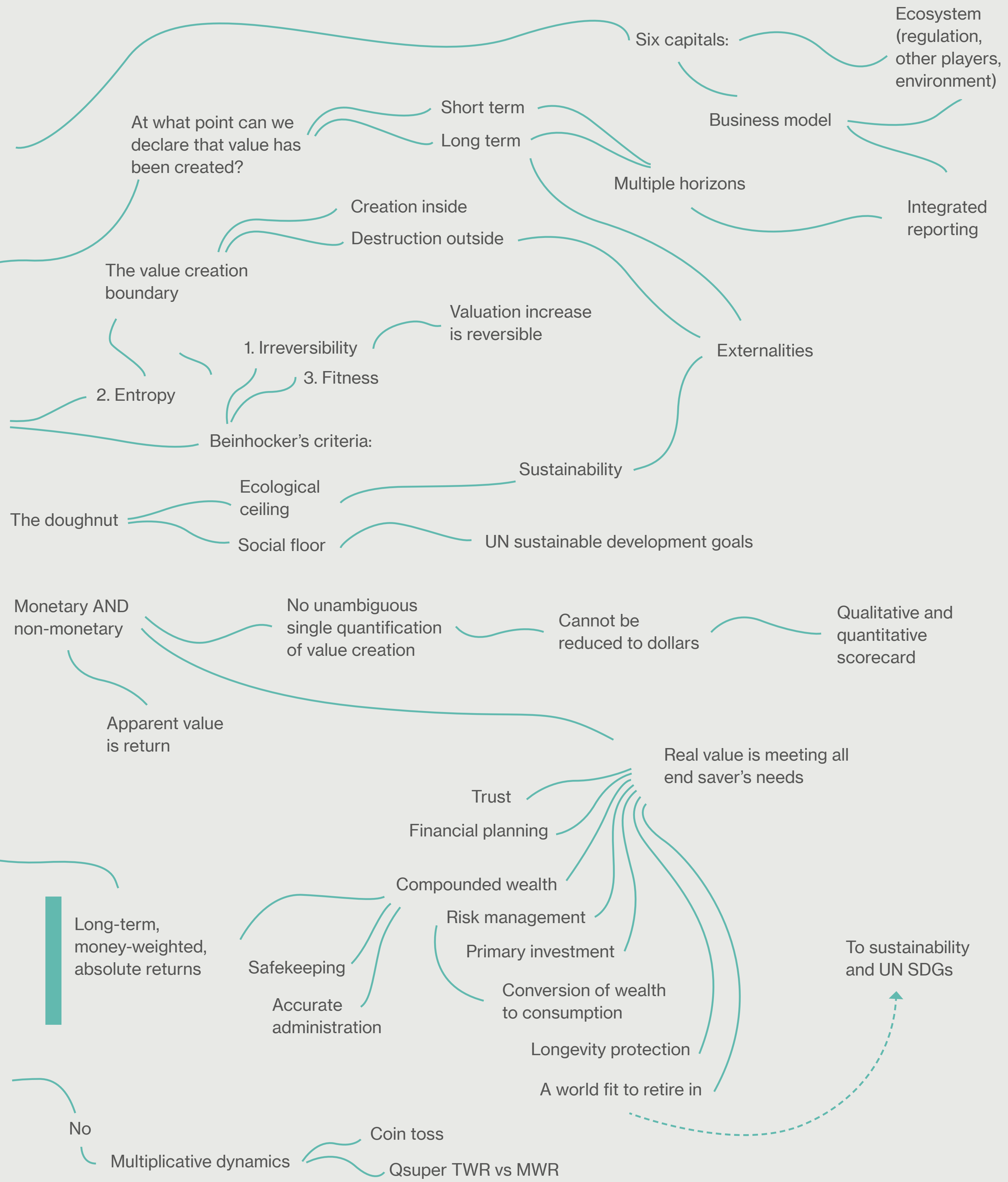
This is where we believe the Thinking Ahead Institute and the broader investment industry comes in (TAI to shift minds, the industry to shift behaviours). If our survival is actually at stake, we have to broaden our value creation boundaries. This in turn can help everybody else on the planet do the same and as a result afford future generations of people a good life on this planet.

It may be our evolutionary duty to drive this, particularly if we need to fast-track change given the challenges we face. We hope that the concepts in this paper and some of the practical tools suggested (the 'code' and the introduction of the self-assessment framework and the monitoring scorecard) help move us towards broader, coherent value boundaries and a good future for us all.

Appendix

Connecting purpose and value creation: working group mind map

Value creation and the asset management industry


Six capitals:
Ecosystem (regulation, other players, environment)
Business model
Integrated reporting
At what point can we declare that value has been created?
Short term
Long term
Multiple horizons
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
Accurate administration
Conversion of wealth to consumption
To sustainability and UN SDGs
Longevity protection
A world fit to retire in
No
Multiplicative dynamics
Coin toss
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 2002 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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