The future of asset management

The investment industry needs to look more holistically at the health of the entire investment value chain in order to build a sustainable business for the future, argues **Tim Hodgson, ASIP**.

The sustainability of traditional asset management is being tested by questions about its role in society, at the same time as the investment world, and beyond, changes evermore rapidly. Predicting its future is very difficult. However scenarios can be used to contrast the most likely future with the most desirable future. This approach yields useful insights into what needs to change to get to a better place. I use this approach below – and I also use the 'rule of three', three times: three lenses, three issues, and three choices.

THREE LENSES

An assessment of the investment industry should consider:

1. Investment strategies
2. Organisational effectiveness
3. Societal legitimacy

The first is a logical starting point – how should we construct client portfolios, and evolve them through time? Is the growth of index-tracking a good or bad thing and how should smart beta or factor investing influence portfolios? We must start with the acknowledgement that, in aggregate, the investment industry will deliver market returns less costs.

In broad terms, organisational effectiveness refers to the efficiency with which investment organisations convert inputs into outputs. As there is a cost to restructuring organisations, they tend to remain fairly stable until sufficient evidence implies that change is really necessary. A quick scan of the horizon shows the approach of digitisation/roboadvice, the retailisation of pensions, the professionalisation of asset owners, and regulatory change. Throw in softer considerations, such as culture, and organisational change seems inevitable.

And then there is societal legitimacy, or the licence to operate. Any industry that loses its licence to operate eventually suffers. In Australia, the size of the self-managed super fund sector (where individuals reject mainstream offerings and run their own portfolios) is generally considered to be evidence of a damaged licence to operate for the mainstream industry. Any regulation that imposes a fee cap is sending a clear message about how the investment industry's value proposition is regarded. The growing pressure for the industry to improve the diversity of its employees is also connected to the idea of societal legitimacy.

Executive summary

- Any assessment of the investment industry should consider investment strategies, organisational effectiveness, and societal legitimacy.
- The investment industry can increasingly be characterised by the popular epithet 'VUCA' – volatile, uncertain, complex and ambiguous.
- Achieving a more desirable future requires more enlightened thinking and the wide propagation of successful narratives and outcomes by exemplar organisations that apply themselves to this progressive thinking and action.

THREE ISSUES

1. Complexity frameworks, models and coping strategies

The world is a complex, fast-changing, inter-connected place. The investment industry can increasingly be characterised by the popular epithet 'VUCA' – volatile, uncertain, complex and ambiguous (used initially to describe the new operating environment after the relative geopolitical calm of the cold war)

Volatility: We expect significant time-varying volatility in future market prices, together with asymmetry and fat downside tails. This requires the building of investment edge through investment intelligence, and applying parsimony to risk models.

Uncertainty: Inability to assess future expectations for return, or to objectively assess risk (Lo and Mueller, 2010) and can be accommodated through the use of deductive processes to derive model parameters and by allowing for estimation uncertainty in risk models and risk assessment.

Complexity: Markets are constantly moving and adapting; they are reflexive, non-linear and discontinuous. Coping strategies include:

- Stronger culture to support competitive edge and adaptability
- Extreme clarity and alignment of mission to achieve organisational coherence
- Understanding internal capabilities and comparative advantage
- Understanding the context of other participants and how that feeds back (meta understanding)
- Recognising the merits of simplicity.

Ambiguity: Given volatility, uncertainty and complexity, the assessment of future states is a matter of subjective beliefs. As there is no equilibrium to fall back on, the adoption of a beliefs-based investment framework, which makes explicit allowance for behavioural biases, can be a helpful strategy.

The likely future is one where the industry does not use complexity in its frameworks, models and coping strategies and consequently suffers negative outcomes. Grappling with complexity is hard work, humbling and depressing; there are no easy answers and any real control over outcomes is limited. These features, among others, make the adoption of a complexity framework unattractive to the majority of organisations.

Understandably, the ideal future is one in which the industry overcomes these issues and there is wide-scale adoption of the framework and coping strategies – with the payoff being improved outcomes. Those improved outcomes would be both at the individual level, where organisations are better able to manage within and adapt to changing conditions, and at the aggregate level, where more robust organisations deliver lower levels of systemic risk. Achieving a more desirable future requires more enlightened thinking and the wide propagation of successful narratives and outcomes by exemplar organisations that apply themselves to this progressive thinking and action.

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2. Sustainability of…

This flows directly from issue 1, and can be applied to a number of topics: defined benefit (DB) pensions delivering on their liabilities, defined contribution in its current form providing meaningful retirement income, capitalism in its current form, climate etc. Picking on the first of these, DB pension funds have had a successful history for around 100 years – which appears pretty sustainable. However, looking forward, we are entering a new phase of maturity. The funds' solvency positions will be increasingly crystallised – either fully-funded or 'impaired'. In the case of impairments, benefits may be delivered through various safety nets (eg PBGC and PPF) but will always involve benefits being reduced.

Clearly the spectrum of possible futures lies between very limited impairment, and serious impairment which would most likely be accompanied by a loss of trust in pensions and, possibly, the investment industry. The impairment to pension property rights will be a problem that grows as time passes – so a bigger issue in the second decade from now. Improved outcomes will require (a) enhanced funding levels and (b) continued trust in the pension system. Higher returns are beyond the industry's control, but improved pension governance and choices which shore up trust are directly within the industry's gift. Returning to the opening list – whether the current forms of DC, capitalism and approach to climate change are sustainable – similar thoughts apply. Each of them could turn out to be unsustainable when, at some future date, there is a form of crystallisation and we find that our DC/capitalist/climate future is impaired. The issue will then be where on the spectrum between limited and serious impairment we find ourselves.

3. Financial crises

While certain measures have been taken since the global financial crisis of 2007-09 to reduce systemic risk, it clearly cannot be eliminated. We propose three 10-year scenarios for the financial system:

1. It is robust with only a small chance (less than 25%) of a system-wide global financial crisis
2. It remains somewhat vulnerable to a destabilising setback and there is a material probability (25–50%) of a system-wide global financial crisis
3. It remains crisis-prone because of its inter-connectedness, complexity and structure; there is a large probability (50%–75%) of a system-wide global financial crisis.

> "The purpose of the investment value chain is to serve the real world and is therefore not an end in itself."

Private balance sheets may be less leveraged but public ones are not; and conventional monetary policy looks far away. In addition, the incentive structures, cultural condition or permitted levels of complexity have not been adequately addressed yet. Given these conditions the likely future looks like scenario 2, whereas the ideal future is clearly scenario 1. So how can the investment industry influence the robustness of the wider financial system? In the choice of any counterparty or service provider, the investment industry acts as a form of search engine, favouring some business models and diminishing others. So individually, any organisation may appear weak against the whole, but the aggregation of individual choices does have an impact. In addition, it is arguable that the industry can have a further indirect impact through better investment strategies and organisational effectiveness, and enhanced societal legitimacy. This leads to three choices.

THREE CHOICES

1. Define success

The current investment industry, as revealed by its structure and behaviours, has chosen to define success as producing single-period, short-horizon, cross-sectionally-diversified, time-weighted relative returns. There are two problems with this. First, in aggregate, the industry cannot produce a positive relative return; second, and more importantly, investors need multiple-period, long-horizon, time-diversified, money-weighted returns. If the industry chooses to re-focus on the needs of the end saver significantly different investment strategies, differently organised firms, and vastly improved societal legitimacy will emerge.

2. Business or profession?

CFA UK recently published a paper entitled: The value of the investment profession. The paper is an excellent review of the status quo, but it repeatedly refers to the profession of investment and makes no reference to the business of investment. The vast majority of individuals in the industry are employed by for-profit businesses, and that aspect cannot be overlooked in an assessment of our collective future. Without wanting to be too contentious, it is arguable that businesses are run for owners (shorter-term profits) and professions for clients (longer-term profits). The pressure to produce profits in the shorter term is more likely to be associated with product proliferation, which does not meet client needs, with pro-cyclical behaviour, such as the TMT bubble, and with lower levels of resources being devoted to stewardship, such as challenging the banks' strategies pre-GFC.

3. Structure of the value chain

The purpose of the investment value chain is to serve the real world and is therefore not an end in itself. In addition, the chain has expanded to involve more, and increasingly specialised intermediaries. Given that context, is the current chain still fit for purpose or should it be restructured? Actually, it is being reshaped already with the relationships between asset owners and asset managers evolving, particularly with the former building internal teams; a growing emphasis on stewardship and active ownership, and how best to make it more effective, and an increased questioning of the role, business model and conflicts associated with investment consultants.

To build a more sustainable investment industry the focus should shift from our own small sphere of operation and engage more with the health of the entire investment value chain. After all, the whole chain must hold for value to flow through to the end savers. ■

Biography

Tim Hodgson, ASIP, leads the Thinking Ahead Institute at Willis Towers Watson. He joined the firm in 1998 in a general consulting and manager research role. His role became increasingly specialised, concentrating on high performance specialist managers and hedge funds, and running portfolios of managers for clients, before evolving further to focus on investment research and new investment ideas.