



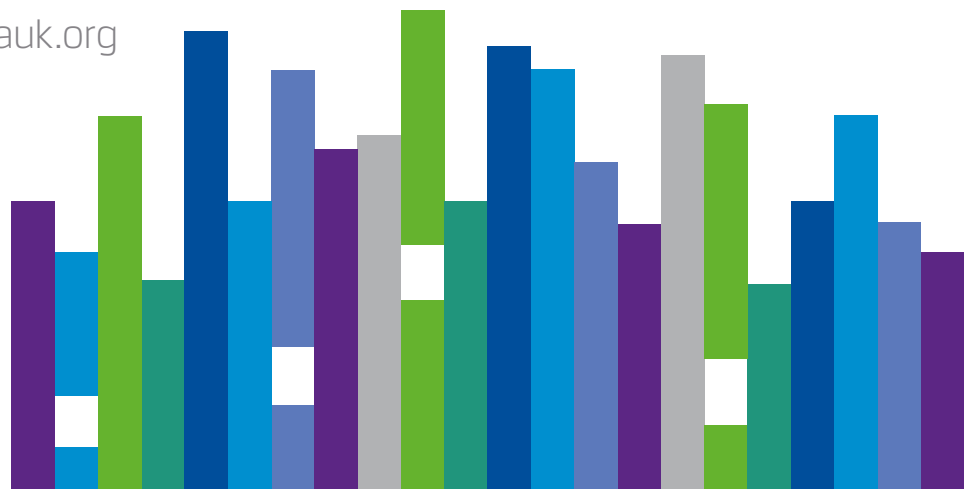
CFA Society  
United Kingdom

APRIL 2016

# THE VALUE OF THE INVESTMENT PROFESSION

A REPORT ON  
STAKEHOLDERS' VIEWS

[Professionalism.cfauk.org](http://Professionalism.cfauk.org)



# PREFACE

CFA UK undertook this report to capture our stakeholders' views of the investment profession's role, its effectiveness and value. It is intended to open a discussion that will form the basis of our advocacy work over the next few years.

**O**ur members perform an important social function, but it is one that is not well understood. It is also one that is widely criticised. Some of the criticisms directed at the profession are a consequence of our failure to explain ourselves; others are more fundamental and should be addressed.

For the purpose of this report, CFA UK met and interviewed key individuals and teams at investment firms, consulting firms, clients and companies. We have also talked to representatives in the other stakeholder universe, such as academics, policy-makers and client representative groups.

This report reflects the aggregated views that we've heard. Our intention has been to provide a clear, simple explanation of the value that the profession provides, how that value can be enhanced and the role that professionalism plays.

## AT EACH OF OUR MEETINGS, WE ASKED FOUR QUESTIONS:

- What is the value of the investment profession?
- How can it be evidenced?
- What inhibits our ability to generate or deliver value?
- How should we address these obstacles?

We have met or spoken to close to close to 200 people across roughly 100 organisations. It has been a fascinating process and we are extremely grateful to all of those who gave us their time and thoughts.

We welcome all feedback on the report.

### **Will Goodhart**

Chief Executive  
CFA Society of the UK

## ABOUT CFA UK AND CFA INSTITUTE

### **CFA UK**

The CFA Society of the UK (CFA UK) represents the interests of more than 11,500 members of the investment profession. The society is the largest member society of CFA Institute (the global, nonprofit organisation of investment professionals) and serves society's best interests through the education of investment professionals, by informing policy-makers and the public about the profession and through the promotion of high professional and ethical standards. The society was founded in 1955.

CFA UK is the awarding body for the Investment Management Certificate (IMC), an entry level qualification for investment professionals. CFA UK promotes the CFA Program, but CFA Institute is the awarding body for that qualification which is a graduate level, self-study programme designed to

equip investment professionals with technical skills, practical knowledge and a clear understanding of ethics and professional standards. For more information, visit [www.cfauk.org](http://www.cfauk.org).

### **CFA Institute**

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organisation is a champion for ethical behavior in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has over 137,000 members in 145 countries and territories. For more information, visit [www.cfainstitute.org](http://www.cfainstitute.org).

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THIS REPORT WAS WRITTEN BY WILL GOODHART AND DAVID CLARKE, CFA WITH THE EDITORIAL SUPPORT OF KAVERI NITHTHYANANTHAN. THE RESEARCH ON WHICH THE REPORT IS BASED WAS UNDERTAKEN BY WILL GOODHART, DAVID CLARKE, CFA, NICK BARTLETT, CFA, ASIP AND ASHLEY RAMSAY.

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# EXECUTIVE SUMMARY

## INTRODUCTION

- This report summarises feedback from stakeholders in the investment profession (clients, investment managers, investment consultants and others).
- The investment profession is thought to generate value by helping clients to meet their financial needs and by contributing to efficient capital allocation.
- The investment profession touches all parts of society through its work for pension schemes, insurance companies, charities and individuals.
- Investment is an agency function that has not required state support.
- This report will be followed up by additional papers on the challenges identified around: communication, clients, competition and capital allocation.

## MEETING CLIENT NEEDS

- The investment profession delivers value by helping clients identify their needs, designing appropriate products and strategies to meet those needs and through the management of those products and strategies.
- Investors gain access to a wide range of investment opportunities delivering returns ahead of those typically available elsewhere.
- The investment profession helps reduce the risk of investment through diversification.

## CAPITAL ALLOCATION

- The investment profession contributes to the efficient allocation of capital across the economy by investing in new capital and pricing existing capital.
- Stewardship of clients' capital (taking into account issues relating to environmental, societal and governance) also adds value.
- The role that the investment profession plays has grown in importance as banks have scaled back their lending activities.

## CHALLENGES

- The investment profession's value proposition is not well understood and should be communicated more effectively.
- The cost of investment is not easy to discern and there should be improved transparency and disclosures in relation to fees and charges.

- Costs matter to client outcomes but price is 'trumped' by performance when consumers buy investment products and services. However, investment performance is dynamic, often mean reverting, and is hard to forecast.
- Clients are not always equipped to work effectively with investment managers and would benefit from additional education and from scale.
- Incentive structures can impact the behaviour of investment managers and consultants. These should be transparent and aligned with clients' interests.
- The market for new assets is competitive, but the market for historic assets is characterised by inertia. The economics of investment management encourages new fund launches, but discourages fund closures.
- The investment profession is making progress on stewardship and ESG integration into investment decision-making, but is communicating this poorly.
- Short-termism among investment managers appears to be of diminishing concern to stakeholders.

## PROFESSIONALISM

- Given the importance of investment and the information asymmetries between consumers and providers, there is a natural need for investment to be a professional activity in which clients' interests are held paramount.
- Professional qualifications and standards are demanded by clients and employers, but not yet extensively required by regulation.
- Professional cultures are difficult to identify, but should matter to clients and more could be done to make them easier to recognise.
- The profession should do more to make sure that it is recruiting and maintaining diverse teams.

## POLICY & REGULATION

- Stakeholders are broadly supportive of policy towards investment management and value effective regulation, but are concerned about the growing volume of regulation and the ultimate cost to clients.
- There are concerns that adapting to changing regulatory requirements is costly and acts a barrier to entry and that policy can be inconsistent.
- Higher regulatory standards for investment professionals and the encouragement of greater scale and more effective governance across schemes and funds would be welcomed by stakeholders.

# INTRODUCTION

**NATALIE WINTERFROST, CFA**  
**CHAIRMAN, CFA SOCIETY OF THE UK**



In recent months, CFA UK has canvassed stakeholders across the investment sector for their views on the profession's value and the factors that may inhibit our ability to generate greater value. We spoke to investment managers, clients, consultants, the regulator, policy-makers and other stakeholders. We are grateful for their time and for the opinions they expressed that are summarised in this report.

**T**here is universal agreement about the fundamental importance of investment, but views vary about the value the profession delivers and how that can be enhanced. Some of those we spoke to put greater emphasis on the profession's role in helping clients to meet their needs. Others stress the role investment plays in improving the efficiency of capital allocation across the economy. All believe the investment profession performs a vital social function in converting individuals' savings into investable capital, which is applied to generate a return for the original savers.

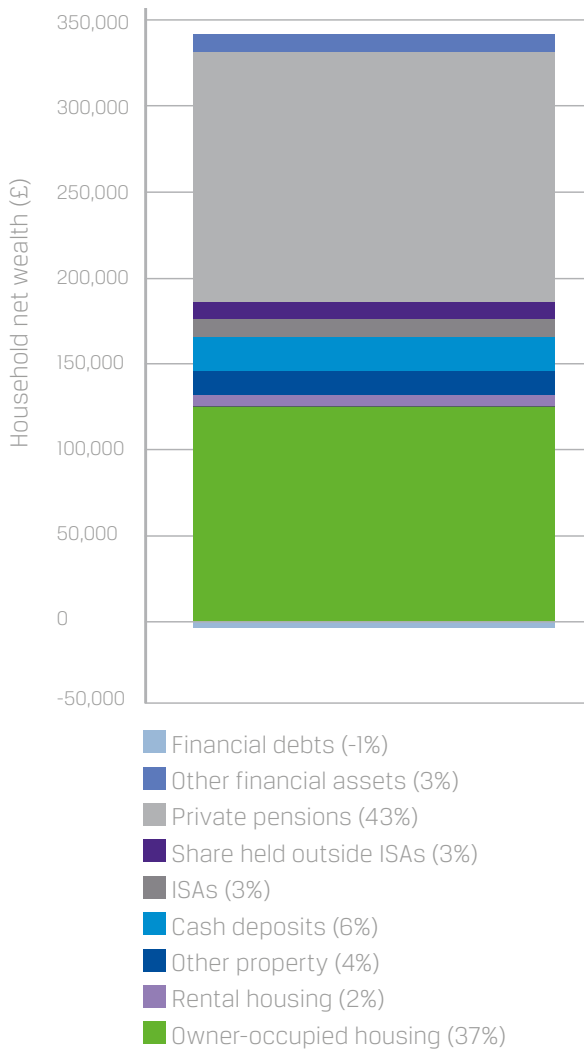
All those we spoke to also identified challenges that the profession should address if it is to enhance the value it delivers and raise its standing. Leaders within the profession are keen to raise levels of transparency and to see the profession's role and actions explained more clearly.

A recent CFA UK member survey reveals that whereas 55% of respondents feel that clients hold the profession in relatively high regard (scoring 7 or above out of 10), less than 20% of respondents reckon that the profession is held in high regard by society more broadly. We need to close the gap by taking more time to communicate our value beyond our client base.

The value the profession delivers is hard to quantify. Our investment actions take time to feed through to returns. The impact of our stewardship is rarely immediate. Our stakeholders, however, are confident that capital allocation is enhanced by investment managers competing to identify productive investment opportunities and that client outcomes are improved by competition to design and deliver products that can best meet their needs. A common observation among those we talked to is that if the investment profession did not currently exist, it would have to be created – even if its design might not then be exactly as it is today.

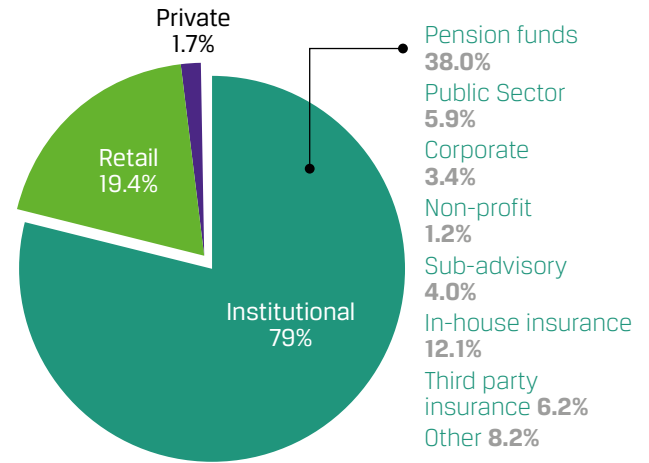
The investment profession touches all parts of society. Our clients – direct and indirect – are numerous. We work directly for many individuals, but support many more through the services and products we provide to pension schemes, insurance companies and charities. More than half of the UK's working age population has pension savings<sup>1</sup>. More than three-quarters of UK households have insurance products<sup>2</sup>. And close to 2,500 UK charities depend on the investment profession to generate the income and build the capital that supports their work<sup>3</sup>.

### The form in which wealth is held



Source: Institute of Fiscal Studies

### Assets managed in the UK by client type



Source: Asset Management in the UK 2014-2015, The Investment Association.

The profession helps clients to identify their investment needs, builds risk-diversified portfolios to meet those needs and provides access to investment opportunities. We use specialist skills and knowledge within this process (and across associated activities such as trading, custody and reporting) so that clients and society more broadly benefit from economies of scale and the division of labour.

The capital entrusted to us finances economic and social activity, contributing to job and wealth creation. Investment professionals do not run the companies in which they are invested, but they help those companies to manage their capital efficiently and they set the price of that capital.

This report on stakeholders' perceptions of the investment profession comments on how investment generates value, then addresses factors that inhibit our ability to deliver greater value, before commenting on the need for professionalism and a supportive policy and regulatory framework. The many conversations that have informed this report were provided on an 'off the record basis' but the unattributed quotes included in the report give a sense of the constructive and insightful feedback we received.

The report will be used to encourage discussion within our membership – and with our stakeholders – about how we can address the challenges that have been identified. We plan to publish additional reports that consider these challenges in depth and make specific recommendations for tackling them. We look forward to this work and to continuing to explain and communicate the importance and value of the investment profession.

<sup>1</sup> IFS, *The Effects of Taxes and Charges on Saving Incentives in the UK*, February 2016

<sup>2</sup> <https://www.abi.org.uk/Insurance-and-savings/Industry-data/UK-Insurance-and-Long-Term-Savings-Key-Facts-2015/Households-and-types-of-products>

<sup>3</sup> *Charity Investment Spotlight*, June 2015, *Charity Financials*

# MY GOOD OPINION ONCE LOST IS LOST FOREVER

**PAUL SMITH, CFA**  
**PRESIDENT AND CEO, CFA INSTITUTE**

This line, one of the most famous in the Jane Austen canon, could be easily ascribed to the British public and its view of the UK's financial services institutions. While the investment management profession has not been immune from censure, particularly around transparency and fees, there is growing recognition that investment managers serve a different purpose to banks, and, crucially, trust between investment manager and retail investor is rising.

In the three years since we last conducted our global investor survey, the faith felt by the retail investor base in the people it entrusts with its money has increased from 51% to 61% globally, with a more modest rise from 39% to 44% in the UK. The industry, however, cannot be complacent. It is notable that while retail investors are more trusting than they were, institutional investors' trust in the profession has remained broadly static (dipping slightly from 61% to 60%<sup>4</sup>).

The biggest disparities between what an investor expects and what they receive relate to fees and performance. The things which are important to clients can be replicated time after time: trustworthiness, communication, and transparency. If asset managers get the basics right, they will likely be rewarded with loyal clients. Performance needs to be defensible but is not the defining factor. Four out of five retail investors call for more clarity around fees and institutional investors ascribe the greatest importance to fee transparency and ethical behaviour from of a 25-strong list of factors.

Clients – whether retail or institutional – need full disclosure on charges and to be confident that they fairly reflect the value they are getting from their investment firms. Only through addressing this will investment managers be able to deepen trust and clearly explain their value proposition.



This question of fees is also particularly relevant when targeting the millennial investor. Millennials tend to pay more attention than others to the fees incurred by active management, particularly in an environment of close to zero interest rates. The investment profession has a robust and compelling proposition to offer these younger investors, yet it often fails to articulate it. Trust, informed by investor education and a full explanation of the fee structure, is therefore vital in attracting and securing the business of the younger generation and ensuring long-term investment success.

The upshot of the global financial crisis is that we now all operate in a low-interest rate, highly regulated environment. The demands placed upon investment management professionals have never been higher. Trust needs to be earned. Our research suggests that the profession is on the right road, but has more work still to do.

Professionalism will be a vital component in earning that trust. The work that we do to equip investment professionals to serve clients – through the CFA Program, our other qualifications, our codes, standards and guidelines and our continuing education resources – helps individuals and firms demonstrate and maintain their professionalism. CFA UK's report identifies many issues that still challenge us as a profession and will form the basis of further work designed to enhance professionalism and to improve client outcomes. We're pleased to support the report and look forward to working with CFA UK to raise levels of trust in investment management.

<sup>4</sup>Within the survey's margin of error

WORD CLOUD OF NOTES COMPILED IN OUR RESEARCH





# MEETING CLIENTS' NEEDS

Investment is an agency function. We work on our clients' behalf not for our own account. Stakeholders report that they value the services that the investment profession provides. By intermediating on behalf of those who wish to invest, the profession enables access to greater investment opportunities than might otherwise be available and reduces the risk to investors by diversifying those investments more broadly. In addition, the profession provides knowledge and expertise in investment selection and in asset allocation.

**T**he investment profession has a wide range of direct clients and an even broader range of ultimate beneficiaries. In the institutional world, investment professionals work for pension schemes, insurance companies, charities, endowments and foundations. While a pension scheme, represented by its trustees, may be the direct client, the work the profession performs will impact that scheme's own members and affect their financial outcomes. The profession's work also has a broader impact. Where pension schemes' investment returns are improved, the need for corporate contributions is reduced, freeing up capital for investment elsewhere. Further, by helping private companies meet their pension obligations, the investment profession reduces the ultimate reliance on tax-funded public entities. Similarly, the profession can positively affect a charity's ability to fund its activities or an insurance company's ability to pay claims and maintain premia at a relatively low level.

As well as the work the profession performs on behalf of institutional clients, it also works for retail clients. Individuals may run

their own portfolios or might use independent financial advisers, wealth managers or private bankers to help them construct and manage a portfolio. Either way, those portfolios will often be invested in collective vehicles such as funds or investment trusts.

The profession's stakeholders – clients, policymakers, the

regulator and others – value the work that the profession does in providing access to investment opportunities and working to deliver returns consistent with the mandates that we are given.

They believe that the profession's work begins with helping potential clients consider whether it is appropriate for them to invest and, if so, by providing them with



## What the customer wants

### Robert Waugh

If you want to know what customers want, it's important to be in the business of serving them. But it also helps if you're a customer yourself.

Robert Waugh has seen both sides. He was a senior investment manager at Phillips & Drew, Edinburgh Fund Managers and Scottish Widows Investment Partnership before switching sides to become the CIO at the pension fund of the Royal Bank of Scotland, which invests its £26 billion with many in the fund industry.

Is the investment management profession giving customers what they require? Often not, Waugh deduces. He says, "The industry tries to deliver alpha, while it really should be more focused on helping people with their savings." He adds: "I'm not arguing that the industry shouldn't exist. I'm arguing that much of the time it is not providing value."

Waugh suggests there's plenty more work to be done on actually designing services around meeting client needs and away from the current obsession with beating investment indices. And he says it is time for the industry to take back ownership of the relationship with clients from consultants and advisers. He observes that it's impossible to know what clients want if you never get to talk to them.

## Behavioural finance: common flaws

<b>1. Herding</b>	Buying when everyone else buys (and/or when share price is rising)
<b>2. Loss aversion</b>	Reluctance to sell losers but willingness to sell winners
<b>3. Mental accounts</b>	Unwillingness to invest in a good opportunity because you missed out already
<b>4. Status quo bias</b>	Reluctance to change a portfolio despite evidence supporting that change
<b>5. Overoptimism</b>	Underestimating the risks around a stock you own or recommend
<b>6. Recency bias</b>	Focusing on recent / upcoming catalysts rather than the long-run thesis
<b>7. Hindsight bias</b>	Assuming you always knew a certain outcome would happen
<b>8. Casual thinking</b>	Assuming a link between a news story and the share price performance that day

Source: Goldman Sachs research, Kahneman 'Thinking, fast and slow', Montier 'Behavioural investing: a practitioners guide to applying behavioural finance'

support and guidance on how to assess their investment needs.

If it is appropriate for an individual or institution to invest, the professional's task is to help them understand what they are trying to achieve (which typically requires them to consider their future liabilities and their investment time horizons). These are not simple assessments to make, but they are critically important. Without a clear understanding of a client's position – assets and liabilities, income and costs, dependents and dependencies – it is not possible to determine how best the investment profession can serve the client.

The development of an investment policy statement that identifies these issues alongside other items such as the client's time horizon, tolerance for risk, constraints and tax requirements – is a fundamental first step in delivering a successful outcome (and is a core component of the CFA Program syllabus<sup>5</sup>). It is unlikely that a client would be able to complete this exercise successfully alone.

Once the client's needs are known it is possible to consider how best these might be met. An investment professional will propose an appropriate balance of assets most likely to deliver the risk-adjusted

*We need to be closer to a whole portfolio understanding. Sometimes clients seem forced into benchmarks that don't seem compatible with their aims.*

*We need to know and understand our clients' needs forensically. You can't run money for people unless you understand the organisation, the people and the beneficiaries and how they will behave under different and difficult market conditions.*

*People pay for expertise and trust. Don't drop the ball.*

*All these are journeys into the unknown. If I know what I want and articulate that clearly, I'd be happy to pay more for someone that totally understands that and then delivers.*

<sup>5</sup>A summary of the elements of an investment policy statement can be found at <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2010.n12.1>

*Clients can't do it themselves and it would not be cost effective to try. They don't have the time, information, expertise or economies of scale.*

*Honesty – that's the value add. Nobody can tell you for sure what the return will be. We're helping people not to make mistakes. We need honesty in expectation setting.*

*They come to us for cost and performance. They stay for transparency, ease of use and quality of service.*

*It's about more than performance, but when we go out we sell performance. We focus on the product and forego the asset allocation part of what we do.*



## **A changing industry**

### **Rod Paris**

#### **Why is the investment profession important?**

There is a democratisation of investment risk - individuals are taking a greater responsibility for their savings, for pensions for example. There is a demand on the part of the consumer for guidance and for help in investing their assets. Now more than ever this is an imperative - there is a genuine social need and we have a duty of care to give those people investment outcomes that meet their liabilities and aspirations.

#### **What does the profession have to do?**

There is a sense of trying to explain how financial liabilities can be turned into desired investment outcomes. That demands a level of transparency in terms of explaining risk, of explaining how we charge fees and in terms of setting sensible expectations of how those outcomes can be met.

We used to talk in a two-dimensional return space, but now we have many more parameters such as volatility or the nature of the investment journey. It cannot be explained in a traditional environment.

#### **So how should the profession be speaking?**

I think the industry needs to engage in a different type of dialogue - one that's framed around optimising client's outcomes, subject to multiple constraints. The industry needs to think about the language and how to explain these issues and these investment outcomes over time. There is a need for a greater degree of sophistication in the discussion. In the past it was the intermediaries who solely handled that conversation but now we, alongside the intermediaries, need to speak to clients directly, especially individual savers. Explaining areas where there is a great deal of complexity in a straightforward manner can be a challenge. We have to realise we now have to have a different sort of conversation with a different audience.

#### **How are we doing as a profession?**

The industry is changing and it requires us to think differently. It's getting better but within the industry it's still quite divided between those who understand that need to change and those who are still working in the old world.

We think ethics are very important in keeping the professionalism of the industry pointed in the right direction and the CFA exams are very helpful in that. Society has changed and the expectations on fund managers have shifted, so it's incumbent on us not just to explain what performance has been achieved, but how it has been achieved. That then speaks to other areas such as the stewardship and governance agenda and socially responsible investing, as well as the ethics within the fund business itself. We need to stay relevant and this is absolutely critical to staying relevant.

returns the client seeks over time. Once agreed, the portfolio will then be constructed through the selection of the appropriate securities or investment vehicles.

Security selection – or manager selection – is a difficult process and, again, one that stakeholders believe is likely to be better undertaken by an investment professional than by a client on their own due to the professional’s specialist skill set and knowledge, ability to dedicate time to the role and access to in-depth information. In addition, the investment professional is able to spread the cost of that activity across multiple clients.

Making pooled, or collective, vehicles available widens the range of potential investments for clients. Such vehicles enable investors to access markets that might otherwise be unavailable to them. The costs are shared and they can benefit from the diversification that can be built into those vehicles, which can lower risk. It is also noteworthy that most funds offer investors daily liquidity allowing them to move into and out of the investment with relative ease.

Once the portfolio is formed, the investment professional will monitor these holdings – buying and selling securities in order to meet objectives outlined in the investment policy – and will provide regular reports to the client about the performance of the portfolio, the costs incurred in managing the portfolio and about the markets in which the investments have been made.

Helping clients to understand market movements and helping them to identify and manage their own behavioural responses to those movements is another way the investment profession delivers value. Without education and advice, there is a greater risk that people might ‘buy high and sell low’. Investment professionals – who have specialist knowledge of different markets and conditions and are more aware of the difficulties and costs involved in timing markets – can help clients to avoid making bad decisions that will damage long-term performance.

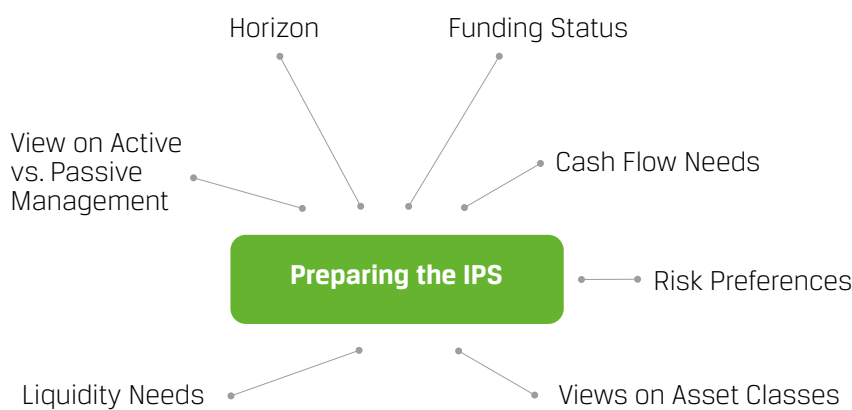
In a perfect world, investment professionals would always deliver the outcome that the client seeks. While an investment

*The range of opportunities for investment is much greater than it used to be. There are lots of chances to obtain access to markets. You can't do that alone. 'Search' has much improved in 25 years.*

*People rely on investment to do the heavy lifting. If there was no investment industry, you'd have to fund pensions out of cash.*

*There's too much focus on benchmark relative performance rather than just the benefit of being in the market. If you invest, then, as economies grow, you get operational and financial leverage into that growth and if you are saving for retirement that's a pretty good place to start. Once that's understood, then we can move on to how we can do that for you.*

## The Investment Process: Step 1, Preparing the IPS



Source: Chapter 4 of CFA Institute's lecture series Investments: Principles of Portfolio and Equity Analysis

*We provide a broad range of consumers with access to a broad range of investment opportunities, but it is not easy to know who to call and there are too many people in the chain.*

*If you understand the client and have a good relationship with the client, then you should get the right outcome for the client and that should be delivered in a way that we can all be proud of.*

*There is a lot of infrastructure supporting access to markets and the efficiency of those markets. Having people in this chain means that you can do things that you wouldn't otherwise be able to do.*

professional should propose and follow strategies intended to deliver the client's objectives (according to their constraints and requirements), those strategies will also be based on the investment professional's best assessment of the client's future requirements and the future development of markets. The passage of time is likely to prove both assessments somewhat inaccurate, but, if a client's potential needs have been researched with sufficient care and the portfolio has been constructed so that it has sufficient flexibility to perform reasonably well in different market conditions, then the client's outcome should tend towards their expectations.

It is commonly accepted that the investment profession delivers social value by enabling clients to invest – individually and collectively. If clients were unable to invest they would find it more difficult to protect and compound the wealth on which they will rely during and after their working lifetimes. The alternatives – reliance on bank savings (that now commonly fail to deliver a real return) or additional investment in property (that can be illiquid, is more difficult to diversify and is a relatively inefficient investment from a societal perspective) – are unattractive. The profession does so in a dependable fashion and, increasingly, also recognises the need to invest in a way that will help to secure the broader social objectives that a client might have, such as limiting the damage caused by climate change or fair treatment of all in a supply chain.

Stakeholders identify a number of ways in which investment professionals can add value. First, as described earlier, they should help clients identify the appropriate time horizon for the portfolio (and hence the portfolio's assets), the targeted risk-adjusted return and the appropriate allocation for their assets. In doing so, they should also agree an appropriate benchmark for the portfolio's return. Second, they should help them to build the portfolio. Third, they should attempt to deliver the client's risk-adjusted return target and report on their performance against that target. Fourth, they should work with the client to ensure that the planned approach changes in accordance with any change in the client's needs or preferences and, finally, they should help them to adjust to changes in the performance of the portfolio and to changes in the market.

Stakeholders note that none of these tasks are simple to perform and that each creates opportunities for conflicts of interest to arise. That such conflicts are identified and mitigated or avoided is critically important and is one of the primary reasons why investment should be seen as a professional activity operating at the highest standards of ethical and professional behaviour.

WHAT'S MORE  
REWARDING THAN  
EARNING THE CFA  
DESIGNATION?

# BECOMING A CFA SOCIETY MEMBER.

*Caroline Connell, CFA*

Ask CFA® charterholders who are members of CFA societies and they'll tell you that earning the designation is only the beginning. Being a society member allows them to connect with over 125,000 charterholders around the globe, share experiences, swap ideas, and participate in dialogue. They also have access to insightful career services. Not to mention, member discounts at valuable events worldwide. Because, for our societies and their members, those three letters are making a real difference every day.

# CAPITAL ALLOCATION

Stakeholders report that the investment profession plays an important economic role through its contribution to the efficient allocation of capital. Economies depend on capital. Enterprises require equity and debt capital to finance their activities, their ambitions and the building of their assets. Historically, most debt capital has been provided by banks, but as they scaled back their balance sheets following the financial crisis, their ability to provide that finance has diminished. Investment professionals have always played an important role in financing the economy through the provision of equity and debt, but in recent years have stepped up their activity to fill the vacuum created by the partial withdrawal of bank credit.

**T**he investment profession provides new capital through primary markets. This new capital may take the form of debt or equity and may be issued publicly or privately. In addition, investment professionals participate in the secondary market as buyers or sellers of existing securities and, in doing so, set the prices for those securities.

Once capital has been provided, investment professionals act as its stewards on behalf of their clients to ensure efficient allocation to those locations where it can properly and most productively be applied. In primary markets, borrowers (companies and countries) compete to attract capital based on investors' perceptions of the balance of future risk and reward.

Investment professionals believe that they provide an important role in capital allocation by assessing the appropriate cost at which to provide capital by undertaking in-depth financial analysis. Their analysis incorporates

the company or sovereign credit's financial information, its operating environment and its governance. Stakeholders also note that investment professionals' reliance on accurate, relevant, consistent data has led them to contribute to the improvement in the quality of the data provided to the market over time.

Stakeholders point at social housing as an example of the way that investment management has compensated for the partial withdrawal of bank financing. Social housing projects used to be financed largely through bank credit. That funding was withdrawn in the years following the financial crisis and those projects are now



## A different future

### John Kay

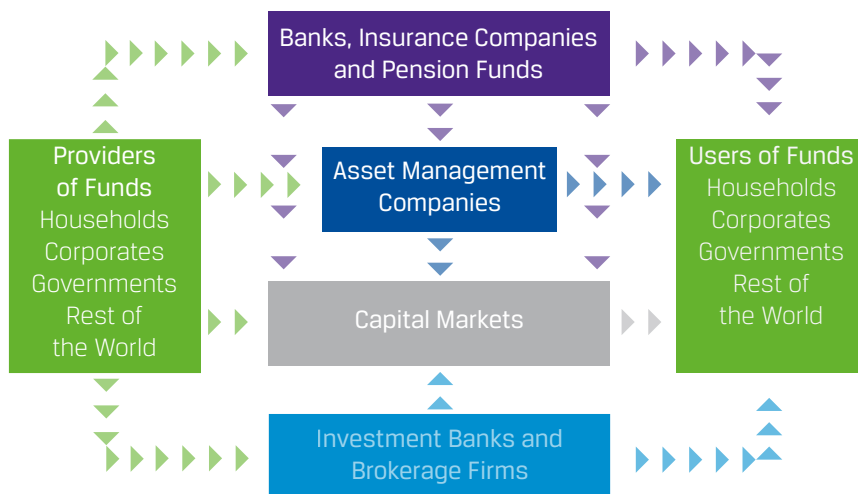
During the 19th and 20th centuries, companies needed large public equity markets to raise capital to fund large-scale manufacturing. That's no longer the case, according to economist John Kay. Investment managers

should focus more on being the conduit between investor capital and start-up and growing businesses, instead of trying to outperform standard indices.

"The profession is spending too much time chasing alpha and not enough time enhancing beta and for the economy as a whole the value comes from the latter, not the former," he says. "Looking forward, I see asset managers having a very large role but not one where I see public equity markets being a central feature."

Kay believes there's room for enhancing returns from public equity markets and a genuine focus on stewardship would be a positive step. Often investment portfolios have far too many stocks – the benefits of diversification run out fairly quickly, he says. Instead, Kay recommends concentrated portfolios that can allow investment managers to guide companies to greater returns.

## Asset management industry in the financial system



Source: EFAMA Asset Management in Europe, 2015

funded directly by investment institutions. Stakeholders believe society's reduced dependency on the banking system has allowed risk to be borne more broadly and taken by parties that are less leveraged than the banking system and which have not required bail-outs by the taxpayer.

### PRIMARY AND SECONDARY MARKETS

Historically, the primary equity markets have been used to source capital to fund growth but stakeholders believe that this function has declined in recent years, though they note that corporate bond issuance has increased (even if that hasn't fed

*Large asset managers can go in and hold companies to account whereas individual investors cannot.*

*The more effective the governance system is, the less visible it is because fewer resolutions emerge that will be voted down by investors. To the outside world it looks like we aren't doing anything.*

*Too many people are focused on short-term price discovery and that's where capital is misallocated. It's noise not signal in the short-term.*

*Carbon companies need guidance now like the tobacco companies once did. You can't leave it to the companies to determine their own fate. They need information from their capital providers.*

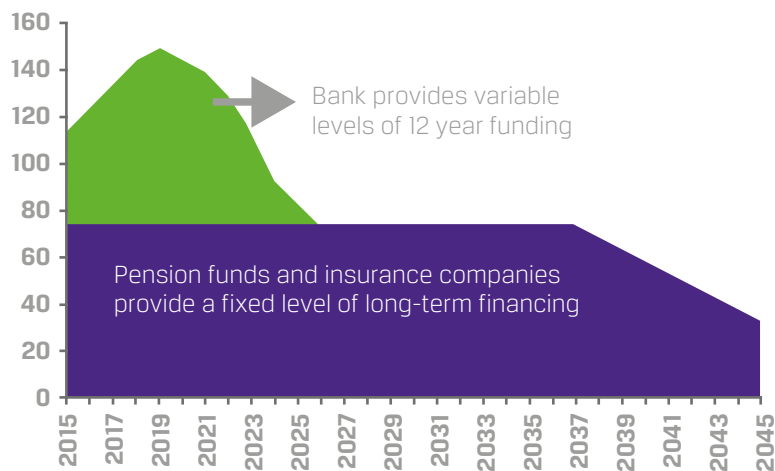
## UK housing associations

A small market – £80bn but providing 9% of UK housing stock

### 2007 – Bank domination

- Housing associations financed through bank loans
- 25+ year loans at Libor +25bps
- Floating rate debt with swap overlays and options

### 2013 – Bank and asset manager cooperation



Source: M&G Investments.



*We generate true value through a thorough understanding of business models and with appropriate time and governance we can do that. We hold existing holders of capital to account.*

*Asset managers play a vital role in the financial system because they enable the allocation of risk capital that can afford to be lost and [asset managers] have never had to be bailed out. It makes better sense than putting your risk capital system on top of your payments system.*

through to an increase in overall business investment)<sup>6</sup>. In recent times, there has been a shift away from growth capital funding through public equity markets. Stakeholders attribute this to the direct cost of listing, combined with the ongoing regulatory and compliance costs (and the availability of attractive funding elsewhere). While the public equity markets may now be a less frequent provider of growth capital, stakeholders observe that they continue to provide a valuable venue for the recycling of risk capital investment. In addition, they provide companies of sufficient size with access to larger pools of capital and, through secondary markets, with liquidity and a continuous valuation of their outstanding capital.

The secondary markets are many multiples of the size of the primary markets. For instance, while \$1.5 trillion of new corporate debt was issued in the US in 2015, outstandings totalled \$8.2 trillion<sup>7</sup>. Capital trading in secondary markets has already been allocated to its end-users – there is no fresh capital raised by companies or governments in secondary markets – but the value of the securities representing the capital can change continuously as investment managers seek to exit or enter and increase or decrease the size of their holdings.

## **PRICE DISCOVERY**

Securities' prices are set by the supply and demand present in the market at any time in a process called 'price discovery'. Price discovery matters because

it impounds new information into prices, indicating investors' views on the outlook for the issuer. Companies whose prospects are worsening – either as a result of poor management or a more difficult trading environment – will likely see the price of their securities fall as investment managers sell them to mitigate against poor future earnings streams and creditworthiness. The converse is true for those companies whose prospects improve.

Price discovery acts to discipline companies so that they are encouraged to operate efficiently and generate an adequate return on their capital. Initially, a declining share price is a warning to a company's owners and managers. Ultimately, a fall in the price of the securities of a struggling company may encourage another company to purchase the struggling company's shares taking ownership of the company to effect a change of management with the intention of restoring the value of the assets.

## **STEWARDSHIP**

Stakeholders broadly believe that investment managers can help management to avert poor decisions through engagement with the company. In theory, by aggregating the interests of shareholders, investment professions can have influence as stewards on behalf of their investors<sup>8</sup>. The stewardship work investment managers do is intended to protect their clients' interests by helping the company to be well-governed, to employ its capital effectively and to monitor its risks.

<sup>6</sup>See <http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2013/qb130407.pdf>  
<sup>7</sup>SIFMA

<sup>8</sup>The Kay Review recommended the establishment of an collective body to help investment firms and asset owners, whose voices might be dismissed individually, to be heard more clearly through collaboration. The Investor Forum ([www.investorforum.org.uk](http://www.investorforum.org.uk)) was established in 2014 to position stewardship at the heart of investment decision making through effective collective engagement.

In recent years, investment managers have encouraged the companies whose securities they hold to pay greater attention to issues relating to the environment and their working practices, as well as to their governance. There is a growing body of evidence to suggest that environmental, social and governance (ESG) issues are financially material<sup>9</sup> and that companies that monitor and mitigate these risks deliver better returns over the long-term. Increasingly, investment managers are integrating ESG analysis into their traditional analytical and valuation frameworks. 61% of the EMEA respondents to a recent CFA Institute survey indicated that they integrate ESG analysis into their investment decision-making framework<sup>10</sup>.

There is general agreement that it is difficult to measure and assess the impact of stewardship. Much stewardship goes on behind the scenes to influence the decisions boards make, and which investors may vote on at annual general meetings (AGMs). Some commentators have suggested that the balance of votes for and against company resolutions might be taken as a proxy for stewardship,

but stakeholders report this is not a good measure. Where stewardship is effective, you would expect the board and shareholders to be in broad agreement about the direction of the company before the resolutions are sent to an AGM.

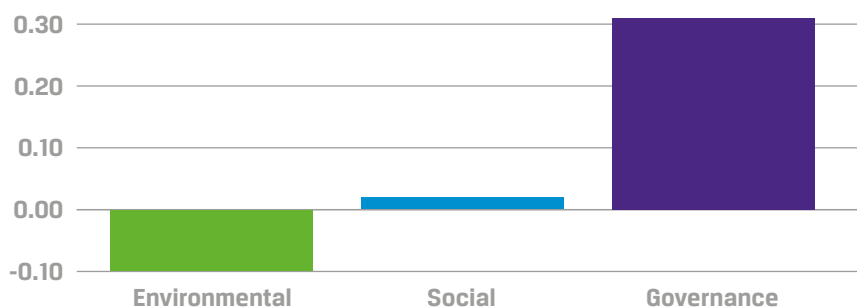
Company representatives spoken to for this report believe that they and their counterparts generally appreciate their relationships with the investment profession (see roundtable on pages 50-54). Investment management firms are sources of capital and can also provide feedback on a company's strategic plans and their implementation. Nevertheless, there is a sense that while the views of long-term shareholders, with an in-depth knowledge of a company's sector and past history, can be useful, the information obtained from short-term price movements are often too 'noisy' and random to contain much useful information about a company's outlook. However, corporate stakeholders accept that the immediate market reaction to an announcement can provide significant information either in support of or against management's plans.

*Our core top 10 shareholders were broadly the same throughout my six years. One activist investor's stake halved and another investor took an opportunity to invest after the financial crisis and sold out a few years later. Shareholders are willing to be patient when you explain to them what you're doing.*

*There's better infrastructure, information and access than in the past, but now there's too much focus on the listed world. There are more interesting market inefficiencies in the unquoted market.*

*The average age of the corporation has dropped from 75 years when I started out to 30 years today, if that. Investment professionals need to discover and finance four generations of viable and profitable businesses during the lifetime of an individual born today.*

### ESG value is driven by corporate governance (%)



Average monthly dispersion in total returns between companies in top decile and lowest decile on environmental, social and governance scores from 31 December 2008 to 31 December 2013  
Source: Hermes Fund Managers

<sup>9</sup>For instance, the Smith School/Arabesque report ([http://www.arabesque.com/index.php?tt\\_down=51e2de00a30f88872897824d3e211b11](http://www.arabesque.com/index.php?tt_down=51e2de00a30f88872897824d3e211b11))

<sup>10</sup> <https://blogs.cfainstitute.org/marketintegrity/2015/08/17/cfa-institute-survey-how-do-esg-issues-factor-into-investment-decisions/>

*We look at debt and equity as equal providers of capital. Debt investors enjoy an extra dimension to their work. It's the ultimate buy and hold. They are more aligned to governance and responsible investing because they are trying to make sure that their instrument is serviced and redeemed.*

*There's a lack of proper risk capital in the UK. We're happy to provide capital to steadily growing businesses, which provide bond-like returns to equity holders, but to really build new businesses you need equity risk investments.*

*Capitalism requires a mechanism to set the amount of capital. Without investment the economy's foundations would fall over. Society chooses the systems and requires different entities to play their parts.*



## **A good industry, but we can do better**

### **Neil Woodford**

#### **What's good?**

There is a fundamentally societally useful function that fund managers provide in a capitalist economy.

The stock market is the place where risk is managed and absorbed in a capitalist economy and the act of providing capital itself to facilitate growth in enterprises brings employment and wealth benefits to the economy.

Where we are operating at our best is in an active scenario where we decide where to allocate capital and where companies that are destroying value, we remove capital from those companies. Capital is recycled to areas for a greater return for employment and the economy.

#### **What about the fact that we generally operate in the secondary market?**

There's a primary and secondary role. Retaining earnings in the business itself is an allocation of capital. If the market held businesses where it had lost trust in the management it would demand the repatriation of capital to shareholders. People lose sight of the fact that there is a capital allocation going on. Retained earnings are a source of funds for businesses, outside of specific capital raising events companies are using equity capital in their businesses.

#### **Are we doing well?**

Not well enough: part of the reason that we don't do well enough is because of the complexity that has been laid on to that quite simple function of taking savings and investing them on behalf of people. All of those involved in the process have added layers of complexity to fee structures that have diluted returns that should find their way back to the providers of capital.

#### **How can we counter this?**

Regulators and government need to think more holistically about the motivation for regulation. Have we moved too far from trusting people's judgment? Lay investors need to be protected but I'm not sure whether we have created a system that would protect them any better than the system that existed when I started doing this. We have created structural inefficiencies. Parts of regulation have created unintended and harmful consequences.

Appropriate risk and returns are what clients look to their investments to deliver. My approach is guided by the asset class that most interests me, which is equities. The equity asset class and the role it can fulfil for investors have been undervalued by the establishment, by regulators, by fashion and government. It has been disproportionately disadvantaged by tax treatment, for instance.

Our industry has been extremely adept at creating a mystery. What we would like to move to is a system where the difference between the gross and net return for the investor is the amount we charge for doing the job we do.

## PRICE MAKERS AND PRICE TAKERS

Stakeholders are quick to point out that markets are inhabited by participants with different views, objectives and time horizons, An issuer is obliged to disclose all financially material information to the market, but market participants have varied knowledge of other factors that may influence the outlook for a company, and they may interpret the same information differently. The decision to buy or sell a particular security may be completely unrelated to the actions of the issuer, driven instead by the changing needs or preferences of the individuals whose portfolio is being managed, or by a change in the relative valuation of another available asset. There are also participants in the market that are not interested in issues relating to fundamental valuation, preferring to extract information from prices

alone. And some participants in the market are insensitive to relative valuations, simply offering investors an opportunity to own the market.

CFA UK believes that different investment approaches can add value to investors, but also believes that market efficiency depends on the presence of sufficient price makers alongside price takers.

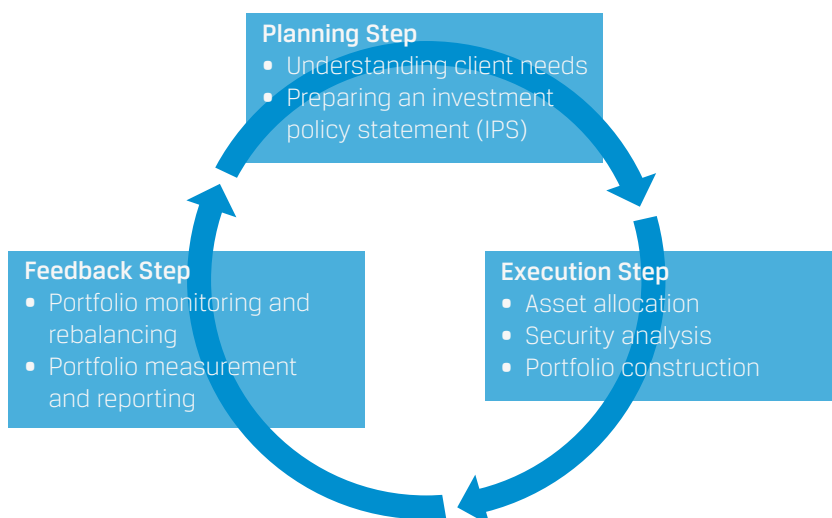
Stakeholders are confident that investment professionals contribute to the efficiency with which capital is allocated across the economy. They accept that this process is bound, with hindsight, to be imperfect, but they believe nevertheless that it contributes value to society by directing capital to where it can be most productively applied, by maintaining discipline in the use of that capital and by allowing clients to access opportunities to participate in economic growth.

*Now the investment managers are the only place where long-term financial capital is going to be available. We're doing what the banks used to do a long time ago.*

*The duty of the investment professional is to find the investments that meet the changing needs of the client. This is done through understanding the qualitative characteristics of the businesses you are investing into.*

*We tend not to get involved in operational business decisions because we're very clear that we're not managing the company. We might talk to them about the different [capital] actions that may or may not be appropriate.*

## Steps in the portfolio management process



Source: chapter 4 of CFA Institute's lecture series Investments: Principles of Portfolio and Equity Analysis

# CHALLENGES

Stakeholders recognise that for the investment profession to have a *raison d'être*, it needs to add value: to individuals by helping them meet their future financial needs; to society as a whole by enhancing the return on the nation's savings, ideally at a reasonably low cost; and to capital markets by allocating capital to its different segments and thereby contributing to their efficient functioning.

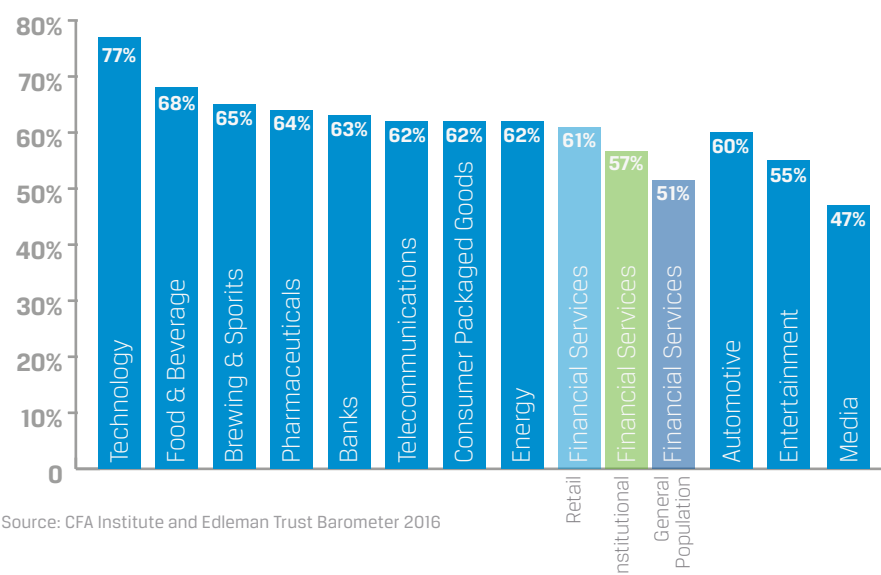
Most practitioners agree that today this value proposition is at best not well understood by society at large, at worst questioned. There is also a common understanding around the topics that need to be addressed: client focus (ensuring that clients are offered strategies tailored to their own needs), competition (to drive down costs and encourage the development of products and services); capital allocation (improving stewardship and aligning investments with clients' time horizons) and communication (to explain the value that the profession provides and to enhance the client relationship).

## COMMUNICATION

Stakeholders report that the investment profession's communications are flawed in a number of ways:

- focusing on individual manager performance and rarely making the broader case for the value of investing
- emphasising returns that are inherently uncertain, rather than processes and costs that can be communicated with greater certainty
- tending to set expectations at too high a level, and
- lacking clarity

**How much do you trust businesses in each of the following industries to do what is right?**



Source: CFA Institute and Edleman Trust Barometer 2016

In short, those we spoke to for this report believe that investment managers spend too much time talking about how they perform relative to one and other and too little time helping clients to understand what they do, how they do it and how that creates value.

This observation should not be too surprising. Investment management is a competitive activity that can generate attractive profits. Investment management firms will – and should – compete aggressively for assets. This can lead them to emphasise their own product in order to differentiate it from other products in the market, but there is also a need to remind consumers and other stakeholders about

the broader value of investment management. It is important to remind people that investment managers act as agents and not as principals. They work on clients' behalf, not on their own account, and owe them a fiduciary-like duty. It would be helpful to explain what that means in practice, how it differentiates investment from other parts of financial services and what that means for clients.

Stakeholders observe it is not just important for investment firms to increase their share of the pie, but to grow the size of the pie. They also comment that the profession has found it hard to unite around a common message about the importance

and value of investing because of competition between different parts of the profession (active and passive; hedge funds and long-only) and their representation across different trade bodies.

Given the growing need for individuals to safeguard their own financial futures, it is important that the profession does a better job of making its case. It is also important that our clients understand what they can expect of us. These expectations are set out in CFA Institute's Statement of Investor Rights<sup>11</sup> (as listed below).

## PRODUCTS AND COMPLEXITY

Stakeholders also express concerns that the profession is too focused on promoting products rather than strategies appropriate to clients' needs and that it values complexity ahead of clarity. It is hard to deny that investment managers have often focused on selling their

products, rather than on how they might serve clients, but that is partly a function of the diversity of the client base; the same product might have different applications for different client groups. As it can be difficult for clients' needs to be aggregated and articulated, it can be hard for the profession to respond other than by developing more products in a search for demand. It is also accepted that the profession is making progress on this issue. The development of multi-asset, target date and other outcome-based investment products is a clear response to the growing client demand for such structures.

The engineering involved in a product or strategy may be complex, especially so in a highly competitive market, but just because what is 'under the bonnet' may be intricate does not mean that the profession should not be able to communicate the purpose of that product or strategy clearly and simply.

### CFA Institute's Statement of Investor Rights

Our clients have the right to:

1. Honest, competent, and ethical conduct that complies with applicable law;
2. Independent and objective advice and assistance based on informed analysis, prudent judgment, and diligent effort;
3. My financial interests taking precedence over those of the professional and the organisation;
4. Fair treatment with respect to other clients;
5. Disclosure of any existing or potential conflicts of interest in providing products or services to me;
6. Understanding of my circumstances, so that any advice provided is suitable and based on my financial objectives and constraints;
7. Clear, accurate, complete and timely communications that use plain language and are presented in a format that conveys the information effectively;
8. An explanation of all fees and costs charged to me, and information showing these expenses to be fair and reasonable;
9. Confidentiality of my information;
10. Appropriate and complete records to support the work done on my behalf.

<sup>11</sup> [https://www.cfainstitute.org/learning/future/getinvolved/Pages/statement\\_of\\_investor\\_rights.aspx](https://www.cfainstitute.org/learning/future/getinvolved/Pages/statement_of_investor_rights.aspx)

*We're very bad at explaining what we do in aggregate. We can't argue our own case. This is not a zero sum game.*

*The industry needs clear, simple, consistent messaging. There's a lot of misunderstanding. It hasn't been a direct to the consumer industry. The industry has never really had to explain itself. We're now in more of a consumer environment.*

*Investment managers have streamlined their businesses but have lost the connection with their clients. We tend to forget that people don't really understand.*

*Good investing is like healthy eating. It should be communicated simply and transparently.*

*They hate us like the bankers, but don't even understand why we're necessary.*

*People have little knowledge or understanding of what's happening with their money and whether they're getting good value.*

*We think about market values and benchmarks, but that's not how business people, trustees or pensioners think about money. They think about cashflows.*

*Nothing makes an investment manager shudder more than being called an investment banker. We need to differentiate and show that we add value.*

*I think that the institutions that we serve understand the value that we deliver very well. They come to us with a problem to solve and we help them to solve it. It's difficult to have the same relationship with retail.*

## CLARITY AND RETAIL

Clear, simple explanations are not easy to provide without running the risk of misrepresenting the potential outcome for clients, but the need for clear communication will only grow. In the past, defined benefit pension schemes held the bulk of UK institutionally invested assets. Scheme trustees, advised by their consultants, had a relatively clear understanding of the value their investment managers could provide and what those managers were doing on their behalf.

Institutional clients report that they have effective working relationships with investment managers. This is less often the case in the retail market where the end client is likely to be several steps removed

from the investment manager, intermediated by combinations of advisers and platforms.

Today, investment management is becoming more retail in nature because of the growth of defined contribution schemes. While most DC scheme members will opt for a default option and rely on the members of their Independent Governance Committee for investment decisions, there will in future be greater retail involvement in investment decision-making. While platforms, ratings providers and advisers will be able to communicate much of the value that can be delivered by investment managers, the investment profession will need to build the capacity to explain itself better to retail clients than it has in the past.



### Where fund managers add value

#### Paul Sweeting

According to Professor Paul Sweeting, who works for L&G Investment Management as well as working as an academic at the University of Kent, the investment profession performs two functions that add value for clients. One is in setting asset allocation and the other is in selecting securities within asset classes. It's easier to demonstrate the value added in strategic asset allocation, he says.

"It's easier again to demonstrate value if you are trying to set an asset allocation with a particular object in mind," he says. "These objects can be massively broad: a pension fund meeting its liabilities, and insurance company meeting its statutory requirements, or an individual meeting their savings targets."

But how did the industry get so fixated on using security selection to beat an index?

"If you go back half a century the main use of indices was to give you an idea of direction of the market, and if you had an asset manager he tried to give you a positive return by investing in a range of securities," Sweeting says. "Then clients started thinking they could use the index as a way to measure their manager, and then some manager said they would aim to give the index, and others used the benchmark as a way of moving away from that. People are starting again to build things from the bottom up."



### Battling against the short-term

#### Sandy Nairn CFA, ASIP

"The mantra should be get rich slowly." That's the advice of Sandy Nairn, a former Director of Research at Templeton Investment Management and CIO of Scottish Widows Investment Partnership, who went on to found his own business, Edinburgh Partners, more than a decade ago.

Short-termism vexes Nairn, who notes that advisers and consultants have a natural tendency to recommend change because they feel obligated to justify their charges. The reporting cycle for companies itself is relentlessly short-termist, he says. As for clients, it's very difficult to ask them to forgive fund managers who are underperforming in the short-term and to advise them that all will be all right in the end.

"The more you educate on what anticipated returns should be, the better. I would like someone reading an advert that is offering too much for too low risk to know instinctively that it's too good to be true. That comes with education but there still needs to be more regulation on advertising," he says.

There's also the issue of how fund managers behave. "Nonetheless", says Nairn, "the private sector is far better at allocating capital than the public sector and the industry is good at creating products that have the correct risk-reward profile for people".

## INDEX-RELATED PERFORMANCE AND RETURNS

Typically, much of the investment profession's communication has related to performance and often to performance relative to a market index. Stakeholders note this approach can serve clients poorly in a number of ways. First, there may be relatively few clients that necessarily seek the index return or its risk. Second, performance relative to the benchmark index has information value, but only over the medium to long-term. Third, by focusing on index relative performance, clients may be wrongly encouraged to spend too much time on manager selection when their time might be better spent in consideration of their overall asset mix relative to their liabilities.

So, why are index-related benchmarks so widely used? Stakeholders believe that it is because, even if they are unreliable, they are relatively simple to calculate and to understand (and therefore to communicate) and that past performance against them is seen by clients as the best available indicator of future value.

The investment profession uses index-related performance to sell its products because that is how our clients buy. Stakeholders believe that whether the profession has conditioned clients to act this way or whether this behaviour is intrinsic to clients doesn't really matter. What matters is that the investment profession should help its clients find better ways to assess and maintain manager relationships.

Stakeholders also comment that investment managers'

*Don't underperform because you'll lose your clients. The safest thing to do is to move to the middle. Every manager will have a three-year period of underperformance over a long enough time period.*

*We fight for market share by highlighting the only tangible proof of excellence, though we know that is temporary and sometimes illusory.*

*We overwhelm simple, sound products with marketing guff. We emphasise complexity because it creates the space for the fairly marginal differences between our products to be made more apparent to clients.*

*Investment is about more than performance, but when we go out we sell performance. We focus on the product and forego the multi-asset and asset allocation part of what we do.*



*The industry is absolutely focused on performance, which is the last 10%. It is the icing on the cake, not the cake itself. Active performance can make a difference, but it feels as if the industry spends 80% of its marketing budget on that piece rather than on the piece that is useful to consumers.*

*Benchmarks are essential for one particular purpose. They represent the a priori definition of righteous ex-post disappointment. The benchmark defines the deal.*

*The notion that beating the FTSE by 20bp should be the target is pretty short-sighted, but the fixation with beating the benchmark is our own fault.*

*The industry sells performance because that's what people buy. There is a need for more financial education so that people understand time horizons and the need to hire good stewards of their assets.*

communications tend to focus on returns (that are uncertain and may be over-promised) and less so on processes and costs that are more predictable. This unsatisfactory approach was well described in an Asset Manager and Investor Council (AMIC) paper on managing client expectations<sup>12</sup>. The paper notes that clients can set performance targets which encourage asset managers to make heroic return predictions to win business and that this problem is then compounded by clients' tendency to award mandates to those whose predicted returns are most heroic. This approach makes disappointment inevitable and encourages clients to make frequent manager changes often to their detriment.

## CLIENTS AND ALIGNMENT

The investment profession has effective working relationships with those of its clients that are best capable of assessing its value and negotiating to capture that value. Those clients that are 'price takers' from the profession and that are less well equipped to work with the profession are reckoned to have less satisfactory outcomes. Stakeholders' worry that clients often lack the necessary scale to resource themselves to work well with the investment profession and that, where they have that capacity, they do not always use it well because of failings in their governance structures.



### Educating the Consumer

#### Campbell Fleming

Campbell Fleming is head of Columbia Threadneedle, one of the UK's largest investment companies. He suggests that the profession has done a great deal for UK savers – it provides investments that are priced every day, highly regulated and came through the global financial crisis relatively unscathed.

He believes the profession could learn from how other sectors communicate with consumers and could provide greater detail to fund buyers on how the profession generate's value.

"In 20 years' time people will look at investment funds in the same way they look at food labelling to make choices. I would like to see our industry follow the example whereby generations of consumers have been educated to understand their choices – about drinking, smoking, sunburn for example – so we have a population of knowledgeable, intuitive investors," Fleming says.

For its part, Columbia Threadneedle uses the active share metric as a way of demonstrating where its managers add value. Says Fleming, "We have nothing against passive, but investors in passive funds may start to feel like a cork bobbing along on the roiling ocean of markets at the moment. We believe a good active manager with an established investment process offers investors a better place to be a passenger."

Adds Fleming: "We believe fund managers should earn a fair price for what they offer. You want well run, well managed, well capitalised companies in this industry. Imagine if people were worried about their provider becoming insolvent."

<sup>12</sup> <http://www.icmagroup.org/assets/documents/About-ICMA>



### Make fund costs simpler

#### Merryn Somerset Webb

Merryn Somerset Webb, editor-in-chief of Moneyweek and Financial Times columnist, says the investment profession in essence has a straightforward task to do, and does it pretty well.

"It's simple – the industry takes the accumulated wealth of people and takes care of it, doesn't lose it, and doesn't go bankrupt," she says. "That is all that people want and in general the profession does this quite well."

But do fund managers exercise their stewardship rights and voice concerns enough on behalf of their clients? "Fund managers utterly failed in their duty during the financial crisis," says Somerset Webb.

Equally she highlights another perceived conflict over how effective fund managers are at questioning board pay when their own remuneration can be at comparable levels. They see corporate executives constantly at professional and social events and many of them get paid in the same league as they do – so challenging them is difficult, awkward and embarrassing."

Another Achilles' heel within the industry is in how it charges people for its services. She says fee structures are often opaque, with clients unable to understand what they're paying for, and this can feed through to resentment.

"Fees should be stated in real terms; not ad valorem. Fund investors should be sent a bill at the end of the year with this amount before the money comes off so they can query this," she adds.

## SCALE AND GOVERNANCE

There's broad agreement that scale is valuable and that clients might work with the investment profession more effectively if demand for investment management was less fragmented and there was a small number of larger, better informed clients. The development of occupational schemes at employer level has meant that the UK has a very large number of schemes. Some of these are large and benefit from professional in-house investment support, but many are small. While some of these are thought to be more than capable of identifying and managing good investment partners, not all have these skills. The situation may improve as the balance of assets shifts from DB to DC with consolidation under

Master Trusts (multi-employer schemes), but even here there is considerable proliferation. In the UK, there are roughly 6,000 DB schemes, close to 35,000 DC schemes and there are estimated to be roughly 70 Master Trusts.

Where asset owners operate with scale, they are able to diversify more effectively by accessing a broader range of investment opportunities and have more leverage with which to negotiate the costs of their investments. The converse is true for smaller schemes. As was noted in a 2015 Financial Analysts' Journal article 'The ideal pension-delivery institution is expert, has scale, and acts solely in the best interests of plan participants'<sup>13</sup>.

Large asset owners can also benefit from being able to afford their own

*How knowledgeable they [trustees] are isn't the point. They still only have four one-hour meetings. It's not a question of competence. It's a structural flaw.*

*There should be more collaborative use of pension fund buying power. We have a genuine ability - especially at the top end - to band together and to make a difference.*

*There's too much fragmentation. You can't have the governance around all of them that will allow them to do this properly. We end up with a hypothesis that too much money is being spent by too many people in pursuit of too little return.*

*To bring market forces to bear, you need people to have larger assets at stake.*

*Different asset managers have different cultures and those matter, but it is difficult for clients to understand and identify them.*

<sup>13</sup>'Why we need a pension revolution', Keith Ambachtsheer, FAJ January/February 2015 | Vol. 71

*There's not enough reviewing of fees. Trustees should review their pricing every year against the industry. We did that with our consultants and they didn't get the fees right for the market. But there is value in fees. This should not be a race to the bottom.*

*Trustees find it very hard to make that decision [selecting under performing manager]. It's easier to talk to clients about managers that are outperforming in under-performing asset classes.*

*You can either professionalise the investment aspects – and certainly the implementation – by having a professional investment board or [you can] just get the internal governance structures organised better so that the right decisions are being made by the right people with the right expertise.*

investment professionals. These individuals, working directly for the asset owner, might manage some or most of the asset owner's own money or they may support the asset owner's work with external managers. They will likely have sufficient experience and expertise to select and monitor managers (by understanding their investment managers' processes and interpreting their performance, both relative to benchmarks and in absolute terms) and are also well placed to review fees and to investigate the relative cost of similar exposures and risk profiles.

However, most observers believe that asset owners only obtain the benefit of in-house expertise where they have appropriate governance structures in place. It is reckoned that in too many instances the asset owner's trustees retain control over operational decision-making and that this only takes place following occasional, relatively brief meetings. Most of those that contributed to this report suggested that it would be better for trustees to set the appropriate reference and policy portfolios and then, where possible, to leave the implementation of the investment portfolio to an in-house investment team. That would leave the trustees with more of their governance budget to spend on the areas that would have the greatest impact on outcomes and would leave tactical issues to informed, aligned employees<sup>14</sup>.

Improving governance capacity is also thought likely to improve outcomes for retail investors. Retail investors typically invest through funds (collective investment schemes) or investment trusts.

While governance is relatively well developed in investment trusts, which are essentially independent companies in which investors are shareholders, it is less secure in collective investment schemes, at least in some European markets<sup>15</sup>. In the US market, mutual funds have boards with independent directors that are required to act in their clients' interest<sup>16</sup>. Stakeholders suggest that similarly stronger governance in the UK might improve outcomes for retail investors.

## CLIENT EDUCATION

While most stakeholders believe that improved governance would be clearly beneficial, they also argue that client outcomes could be significantly improved by helping clients to understand what they can reasonably expect of the investment profession so that they temper their expectations and avoid unrealistic promises of high returns at low risk. They also think that the investment profession should educate clients to ignore their own behavioural impulses<sup>17</sup> and to help them identify how they can best extract value from working with investment managers.

Too often, clients are reckoned to fail to exploit the opportunities that their time horizons provide and seen to respond badly to market movements on both the upside and the downside. Stakeholders report that clients appreciate that risk matters when they are establishing their preferred portfolio, but then show little interest in risk-adjusted returns. Similarly, they often react instinctively and inefficiently to short-term underperformance.

<sup>14</sup>CFA Institute's primer for investment trustees (2011) is a useful guide to how trustees can work with and challenge investment professionals (<http://www.cfapubs.org/doi/pdf/10.2470/rf.v2011.n1.1>)

<sup>15</sup> Among others, EFAMA has a clear code of conduct that encompasses fund governance and directors' duties (<http://www.efama.org/Publications/Public/CorporateGovernance/efamacodeofconduct.pdf>)

<sup>16</sup> There is considerable material on aspects of retail fund governance on CFA Institute's site (such as <http://www.cfapubs.org/doi/full/10.2469/dig.v43.n2.3>) and

<sup>17</sup> There is a large body of material on helping clients to identify and deal with behavioural biases on CFA Institute's website (such as the online course 'Understanding behavioural biases' by Michael Pompian CFA)

## INVESTMENT CONSULTANTS

Investment consultants ought to be able to help clients – large and small – extract better value from investment management, but there is a general sense that this has not always been the case.

Investment consultants act for asset owners, helping them to identify appropriate approaches to managing their assets and helping them to identify the right people to manage those assets on their behalf. In practice, for many schemes, the consultant ultimately operates rather like an in-house investment team, helping the scheme with reporting and administration as well as with asset allocation, manager selection, fee negotiation and manager monitoring.

The criticisms relating to investment consultants are that they accentuate the tendency for asset owners to select managers that have recently outperformed (and that are then likely to underperform due to mean reversion), that they encourage too much activity because of their fee structures and that they have conflicts of interest because, in some cases, they offer products that

compete with external managers (such as fiduciary management).

Some consultants have avoided these conflicts by staying out of the investment management business and by operating a fixed and/or flat fee structure. Some stakeholders note that consultants have begun to address challenges to their value creation by being more open about the impact of their advice over time. Others note that, as pension scheme trustees bear a regulatory requirement to seek expert advice, improvements in the competence, capacity and governance of schemes would likely also lead to an improvement in the quality of the market for investment consulting.

## INCENTIVES AND ALIGNMENT

While there are concerns about incentive structures and conflicts of interest in investment consulting, these are more acutely felt in relation to investment management.

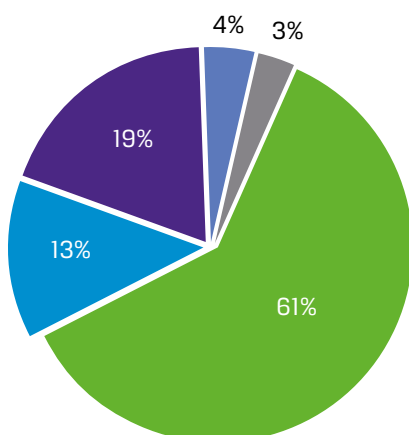
In essence, investment managers' interests are closely aligned with those of their clients. If investment managers perform well (to their clients' benefit), they will probably see the value of the investments that they manage increase and

*The largest schemes have access to the information, advice and managers, but it's the opposite for the small schemes. We can interrogate and beat up our investment consultants and our managers and we can be very clear with them about what we're looking for.*

*Our consultant never brings us a manager that has recently underperformed. They've all been in the top five for the last three years. The client always wants to choose whoever's done well. The buyer accentuates the problem.*

*Our governance budget was all spent on managing our credit manager against their benchmark, when actually we just wanted to get the spread. We don't focus on the things that matter. My team loves spending time on hiring and firing managers.*

### What compensation practices best align asset managers' interests with those of investors?



- A cap on incentives or bonuses for asset managers
- Greater deferral of asset managers' incentives or bonuses
- Greater deferral and longer performance period for assessing the basis
- Claw-backs of asset managers' incentives or bonuses
- Increased transparency of incentives or bonuses

Source: CFA Institute Financial NewsBrief (2013)

*The ad valorem fee structure is an absurdity, but it's one I'd be very reluctant to say goodbye to.*

*A change in the fee structure would help people explain the value in the business because then the alignment of interests would be there.*

*The big revolution will be when fees are based on the complexity of what's done with them and not on the denominator.*

*We're happy to use performance fees if managers will commit to keep assets at or below a certain level - in the equity market at least, where size is the enemy of performance.*

*We have to be transparent not just about the value of what we do, but about how we charge people and about how we pay ourselves. We hinder our ability to tell the story by obfuscating about what we charge and how much we pay ourselves.*

may gather more assets and, operating under the ad valorem (AV) fee structure, they then earn more income. Equally, if the value of clients' assets falls, then the investment manager's income falls and the prospect for asset gathering worsens.

However, as the AV fee structure is linked directly to asset values it is thought to encourage asset gathering ahead of the appropriate management of existing assets. Asset gathering can be to clients' benefit as a larger fund will generate increased income and profitability (as costs grow more slowly than revenues) and be more sustainable for an investment manager to support. However, asset gathering can also come at clients' cost. Large funds may start to experience diseconomies of scale as they find it more difficult to invest without market impact. In addition, the profitability of a large fund (which might have an operating margin of 70% or more) may encourage the investment manager to reduce the fund's risk in order to protect past performance and to avoid giving investors a strong reason to move their assets elsewhere.

Stakeholders also note that the AV structure does not distinguish between luck and skill. The investment manager's income depends significantly on the movement of the market, rather than on the manager's specific contribution alone. They also comment on the fact that, while AV fees might taper based on asset size for institutional clients, they are unlikely to do so in retail structures. Stakeholders regard the investment profession as being slow to share the benefits of economies of scale with its clients.

Alternative fee approaches exist (blends of AV and performance fees; zero base fees combined with high performance fees and symmetric approaches to performance fees so that under-performance requires past performance fees to be repaid), but are not widely used. Stakeholders comment that clients appear hesitant to invest in products that have different models, preferring the comfort of the standard AV approach even if it might not be well aligned with their own interests. In addition, they observe that the reductions in base AV rates offered in return for the application of performance fees (in theory a good way to align interests) is rarely sufficient to justify the move to such a structure.

Those that we spoke to for this report believe that the investment profession could do more to share the benefits of scale with clients (which might compensate them for the diseconomies of scale in relation to performance) and that new fee models should be considered based more directly on effort and skill. For instance, if an active fund has a relatively low active share, should fees be set so that passive pricing is applied on the part of the portfolio that follows the index and active fees applied only on the remainder?

It is notable that stakeholders broadly had few concerns about fee structures on passive products where fees are considered to reflect better investment managers' inputs and where vigorous competition has pushed fees lower. Competition has also reduced fees on active products, but stakeholders do not perceive them as being as closely linked to inputs or the value they deliver

In our 2013 paper on fees and compensation<sup>18</sup>, CFA UK noted that fee and compensation structures should be transparent and aligned with clients' interests. Co-investment, in which managers and analysts invest their own capital alongside their clients, can provide a direct means to align the interests of clients and their managers. Stakeholders respect that approach, but observe that true alignment is only achieved if the client and its managers also share the same objectives.

A 2013 CFA Institute survey suggested that members see assessing performance over periods that are more closely aligned to clients' investment horizons (and then deferring that compensation to increase the term further) as the optimal route to alignment of investment manager and client interests. Since that time, regulation and market practice has evolved such that few of the stakeholders that we talked to for this report now complain about the misalignment between clients and investment managers in relation to the term over which compensation is determined and paid out.

## COMPETITION

Competition contributes to value generation. In theory, rivalry in a market, the threat of new entrants or product substitution, supplier power and buyer power combine to encourage innovation and price competition and will influence the degree of concentration in a market.

In a recent CFA UK member survey, close to 90% (87%) of respondents indicated that they view the UK market for investment management products and services as competitive or highly competitive. But the

survey's respondents also indicated that they perceived barriers to entry in asset management as high (58%) and clients' ability to assess value in asset management as low (55%). In response to the question 'Is the current market for investment management products and services sufficiently efficient and competitive to operate in clients' best interests?' Our members responded with 39% yes, 33% no, and 28% unsure.

These survey results suggest that the society's members believe that they work in a competitive industry, yet one in which competitive forces are impeded. Members appear to believe that investment firms compete aggressively across different segments of the market, differentiated by firm type, client type and product type, but that barriers to entry are getting higher (as scale and the ability to sustain the appropriate regulatory and operational infrastructure become more critical) and that clients and/or their representatives find it difficult to assess the relative value that investment managers will provide ex ante.

Investment professionals believe that firms are willing to control costs along the value chain and can control many relevant costs. Data demonstrates that asset managers have been able to reduce the costs of funds - both active and passive - to investors' benefit. Technological advances have been effectively harnessed by the industry in many aspects of the investment and administration process to the benefit of end clients both in terms of cost, clarity and efficiency. However, there are areas where an asset manager is not able to exert full control such as distribution and management

*Price only becomes an issue when nominal returns are low, then you might take down a price to hold onto assets or if you think there may be some residual assets looking for a home.*

*Long-only indexed equity is now commoditised, but there's no price pressure on absolute return.*

*The US market is about efficiency and price. In the EU it is about active and stories.*

*The focus is still very strongly on performance especially very short-term performance and that is fundamentally wrong. The focus should be more on risk management.*

*Risk is more difficult to sell than performance, but over the long-term if you can demonstrate that you're managing someone's capital well, you should be a winner. Often you don't receive enough time to prove it.*

<sup>18</sup> [https://secure.cfauk.org/assets/3769/CFA1192\\_Fees\\_Comp\\_Position\\_paper\\_v2.pdf](https://secure.cfauk.org/assets/3769/CFA1192_Fees_Comp_Position_paper_v2.pdf)

*People need to be able to compare performance, but it is very difficult to standardise risk usefully and explaining risk-adjusted returns to clients is difficult. We need transparency and competition around standardised reporting approaches.*

*People don't understand what they're paying.*

*The pricing structure relates to activity not outcomes. You only really know the value afterwards. As active managers we're selling hope.*

*There's a lot of obfuscation around fees. They might charge the AMC, but then there can be on-fund charges of up to 50% of the AMC with no explanation.*

of the growing regulatory and compliance burden (a major area of headcount increase).

Stakeholders more broadly believe that the market is competitive where buyers have sufficient power to attract competition, but note that buying power in the retail sector is diffuse and that the sector is not as price sensitive as might be expected given the certain impact of costs on returns. There are additional concerns about price transparency and about the transparency of performance.

## TRANSPARENCY

As we noted in our December 2015 paper on the cost of investing<sup>19</sup>, alongside the base fee (likely some level of AV or fixed percentage fee on the invested assets) there are other charges that need to be taken into account such as transaction costs, bid-offer spreads, commissions, taxes, dilution levies and market impact costs. In the UK, determining the total cost is not without challenge and while future transaction costs are unlikely to be known, indications of these and other charges need to be communicated effectively<sup>20</sup>.

Stakeholders feel that there continues to be too little transparency about the all-in costs of investing and there remain calls for a single published charge<sup>21</sup>. These calls are typically directed at the retail market. In the institutional market, clients are better equipped to seek out and analyse the necessary information (and understand some of the

potential flaws in a single charge), but even here clients report that it can be challenging to obtain the necessary information from their investment managers.

Even when they do so, stakeholders report that it remains hard to assess the value for money that an investment manager delivers because there is no standardised approach for the reporting of all information about costs. As a consequence, there can be no utility provider that allows clients to compare costs across their entire portfolio. In the same way that the Global Investment Performance Standards (GIPS)<sup>22</sup> enabled standardised approaches to performance reporting, stakeholders believe it would be helpful for there to be a commonly accepted approach to cost reporting.

It is also difficult for clients to assess the performance for which they are paying, or at least the manager's contribution towards that performance. Performance is dynamic; it changes over time as a manager's style generates greater or lesser returns and will also vary according to the effectiveness of the manager's process and their skill in implementing that process. Past performance may provide some information about the longer-term likelihood of future performance, but there are many other variables that will influence future performance and which the client may be ill-equipped to assess without advice and guidance. Ultimately, the client's outcome will also be partially determined by the duration over which they choose

<sup>19</sup> [http://professionalism.cfauk.org/wp-content/uploads/2015/11/CFAUK\\_PP\\_Fees\\_DEC2015.pdf](http://professionalism.cfauk.org/wp-content/uploads/2015/11/CFAUK_PP_Fees_DEC2015.pdf)

<sup>20</sup> The Investment Association plans to deliver a code on costs and charges disclosures (<http://www.theinvestmentassociation.org/media-centre/press-releases/2016/press-release-2016-03-04.html>).

<sup>21</sup> A recent CFA Institute survey showed that retail investors' primary concern in relation to trust is that investment firms should fully disclose fees and other costs [https://www.cfainstitute.org/learning/future/getinvolved/Pages/investor\\_trust\\_study.aspx](https://www.cfainstitute.org/learning/future/getinvolved/Pages/investor_trust_study.aspx)

<sup>22</sup> <http://www.gipsstandards.org/>



### The source of short-term thinking

#### Mark Barnett

Mark Barnett, who runs one of the UK's biggest retail funds, the Invesco Perpetual High Income Fund, says that pressure on fund managers to think short term is immense and comes from three distinct areas: clients, management of fund companies and the company reporting calendar.

He says it's really important that clients understand the value of long term investing and do not focus on short term performance blips:

"If the client is concerned about three months performance figures, then the manager may worry," he says. "I say to clients, judge me over at least three years but the longer the better. Five years is a better time frame."

Equally, a CEO of a fund management company may be the source of short term performance focus.

"Managers of these businesses may worry about the business risk of performing badly over short periods of time and that in turn can encourage certain behaviour in fund managers," he says.

Finally, the regular company reporting cycle influences managers and their decision making.

"We have companies that report quarterly, at the AGM and then have a pre-close statement. There are many companies that are issuing statements to the stock market up to 10 times a year, so you are creating a newsworthy event every one and half months. That almost certainly creates short-term behaviour on the part of investors who should not be thinking about the next three months but about the next two or three years."

Notes Barnett: "I am investing in businesses that I can hold for the long term so that my investors can enjoy the growth of profits and cash flow in the form of growing dividends. You have to be patient enough and disciplined enough to be invested for the long term because the value of what I do is not necessarily generated over neat, consistent three- or six-month periods of time."

to hold an investment. Clients who invested in the same fund at the same time may have very different views on the value of their investment depending on when they chose to close that investment.

### SENSITIVITY TO COST

Information about cost appears to be most highly valued where cost is expected to be the primary variable influencing total return. In the market for passive products, where providers are providing access to the market or factor return and not applying additional skill,

price is a significant contributor to competition and to value generation for clients. Price information is thought to be less highly valued in the market for active products where providers seek to outperform the market return.

In active markets, performance is said to 'trump' price. Retail clients will note price, but if the promise of performance is sufficiently great, their consumption choice will be based on the expectation of future performance rather than on the certainty of future cost. However, stakeholders point to the growing

*The fees my clients are paying have fallen, but that's not because fund managers are cutting fees, it's because clients are negotiating more and because of the impact of passive.*

*Retail would be better off being offered 20 asset classes from 40 managers than being offered two asset classes from 10,000 funds.*

*You get to a point where the manager is just trying to retain, not outperform. As long as you're not terrible, it's a long annuity. You are locking down the risk and locking out the possibility of outperforming significantly.*

*There comes a point fairly early on in the process where your compensation becomes disconnected from your effort.*

*There's far too many people here – but I'm not one of the too many.*



*How important is price discovery – asset values don't change by the minute and long-term liabilities don't change in value overnight so why do prices need to do so?*

*You don't need that much liquidity. There are too many incentives to act and to do things.*

*The market price tells us only what those who needed, or desired, to trade on a given day established between themselves as the clearing price.*

*In the end the truth will out and the market will probably get it right, but it can be wrong for a long period of time before it's right.*

*Why would you take the time and money to close a fund at a cost of £1m when you might generate £5bn at 60bp in a new fund??*

new money flows going to low-cost indexed or passive products relative to higher cost active funds in the most efficient equity and fixed income markets as a sign that price competition is working in markets where persistent outperformance is less likely.

Stakeholders believe that while competition is increasingly effective in the market for new assets, it appears relatively ineffective in the market for historic assets which is characterised by inertia. They comment that the economics of investment management encourage the development of new funds, but discourage the winding up of existing funds. As it is difficult for investment firms to know with certainty which funds will draw demand in the future, there is an incentive to build and maintain a range of funds so that clients have appropriate choice, but also so that the investment firm optimises its chances of developing a 'winner'. The profitability of these large, successful funds can then be used to subsidise the maintenance of the broader stable and the development of future, potential winners.

### FRAGMENTATION AND OVER-SUPPLY

The consequence of a blend of inertia and economics is fragmentation and over-supply. The large number of fund structures in the EU means that the market in

aggregate is paying too much for the administration of the investment management services that it buys.

Stakeholders agree that it is important that the market for investment products and services is competitive. Buying power is effective in some parts of the market and less so elsewhere. Suppliers compete aggressively across the market, but have tended to do so on performance rather than price (other than in passive products). Despite the widely acknowledged fragmentation and over-supply that characterises the market, some stakeholders are concerned that barriers to entry should be no higher than they already are. They argue that consolidation towards a smaller number of scale providers might lead to a further adverse shift in the balance between supplier and buyer power with no balancing improvement in the net performance generated for clients.

### CAPITAL ALLOCATION

An inherent part of the contribution of the investment profession, one that goes hand in hand with seeking the best returns for our clients, is in the effective allocation of capital. However, some stakeholders raise a number of objections to the profession's claim to contribute to capital efficiency and believe that there are flaws in the way that the profession's contribution is made.

Number, Size and Fees of mutual Funds EU vs US			
	Number of Funds	Average Size (€ million)	Average fee (equity funds only, bps)
EU	32.750	222	175 (2010)
US	7.886	1.568	70 (2014)

Sources: BETTER FINANCE, ECMI, EFAMA, ICI

## SHORT TERMISM

Professor John Kay is one of the leading commentators on the profession's contribution to capital allocation. He tackled this issue in the government review that he led between 2011 and 2013<sup>23</sup> and again, more recently in his book 'Other people's money'<sup>24</sup>. Among the arguments made by Professor Kay (and supported by others such as the Bank of England's chief economist Andy Haldane)<sup>25</sup> is that investment professionals are too short-term, discounting future investment returns too aggressively which causes the future returns to longer-term investment to be underestimated. He also argues that too much activity takes place in relation to price discovery, such that there is little to no value generated by much of this activity.

Some observers suggest that incentive structures within investment management and the high level of competition within the sector encourage investment professionals to value immediate or short-term returns more highly than long-term returns, which impedes the allocation of capital to long-term projects. At the margin this might be true, but there is evidence to suggest that investment professionals can overvalue long-term returns as well as undervaluing them. The high valuations given to technology, media and telecom stocks in the early 2000s (which then collapsed) was a good example of the investment sector being too optimistic about the outlook for returns.

In addition, while the investment sector is an important contributor to

capital allocation, it is not the only one. Companies generate their own capital through retained earnings and currently hold high levels of cash on their balance sheets. Business investment is subdued. It appears that the investment profession and the corporate sector's views on the outlook for long-term investment are relatively closely aligned. Some stakeholders would suggest that this shared view might be the outcome of each party benefiting from common incentive structures based on similar metrics.

One common criticism of the investment profession relating to short-termism is that it trades its portfolios too aggressively and holds its investment in companies for too short a period. This observation often arises from an incorrect reading of the relationship between market turnover and total market capitalisation. Turnover figures might indicate that the whole market must trade three times a year, leading some commentators to conclude that the average holding period for a stock is four months.

To arrive at the correct figure it is necessary to understand that the data is skewed by extremely high levels of turnover in a relatively small part of the market<sup>26</sup>. Empirical data suggests that holding periods are much longer.

Most stakeholders from the institutional asset owner community do not raise short-termism as a concern. Possibly, this is because they suffer from the same condition. Another possibility is that they have more pressing concerns to comment on, but it may also be that they do not believe the investment management

*What the market has capitalised is beyond the planet's ability to supply. We need to have a more sophisticated conversation about how we invest for growth in a way that accords with the fundamental boundary condition.*

*We need to redefine our measures of success. If your only measure of success is outperformance of the market cap benchmark, I don't think that's good enough. Our managers are stewards of my beneficiaries' capital.*

*Being a good steward shouldn't be optional. The returns to stewardship are shared equally among all capital holders, but are paid for by the few that bothered.*

<sup>23</sup> <https://www.gov.uk/government/publications/kay-review-of-uk-equity-markets-and-long-term-decision-making-implementation-progress-report>

<sup>24</sup> <https://profilebooks.com/other-people-039-s-money.html>

<sup>25</sup> <http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2011/speech495.pdf>

<sup>26</sup> [https://secure.cfauk.org/assets/166/Note\\_on\\_the\\_HOLDING\\_PERIODS\\_OF\\_EQUITIES.pdf](https://secure.cfauk.org/assets/166/Note_on_the_HOLDING_PERIODS_OF_EQUITIES.pdf)

*It is difficult to do engagement from passive. Companies understand the reality of the position.*

*Stewardship adds social value. You are guarding against low probability, high impact events that can have a long-term impact.*

*Investors should make enlightened long-term decisions, but they don't because of human nature.*

*Costs don't scale at anything like the fees. There should be a reward for success, but they could do more to share the economies of scale. Things like that undermine trust in the industry.*

profession is systematically failing to identify and invest in sound long-term investments.

Company representatives also do not appear overly concerned about short-termism among investment professionals, although they can see that pressure from clients may affect an investment managers' ability to maintain a long-term perspective. They are interested in the market's view of the value of their companies' capital, but they report that they do not obsess about their share price in the short-term, accepting that there will be times when the market's view does not match what they would expect (both on the upside and the downside).

CFA UK's position is that the key issue is not term, but value generation – how that can best be achieved and how the investment profession can contribute towards that. CFA UK advocates<sup>27</sup> that there is no single optimal time horizon from an investment perspective. The time horizon chosen by an asset owner and applied by an investment professional should appropriately reflect the stakeholder's preferences and requirements. The time horizon is an outcome of a robust process rather than a driver of the process. There are short-term investors in the stock market and there are long-term investors as well. They both have an important part to play in the provision of capital and in the maintenance of liquid markets.

## **LIQUIDITY AND PRICE DISCOVERY**

While it is hard not to sympathise with Professor Kay's view that there is too much costly activity devoted to price discovery, this was not a primary concern for most

stakeholders. There are distinct views on the value of liquidity, but most stakeholders believe that it is important for price information to be frequently updated, if not as frequently as currently occurs.

Liquidity is valuable to market participants and should be valued by clients. It allows clients to enter and exit investment positions relatively easily at low cost. In addition, the presence of liquidity allows arbitrageurs to enter markets to adjust prices that may be out of line with fundamentals. However, some stakeholders argue that high levels of liquidity (which come at a cost) are less socially useful than they might seem, encouraging people to make riskier, short-term decisions than they might otherwise do on the basis that they can exit at little cost.

## **STEWARDSHIP**

Investment manager's execution of stewardship is a frequently expressed concern for stakeholders. They are anxious that their investment managers should engage with the companies in which they invest their clients' capital and typically want them to take into account non-financial information (such as that relating to environmental, social and governance issues) in their analysis and investment decision-making.

Stakeholders commonly believe that stewardship, the management and care of assets through a close engagement with the businesses held in clients' portfolios, should be seen as a distinct and necessary part of the investment process. Similarly, it is thought that the profession should do more to highlight how it engages with the companies in which it invests and how it seeks to

<sup>27</sup> [http://professionalism.cfauk.org/wp-content/uploads/2015/11/CFAUK\\_PP\\_Termism\\_DEC2015-1.pdf](http://professionalism.cfauk.org/wp-content/uploads/2015/11/CFAUK_PP_Termism_DEC2015-1.pdf)

## Performance indicators of the Market for investment products

	Comparability	Trust	Expectations
<b>Questions</b>	On a scale from 1 to 10, how difficult or easy was it to compare the products and services sold by different suppliers?	On a scale from 1 to 10, to what extent do you trust suppliers to respect the rules and regulations protecting consumers?	On a scale from 1 to 10, to what extent did the products/services on offer from different suppliers live up to what you wanted within the past period?
<b>8-10</b>	<b>35%</b>	<b>35%</b>	<b>39%</b>
<b>5-7</b>	<b>43%</b>	<b>43%</b>	<b>47%</b>
<b>0-4</b>	<b>22%</b>	<b>22%</b>	<b>15%</b>
<b>Average rating</b>	<b>6.1</b>	<b>6.1</b>	<b>6.9</b>

Source: European Commission, Consumer Markets Scoreboard.

promote good corporate behaviour. The investment firms that we spoke to cited the thousands of company meetings they have every year and most investment firms see their remit as extending much further than just owning a security. Investment professionals believe that they bring detachment and objectivity as well as experience of past business cycles. They can also act as a useful counterbalance to a 'growth at all costs' mentality and to advice from investment bankers in favour of mergers and acquisitions.

Progress has been made on stewardship, but more can be done to highlight this, and it is argued that investment professionals should be more vociferous in challenging businesses publicly where they think management is mistaken in its approach. Criticism has been levelled at the profession for not preventing the banking sector from entering the financial crisis a decade ago. Stakeholders believe that the profession should be more vocal in future and play a clearer role in promoting productivity<sup>28</sup> and the pursuit of sustainable profits.

## CONCLUSION

The investment profession delivers value to society by helping savers to become investors and by allocating capital productively. It does this well, but most stakeholders believe that it could perform these tasks better. The challenges described in brief above are well known and not new. Some will be easier to address than others. It is heartening that stakeholders across clients, consultants and investment firms are prepared to identify and acknowledge these issues as it suggests that there is a widespread appetite to address them.

*There's a huge difference between cheap and value. The net value is what you're looking to maximise.*

*You need to show that you deliver benefit and that the cost is proportionate to the benefit delivered.*

*We need to be more competitive, more honest and to have better educated clients*

*We may have to adjust to lower profit margins, but higher levels of profits overall.*

<sup>28</sup>Through measures such as those outlined in the Investment Association's recent report <http://www.theinvestmentassociation.org/media-centre/productivity-action-plan/>

# PROFESSIONALISM

The stakeholders that we spoke to for the purposes of this report are clear that the investment profession owes a responsibility to its clients and to wider society. As investment is an important activity – and one where there are significant information asymmetries between the consumer and the provider – they believe it is important that the provider is not just technically competent, but is also aware of the ethical and professional responsibilities they owe to their client.

These responsibilities are made clear in CFA Institute’s Code of Ethics and Standards of Professional Conduct<sup>29</sup>. All candidates in the CFA Program<sup>30</sup> study the code and standards at each of the three stages of the examination process and every member annually attests to abide by and adhere to the standards. All CFA Institute members and CFA Program candidates learn that the core value of their professionalism is to place their clients’ needs above their own.

The emphasis on professionalism should be unsurprising. As Nitin Mehta, CFA, managing director for CFA Institute in the EMEA region has noted previously: ‘Investment professionals owe a duty of care to their clients and to the market. We would not expect doctors and other medical professionals to be able to practice without having first received proper training in the technical and ethical practices required. We should require the same standards

and ensure that those working in investment management are qualified to act professionally.’

In its recent report on ‘Building real markets for the good of the people’<sup>31</sup>, the Bank of England noted that to promote prosperity financial markets need to meet two conditions: they must be effective (operating competitively to allocate capital and risk) and must maintain their social licence. While the Bank of England was commenting primarily on the operation of the capital markets, the investment market also relies to some extent on a social licence. To do so effectively, the investment profession will need to hold itself to standards that are demonstrably designed to serve clients’ interests. As in medicine, investment professionals cannot be certain about the outcomes for those they serve, but they can set out to help them as far as they are able and should emulate medicine’s best practices around communication. CFA UK’s 2014 paper<sup>32</sup> on informed consent noted: ‘The typical saver is unaware of the range of possible investment

options, their likely ‘success’ and the risks associated with them. An investment professional has a responsibility for the financial health of their client akin to the responsibility a doctor has for their patient’s wellbeing. Like the medical profession, investment professionals should establish and maintain effective partnerships with clients and, where appropriate, their representatives based on openness, trust and good communication’<sup>33</sup>.

Given the role the investment sector already plays in safeguarding and allocating capital, it is important that its social license is maintained. With the sector’s increasing involvement in the provision of pension outcomes and in the provision of long-term capital to the corporate sector, it will be increasingly important that the investment profession is not just seen as necessary, but as carrying out activities that are trusted and approved by society. Based on the conversations that we have held for this report, the profession embraces this responsibility.

<sup>29</sup> <https://www.cfainstitute.org/ethics/codes/ethics/Pages/index.aspx>

<sup>30</sup> The CFA Program is the leading global qualification for investment professionals. Those who pass all three levels and have sufficient, relevant experience are awarded the CFA charter. Globally, there were more than 260,000 candidates for the CFA Program in 2015.

<sup>31</sup> <http://www.bankofengland.co.uk/markets/Documents/openforum.pdf>

<sup>32</sup> [https://secure.cfauk.org/assets/3769/CFA1368\\_Pos\\_Paper\\_Informed\\_Consent\\_2014.pdf](https://secure.cfauk.org/assets/3769/CFA1368_Pos_Paper_Informed_Consent_2014.pdf)

<sup>33</sup> [https://secure.cfauk.org/assets/4379/CFA1368\\_Pos\\_Paper\\_Informed\\_Consent\\_2014\\_v2.pdf](https://secure.cfauk.org/assets/4379/CFA1368_Pos_Paper_Informed_Consent_2014_v2.pdf)



## Re-establishing trust

### Martin Gilbert

#### What inhibits our ability to generate or deliver value?

Right now, there is a general lack of trust in financial services. As an industry, we have got to do more to re-establish trust. What does success look like? People will see us as reliable and worthwhile guardians of their

savings, preferring to trust us rather than look at alternatives – most likely, cash or bricks & mortar.

To make progress, the industry must continue to demonstrate integrity and the competence to deliver what it says on the tin. One of the other things I'd like to see is a bigger profile for the many professions, such as accountants, lawyers and of course the CFA societies globally.

These organisations have codes and standards of conduct, educational requirements and disciplinary structures. I like to think that the broader promotion of these bodies – and of the standards by which they regulate their activities – might have helped to rein in some of the excesses in the run-up to the global financial crisis. It would still be valuable today.

#### How can we diminish the obstacles to value generation?

By understanding clients as best we can. In practice, this means working in partnership with clients so we can show close up why we deserve their trust whilst creating the value they want to see over their specified time period.

The more clarity we have on this, with mandates fully reflecting that, the more effectively we are able to invest for the long term as well as support new and existing businesses. That way, we maximise long-term economic growth and job creation, which in turn benefits our clients, our profession, our firms and society as a whole.

Professionalism encompasses such qualities as fairness, accountability, honesty and competence, and stakeholders agree that investment is a professional activity and should be practised in that fashion. They believe that practitioners must be trained, tested and held to high ethical and professional standards. In many areas (such as law and medicine), such standards are regulatory requirements for practitioners. In others, including investment management, regulatory standards are set at a lower level. While professional qualifications and standards are often demanded by clients and employers, they are yet to be extensively required by regulators.

As Paul Smith, CFA, CEO and President of CFA Institute, recently noted, "Though we have a solid foundation from which to address the future, we have considerable work to do to advance the investment profession. We have to better demonstrate what it means to be a profession by promoting the highest standards of education, competence, and professional conduct. When we visit the doctor, we assume they are qualified and competent to diagnose what ails us. Investment managers should pursue the best qualifications if society is to trust our competence to serve their investing needs. We all have a personal responsibility to spread the word about the

*If we are going to fix the savings problem, we need to rebuild trust. You can't fix savings without investment managers.*

*We're not in a 'trust me' world any more. The only way out of this is more transparency.*

*The investment profession is needed more than ever because the state's ability to support people is going to diminish.*

*Culture is a huge factor for clients because they are looking five, 10 or 20 years outwards. You want to know that it's a business that you'd like to do business with.'*

*We need less focus on technical skills and more on doing the right thing. We can't turn investment into divinity, but if we don't have proper values then the whole thing goes out of the window.*

*The one thing that we have to be clear about is that we are agents.*

*We have fiduciary responsibilities and we need always to put the client's interests first and foremost.*

*The profession could do with a dose of humility, there should be better alignment of interests and there should be more educated consumers.*

*We want to outsource but our challenge is that we can't find people who want to run our capital in our interests. They typically want to run it to manage their own business risk.*

*We struggle to find the right people to give our money to. It takes a lot of work to follow the markets. But if people really did that with our best interests in mind, we wouldn't mind paying. It comes down to trust.*

need for well-trained people throughout the investment management value chain.'

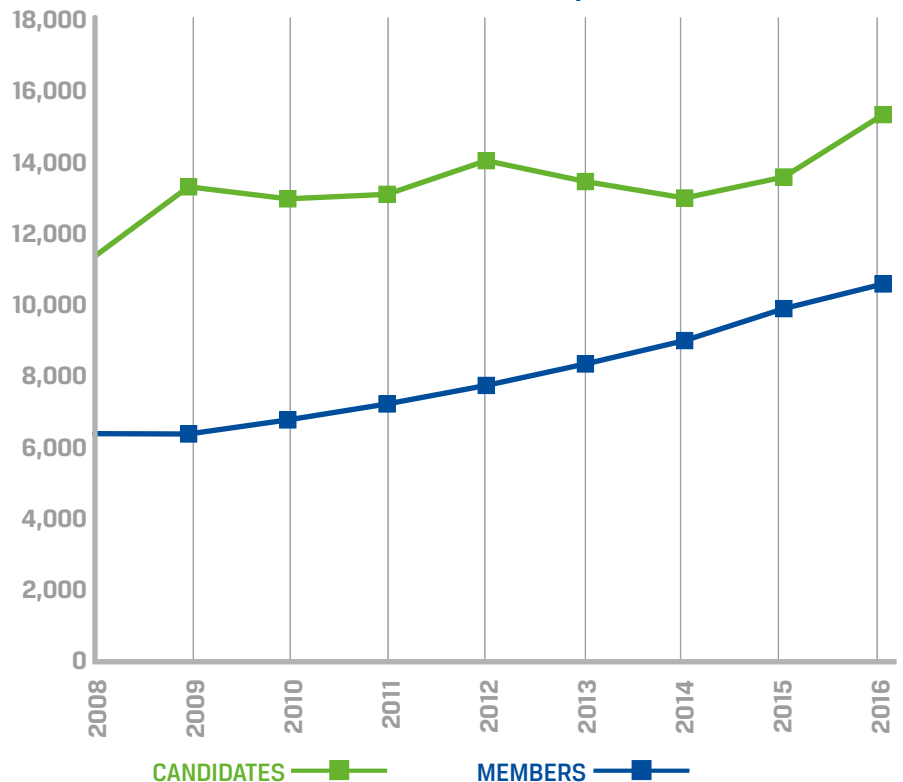
A recent global investor survey undertaken by CFA Institute and Edelman<sup>34</sup> identified the attributes that most matter to retail and institutional investors when it comes to working with investment firms. Transparency around fees and costs was rated of higher importance than returns by both investor groups and a commitment to ethics is of significant importance to institutional clients.

It is clear that companies recognise the commercial importance of professionalism in how they present themselves and their staff. Many firms now insist on their front-line investment staff taking the CFA Program as a demonstration of the importance they place on having a highly trained workforce. It is widely agreed that a commitment from all in the industry to

higher ethical and professional standards – combined with improved levels of transparency and clearer communication – would do much to improve levels of trust in the profession.

One of the observations made by stakeholders during our research was the difficulty of assessing cultures at different investment firms. Investment professionals and their clients believe that culture is important – and agree that professionalism is a key element within that – but they also believe that an understanding of the broader culture within a firm matters. How a firm recruits, remunerates and supports its staff; how they measure their performance and reward that; how they express and manage their relationships with clients and other stakeholders – all of these things are regarded as important, but difficult to measure.

**CFA Institute candidate and membership numbers in the UK**



Source: CFA Institute.

<sup>34</sup>[https://www.cfainstitute.org/about/press/release/Pages/02172016\\_128524.aspx](https://www.cfainstitute.org/about/press/release/Pages/02172016_128524.aspx)

A recent CFA UK survey asked members to provide a score (out of 10) for how much a firm's commitment to ethics and professionalism should matter to clients when they are considering awarding a mandate. Close to half (48%) of the 500-plus respondents gave this factor a maximum score of 10 out of 10 and the weighted average score was just under 9. However, when respondents were asked to provide a score for how much ethics and professionalism actually matter to clients that are considering a mandate, less than 20% gave a maximum score and the weighted average was 7.6.

A common suggestion from stakeholders is that the profession could do more to help them assess cultures.

## **HUMAN CAPITAL AND DIVERSITY**

There is also a belief among stakeholders that the profession should more closely reflect the composition of the society that it serves. There is agreement that greater diversity within the profession would benefit clients (and the profession itself) by

promoting diverse cognitive thinking within investment decision-making. Yet, progress is slow. Women still represent only 20% of CFA UK members and just over one-third of all new candidates for the CFA Program in the UK. It is hard for the investment profession to argue that it allocates capital efficiently, when it fails to allocate human capital efficiently within its own businesses. There are many strong reasons to build a more diverse profession, but the need to act in our clients' [themselves a diverse group] best interests is reason enough to address this challenge.

As CFA Institute's Smith has noted: 'Our profession also has a diversity problem. If we are to change we must also change our demographic. We need to hire and promote more women within our businesses. Studies show that mixed-gender teams bring much needed diversity of thinking to the investment process and improve investment outcomes.'

*This is a great profession, but if we are struggling to enunciate the message, that says something.*

*Most people I know get up in the morning to do a good job for their clients.*

*The industry has morphed from a profession to a business. CFA's potential role might be to restore that professional ethos.*



# POLICY AND REGULATION

Given its important role and the influence that the profession has over individuals' financial outcomes, it is unsurprising that policymakers and regulators take an active interest in the sector. Their involvement is supported and broadly welcomed by stakeholders whose views are summarised in this report. They understand the value of effective policy and regulatory frameworks in building trust. However, they would appreciate greater consistency in policy (particularly with regard to pensions), are anxious that regulation impedes competition and would welcome greater regulatory support for professionalism.

**T**he investment profession has an important role to play in relation to a number of key UK policy challenges. In particular, it will help an ageing population support itself and cater for the future financial needs of the young working population. It also helps the UK to improve its productivity<sup>35</sup>. In addition, the sector is an important contributor to UK GDP helping to boost a services trade surplus that partially offsets the deficit in goods.

Recent policy in relation to investment management has taken two forms: the first focusing on amending behaviour to encourage improved capital allocation and client outcomes; and the second supporting and promoting the sector because of its role in helping people to save and as an important contributor to UK GDP.

Domestically, the profession is regulated by the Financial Conduct Authority (FCA) (and in some cases additionally by the Prudential Regulation Authority). The FCA's mandate requires it to protect consumers, protect the

integrity of markets and promote competition. The focus in recent years has been – and remains – on consumer protection and competition with a particular

emphasis on transparency and disclosures. The intention has been to help consumers make informed choices of competitive products and services based on



## Close underperforming funds

### Philip Coggan

Journalist Philip Coggan who writes the Buttonwood column in the *Economist* magazine, says the profession could benefit if it was easier to close funds, which would make the system work more efficiently.

Coggan highlights one of the problems in the fund management industry is that it starts to sell funds because a certain asset class appears in fashion, but many then continue to exist long past their sell-by date.

He says it's difficult for companies and the wider investing public not to get sucked into fashionable investments. For companies the difficulty lies in not taking advantage of where it can quickly gain new assets – in effect it's difficult for businesses to turn down the opportunity for growth. For the wider public, they don't want to miss out on the hot, new investment, whatever that may be.

"It's really hard for people not to follow fads."

Once the asset class where they are invested loses its lustre, Coggan notes that funds often then lie dormant, doing little for the many clients who suffer from inertia when it comes to making investment decisions.

"It should be easier to close a fund," he says. "Regulation and fund companies could help with this."

While there may be room for improvement, he still holds the profession in high regard.

"I have met lots of smart fund managers who genuinely do care and want to do a good job," he says.

<sup>35</sup> The Investment Association launched its Productivity Action Plan in March 2016 (<http://www.theinvestmentassociation.org/media-centre/productivity-action-plan/>)

sound advice. The regulator has also been keen to make sure that firms properly manage the conflicts inherent within their agency role.

Fundamentally, stakeholders are broadly supportive of the current regulatory approach and appreciate the importance of working within a well-regulated sector. They understand that clients need to know that providers are effectively regulated and supervised.

Stakeholders typically welcome the work that the regulator has done on conflicts of interest around costs and charges, through both the Retail Distribution Review and other initiatives such as the

changes to payments for research. In a number of its past responses and communications with the FCA, CFA UK has noted that some of the proposed regulatory measures address symptoms rather than root causes. That view is shared by some stakeholders. For that reason, CFA UK and many stakeholders welcomed the regulator's decision to undertake a more fundamental review of the competitive structure and nature of the market for investment services and products.

However, stakeholders also raise concerns about the overall burden of regulation bearing down on investment management. They note



#### **Eliminate barriers to entry**

#### **Maarten Slendebroek**

Jupiter CEO Maarten Slendebroek is bullishly pro active management. He believes the recent increase in money going to passive funds only creates a bigger opportunity for those skilled at picking stocks.

"We live in a golden era for active managers. There is such tremendous growth in tracker and index huggers – it creates a monumental opportunity for those of us who don't do that," Slendebroek says.

He is also strongly of the opinion that regulation, while well-intentioned, can do more damage than good and that it's not clear whether clients are better off now than they were before the proliferation in the rules that govern the profession. He believes regulation can have the unintended consequence of stifling competition to clients' detriment.

"Regulation per se is not a bad thing – it is important consumers are protected. But the proliferation of rules and their increasing complexity have increased barriers to entry and that's hampering competition to the detriment of consumers," he says. "It's really difficult to start a mutual fund company today."

Regulators should look for ways to eliminate barriers to entry, he believes. "A category of simple funds regarded as suitable for all investors could be approved at the product level, for example. That would remove the requirement for annual suitability tests and open up the market for new competitors with web-based distribution models. An informed citizen should then be able to work out what they want from this range without the need for advice."

Slendebroek also proposes the profession should pre-empt any new rules by taking responsibility for making things better itself. He says one thing it could do would be to work with trade bodies to introduce a more comprehensive and standardised set of measures for funds so clients can compare prices and performance after all fees more effectively.

*Investing is a long-term activity, but the [pension] rules are changed continuously.*

*There's a paranoia about giving advice. We are scared to say anything because of regulation. We need to be able to be honest.*

*It should be made easier to close down funds. HMRC makes it hard to collapse them.*

*We must talk in net terms and there should be more transparency about where those fees go. The client should have visibility about who's getting what.*

*Getting from zero to a sustainable business is an immense challenge. With consolidation in the wealth management space you need quite a big asset size to get any allocations.*

*Daily liquidity is not in investors' interest and they don't need it.*

*There should be transparency to the nth degree.*

*There has been a 32-fold increase in pension regulation in the last 25 years. There is constant change in rules and we have sometimes forgotten the liability we're trying to hedge in the first place.*

*Regulation gives a common platform and a safety net and it's important that clients feel that there's a strong regulatory environment supporting them. That said, a lot of the regulation is just misguided.*

*Regulations are eliminating exposures and therefore reducing returns. Everything that has been done is harming potential returns in a long-term, low inflationary world.*

*It would be good to have a level playing field globally. This is a truly global industry buffeted by regulations that are not.*



## **Integrate into the political fabric**

### **Lindsay Tomlinson**

According to Lindsay Tomlinson, the former head of Barclays Global Investors, the profession fails itself in not spearheading public policy debates and demonstrating the good it does for society and individual savers. The job of sitting in between asset

owners and companies is a massive responsibility that has not been publicised enough, he says.

"The asset management industry needs to get out there and tell its story. We need to be grown up and integrate into the political fabric," Tomlinson adds.

The profession also needs to be more assertive about its identity. He says those drawn to investment management should be totally focused on the clients' needs, and dedicated to providing the thoughtful, contemplative approach that can help direct capital to where it's needed and steward those investments to ensure they provide the best possible returns.

that implementing new regulatory requirements is time-consuming and costly, suppressing competition and distracting management attention from the primary task of acting in their clients' best interests. Stakeholders accept that much recent regulation may ultimately benefit clients, but each points to some measure that they think will not.

A recent member survey conducted by CFA UK showed that close to 90% of members describe the market for investment management as either competitive or highly competitive, but that about 60% believe that the barriers to entry are high. That said, stakeholders also believe that the fund market is overly fragmented – as a result of the difficulty and cost associated with closing funds.

Stakeholders also express concern about the emphasis that the regulator places on the provision of liquidity within investment products. They note that liquidity requirements impose costs that may not be exceeded by the supposed benefits and that they prevent

some investors from accessing investments offering attractive returns due to their illiquidity premium. More immediately, they worry that fund providers may offer products that promise liquidity, but that are ultimately unable to meet those promises because of the fundamental liquidity mismatches inherent between the fund's holdings and the investors' needs.

There are also concerns about the regulator's perceived preference for more certainty around potential outcomes for clients from an activity that is inherently uncertain and based on risk. Stakeholders worry that regulation may limit their ability to take risk on clients' behalf. They also reckon that regulators fail to take into account contemporary decisions (and the context for those decisions) when considering, with the benefit of hindsight, situations in which investment products and services have ultimately delivered poor outcomes.

With some reservations, stakeholders are largely supportive of the recent policy approach with respect to investment management.

## Regulatory Landscape

Key points		2016	2017
<b>CRD IV / CRR</b>	<ul style="list-style-type: none"> <li>- Bonus cap</li> <li>- Op risk requirements</li> </ul>	EC review of bonus cap scope (Q2) ▶	Possible changes to bonus cap scope (est) ▶
<b>MiFID II / MiFIR</b>	<ul style="list-style-type: none"> <li>- Market structure</li> <li>- Transparency requirements</li> <li>- Investor protection</li> <li>- Third Countries</li> </ul>	EC DA (Apr est) ▶ EC RTS (June est) ▶ ESMA ITS (Q3 est) ▶ National rule making (Q4 est) ▶	In force (2017 - DEADLINE DELAY PROPOSAL) ▶
<b>Shareholder Rights Directive</b>	<ul style="list-style-type: none"> <li>- Additional disclosures for listed firms &amp; AIF's, and for IMs</li> </ul>	Ongoing negotiations ▶	Implementation (2017 est) ▶
<b>AIFMD Alternative Fund Manager Directive</b>	<ul style="list-style-type: none"> <li>- Investor protection</li> <li>- Transparency</li> <li>- Regulatory capital</li> <li>- Manager Remuneration</li> </ul>	ESMA second report on application of passports to non-EU AIF/AIFM (July) ▶	EC Review and possible amendments (Jul) ▶
<b>UCITS V</b>	<ul style="list-style-type: none"> <li>- Depositories</li> <li>- Manager Remuneration</li> <li>- Sanctions</li> </ul>	ESMA remuneration guidelines (Q1) ▶ EC review of cross border funds distribution (Apr est) ▶	ESMA RTS UCITS AIFMs disclosure (est) ▶
<b>EuSEFs / EuVECAs</b>		EC review (Jan) ▶ EC possible amendments (Q4 est) ▶	
<b>PRIIP KID</b>	<ul style="list-style-type: none"> <li>- Key Information Document</li> <li>- UCITS caught under ESMA proposal for Multi-Option PRIIPs</li> </ul>	Revised RTS (Apr est) ▶ RTS adopted (Sept est) ▶	Implementation (2017) ▶
<b>ELTIFs ("Long-term" Investment Funds)</b>	<ul style="list-style-type: none"> <li>- Limited assets</li> <li>- Restricted access</li> </ul>	Under CMU: encourage take up ▶	
<b>Money Market Funds</b>	<ul style="list-style-type: none"> <li>- Severe restrictions for CNAV's Liquidity requirements</li> <li>- Credit quality</li> </ul>		Dialogues awaited (Q3 est) ▶ Implementation (2017 unlikely) ▶
<b>EC Call for evidence on financial regulation</b>	<ul style="list-style-type: none"> <li>- CMU/jobs &amp; growth agenda</li> <li>- Recalibrations and amendments</li> </ul>	EC call for evidence deadline (Jan) ▶ EC report expected (Jul) ▶ EC proposals (Q4) ▶	

Source: KPMG

They appreciate HM Treasury's support for the sector on issues relating to tax, regulation and marketing and largely welcome the recommendations that emerged from the Department of Business Innovation and Skills' Kay Review. The work to implement those recommendations relating to transparency, alignment and stewardship is ongoing, but already delivering results.

The area where stakeholders believe that policy has been poorly managed is in relations to pensions. There, stakeholders point to the

multiple changes in approach and myriad amendments to detail that have confused clients and imposed unnecessary costs.

In the areas of financial education, transparency, investment governance and client capacity, stakeholders believe that more work could usefully be done. They note that consumers remain ill-equipped to identify how best to work with the investment profession and that they find it difficult to assess the value of investment products and services. There is also a common belief that

*The regulator's concept of liquidity is insane.*

*In large parts of the financial sector, the focus is on spurious differentiation rather than on actual value creation. You end up with more complexity and more regulation. That doesn't lead to net welfare gains.*

*The policy solutions are not that difficult to see, but I'm not sure how much political support they'd get - fewer products, fewer providers, lower charges and a return to long-term thinking.*

*The only long-term solution to short-termism is education about the system, what it does with their money, how it changes the world that they live in and how they can govern it.*

*We need a consensus on what to measure and report. A particular level of disclosure could lead people to draw entirely the wrong conclusions. The lack of transparency is an issue, but getting to a level of constructive disclosure is difficult.*

*There's no point in the regulator talking about value for money if you don't actually know how much the costs are.*

whereas institutional investment governance arrangements are adequate, much could be improved at a retail level. While there is relatively good governance within investment trust structures, there is thought to be too little independent representation for investors within other retail investment structures.

While institutional governance arrangements are thought to be adequate, stakeholders believe that they could be improved in two ways. First, institutions should be encouraged to seek scale through collaboration. This is taking place among local government pension schemes, but occupational schemes and other institutional investors should be encouraged to obtain scale to allow them to have a more even relationship with their providers. In addition, there should be greater professionalisation of investment decision-making among asset owners. Trustees should be encouraged to set the framework for investment policy, but should seek in-house professional resource to help them implement that policy. Asset owners can probably only take such a step where they have sufficient scale.

Given that stakeholders typically believe consumers find it difficult to assess how best to work with the profession, they are surprised that the regulator is not more demanding with respect to the qualifications required of

investment professionals. CFA Institute's three-point action plan for building a better investment<sup>36</sup> profession lists a regulatory demand for higher levels of technical and ethical competence as one of its key objectives.

The regulator's approach has paralleled work undertaken by both CFA Institute and CFA UK with respect to the duties owed to clients around reporting and behaviour. Alongside the Code of Ethics and Standards of Professional Conduct to which each member must attest annually – and which have at their centre the requirement to put clients' interests ahead of our own – CFA Institute also operates standards and guidelines in multiple areas relating to the promotion of clients' interests (notably the Global Investment Performance Standards and the Asset Manager Code of Conduct ). Similarly, CFA UK has published multiple position papers intended to help members and other investment professionals meet their duties to clients.

CFA Institute and CFA UK work closely with regulators and policymakers at an EU and national level, commenting on proposed measures, raising points of concern and informing them about the work that CFA Institute and CFA UK are doing to educate investment professionals, maintain standards and promote professional behaviour.

<sup>36</sup> <https://www.cfainstitute.org/about/vision/Pages/action.aspx?PageName=searchresults&ResultsPage=1>

# HOW THE INVESTMENT PROFESSION SERVES SOCIETY

## A ROUNDTABLE DISCUSSION WITH CFA UK FELLOWS

### CFA UK:

What value does the investment profession deliver?

### **Robert Jenkins:**

We collect small streams of savings and aggregate them into rivers of capital, which have the power to fuel economic growth, jobs and boost welfare. We also provide a vehicle by which individuals and institutions can achieve diversification and market access at a price and to an extent that they could not do on their own. Those are two very important contributions. There are of course gaps. One gap is between what we have allowed our clients to expect of us versus what we can reasonably deliver and the second is the value that we can reasonably deliver versus the price that we charge for that value. One of the challenges is to close those gaps.

### **Anne Richards:**

I wholeheartedly agree. Our debate should not be around whether or not we need this system but how we can improve it. My second point is because of the length of the pipe between the streams and the pool we invest, there are things done along that pipe, which are sensible but in aggregate impede that smooth flow. We need to remove the debris that clutters up the pipe as that ultimately adds cost. That's one of the reasons why we have this gap between expectation and deliverability and why the value extracted by the whole



### **Robert Jenkins**

Robert is an adjunct professor of finance at London Business School where he teaches investment management and Chairs the AQR Asset Management Institute. He previously led F&C Asset Management – first as CEO, later as Chairman. Robert chaired the IMA, co-chaired the Chancellor's task force on the 'Future of the UK Investment Industry' and served on the UK's Takeover Panel. From 2011-2013, he served as a founding member of the Financial Policy Committee of the Bank of England. He is a Fellow of CFA UK, a senior Fellow at Better Markets and a Governor of CFA Institute.

chain is perhaps too great versus what's delivered.

### **Peter Montagnon:**

A problem is that individual customers don't actually know that you're funding the economy and doing all of this. They don't see the social value. They see somebody who is actually taking their money, investing it for sometimes rather mediocre returns and charging a rather large fee. One of the big problems here is not necessarily saying 'we fund infrastructure, we fund companies', but 'we serve your interest as a customer, as an individual'. That's really got to come across before people begin to see the value.

### **Elizabeth Corley:**

Is it simply that we need to communicate better or can the system be improved? I think it's both. We've been a largely ignored industry for a while, which suggests we were quite benign and doing a good job. We do an outstanding job in a way, which

is channelling individual savings and private capital and applying that ideally at the lowest cost of capital for the highest return, but with stewardship and a fiduciary responsibility. A lot of the value of stewardship, of a fiduciary responsibility does not generate an end result the customer necessarily sees. The customer judges us on the quality of our return. Politicians and other agencies possibly judge us on the effectiveness of our capital allocation and stewardship. We have a disparity of stakeholder interests and that may be why we have the communication gap. Maybe our communication isn't nuanced enough for the role that we're performing in society.

### **Lindsay Tomlinson:**

This industry sits at the heart of the capitalist system so the efficient functioning of this industry is absolutely fundamental and therefore that is a major social purpose and a major social good. On a medium-term basis the financial markets have suffered

appallingly by being captured by short-term interests. That was totally exposed by the financial crisis. The investment banks have been reined back as a result as has the whole banking industry. There is now an opportunity for the asset managers to step forward into what is a policy vacuum and explain what they do and why markets should operate in ways that actually benefit the end investor.

**Anne Richards:**

There is also an assumption that individuals all want the same thing with their money and don't perhaps appreciate their role in being part of this long term flow of capital. You can't lose sight of the fact that those individuals have their own priorities. They may not care whether their investment funded a rights issue and created jobs. When I give money to somebody else to invest, I actually don't look at the relative performance because relative performance pays no food bills or rent. I care about the absolute performance. As an industry we have gone down a very narrow benchmark channel and have sometimes lost sight of the bigger picture for individuals.

**CFA UK:**

Do we need to talk more about long-termism? Can we sell long-termism?

**Anne Richards:**

If somebody comes to us to raise seven year money for a bond that's



**Lindsay Tomlinson OBE**

Lindsay is a non-executive director of Legal & General Investment Management and a past non-executive director of Legal & General Group plc. He is also a NED at the Investor Forum and at the Pensions Infrastructure Platform. He joined Barclays Global Investors (BGI) in 1987 before becoming UK CEO in 1994 and Pan European CEO in 1996. He later became the firm's Vice-Chairman and, following BlackRock's acquisition of BGI in 2009, he remained through the integration process before retiring in 2011. He was previously Chairman of the UK's National Association of Pension Funds and is Chairman of the Code Committee of the Takeover Panel. Lindsay was also a director of the Financial Reporting Council. He is a Fellow of CFA UK.

going to build a new factory, why should I expect capital markets to instantaneously give me my money back at a moment's notice? There is a fundamental mismatch between the investing horizon of the companies that we're talking to and the products we offer clients, which typically require daily liquidity. Just because it's other people's money doesn't mean that we shouldn't be able to put appropriate boundaries around withdrawals. If we want to really engender long-term investing, we need to find a way of teaching people that if they want instant access to their money, a current account is a really good place for that. If they want a higher return than maybe they might have to expect some degree of illiquidity.

**Elizabeth Corley:**

Banks and building societies do that and people know instinctively that they can get a different rate of interest. It's a regulatory response to not trusting opaque locked in money. The way you protect

the customer is to make sure it's transparent and accessible. At the moment there's an awful mismatch between the illiquidity premium and the regulatory structure we've got for a lot of collective savings. A way around that would be incredibly helpful.

**CFA UK:**

How can we improve the public's perception of the investment profession?

**Anne Richards:**

One of the things we need to address is our fees and the value we deliver for them. The vast majority of funds use the same pricing mechanism which is a percentage of assets managed. Most other professional services firms use some measure of billable hours or flat fees for work delivered as a mechanism. It's strange that there isn't more diversity of charging structure in our industry.

**Elizabeth Corley:**

I think that's going to come through. I think we're going to find much more experimentation with the low return outlook.

**Robert Jenkins:**

Pursuing that line of argument, it's worth asking to what extent a prolonged period of financial repression would shape our industry? There was a presumption in the past that equity markets would always provide a positive real return over time and the game became to create uplift through relative performance. What are the implications of financial repression for our industry? One of them is fee compression, another is increasingly fashionable outcome and solution orientated investments. Since you can no longer promise the customer any significant return, you have to engage with the customer about what problem he's trying to solve, over what period of time and what kind of risk he is going to have to take. In a way the current environment forces a more intelligent conversation that should have been there all along.



**Elizabeth Corley CBE**

Elizabeth is vice-chair and past CEO of Allianz Global Investors. Her experience extends to 11 years working at Merrill Lynch Investment Managers and as a consultant and then partner with Coopers & Lybrand, and prior to that worked for a number of years in the life and pensions industry. She is a member of the Management Committee of the Forum for European Asset Managers and in 2014 was appointed to the European Securities and Markets Authority's stakeholder group. Since April 2011, she has served as non-executive director on the Financial Reporting Council. Elizabeth is a member of the CFA Future of Finance Council and is a nominee for CFA Institute's Board of Governors.

**Elizabeth Corley:**

The silver lining of these markets is that they will force out a bit of laziness and inertia in the market. We will have to become much more effective, efficient, accountable and leaner. That's a good thing. I think this is why you get tension in the industry about how fast you do it and how proactively you do it. I think there's going to be a separation within the industry between those that are trying to anticipate these changes and those that are resisting.

**Peter Montagnon:**

What we're talking about here is a shift in the perception of the industry but isn't the conversation with the customer only going to bear fruit in the long-term. Isn't there a risk that the challenges could become acute very quickly?

**Anne Richards:**

There are occasions, such as the extreme environments we saw in 2008/2009, when the single best thing we could do for customers is to prevent them trading. What 2008/2009 taught us is that the people who panicked at the bottom were the ones who lost out.

**Peter Montagnon:**

Investment managers need to talk about what you are doing to ensure companies don't go off the rails. Then the question is, what is the value that you're generating for your clients by going in there with your sleeves rolled up and trying to work this out compared with selling out at the top?

**Elizabeth Corley:**

Evidencing what you do rather than what the outcome is, is probably as good as it gets on stewardship.



**Anne Richards CVO, CBE**

Anne was chief investment officer at Aberdeen Asset Management. Subject to regulatory approval, she will join M&G Investments later this year as its chief executive. She began her City career as an analyst with Alliance Capital in 1992, subsequently moving onto portfolio management, firstly with JP Morgan

Investment Management, and then with Mercury Asset Management, later MLIM. In 2002, she joined the main board of Edinburgh Fund Managers plc as CIO and joint managing director. She continued in her role as global CIO for the combined entity when EFM was taken over by Aberdeen Asset Management in 2003, joining the main board in 2011 and served as a director until February 2016. She is a Fellow of CISI and of CFA UK.





### **Peter Montagnon**

Peter is Associate Director at the Institute of Business Ethics. He is a member of the Corporate Governance Advisory Board of the Norges Bank Investment Management and member of the Board of Hawkamah Institute, Dubai. He was previously Senior Investment Adviser at the Financial Reporting Council, UK, and

Director of Investment Affairs at the Association of British Insurers. Peter started his career as a financial journalist and worked for 20 years at the Financial Times where his assignments included Asia Editor and head of Lex.

### **Lindsay Tomlinson:**

If you own 5% of the company irrespective of that fact that you can't sell it, the company is very interested to talk to you and there has been a core group probably consisting of about 20% of the UK equity market that been talking to companies for 10 years or so. And actually has by and large developed reasonable relationships with companies. I think we should look at what we were arguing about with companies 20 years ago and what we're arguing about now. Now we tend to be arguing about the company strategy, but 20 years ago we were arguing about why they owned a grouse moor. A lot of these companies were actually being run for the benefit of the board and that's gone.

### **Anne Richards:**

Transparency. If people saw the value in what we did and if we articulated better what we do, there'd be more trust but we don't make it very easy for them to see what we get out of it and they become suspicious.

# THE RELATIONSHIP BETWEEN ISSUER AND INVESTOR

## A CFA UK/IR SOCIETY ROUNDTABLE DISCUSSION

### **CFA UK:**

Is the information flow from the investment profession to UK plc valuable?

### **David Lloyd-Seed:**

It is massively valuable, but a bit lacking. You go into a meeting with investors and it's very often a one-way street of information flow. It would be helpful to both sides if we improve the two way dialogue.

### **CFA UK:**

How well prepared do you think or how well informed are investment professionals typically about your companies?

### **David Lloyd-Seed:**

Most of the ones I meet are exceptionally well prepared. This has massively improved from when I started in-house 12 years ago, back then it would be half and half I'd say. Now, particularly if they're meeting the chief executive or finance director, the fund managers know the business well.

### **Sue Scholes:**

You still get the odd exception. It's hugely frustrating if the key person doesn't turn up to a meeting and they send along a junior who doesn't know much about the business. They're sitting there with the CEO whose time is precious and the opportunity cost of that is immense.

### **Ross Hawley:**

If you're in a sector that is big enough

for a fund manager to spend their career looking at that and a couple of others then the engagement is much stronger. You then get some of the senior fund managers who really understand it so you get very good dialogue. The universe has changed over the last 10 or 15 years. Then the proportion of the FTSE 350 being held by your standard pension fund managers was about a third. Roll forward to now and more than half is with stock pickers, concentrated funds, and some of them can hold very significant chunks. The traditional well known managers are actually holding less and the dialogue that you get with the concentrated stock pickers is very high. They've done the work on you and it is daunting how much they do know; how much they've spoken to your suppliers and customers and peers.

### **Sue Scholes:**

If I was to talk to my old CEO and ask him, "Where do you like doing IR meetings", he'd always go for the US. He was more likely to come across the stock picking and detailed analysis, and those meetings were full of questions that would stretch him. Then you'd have your standard UK schedule within which would be the kind of meeting where you could predict every question in advance and you could predict how it was going to be answered. There was not always that same challenge and it wasn't as clear that you're being assessed in the context of your industry and your peer group.

### **CFA UK:**

Are the stock pickers long-termist or are they hoping to generate a return quickly?

### **David Lloyd-Seed:**

If you look at the stock pickers, their holdings are probably longer because they have that holding as a fundamental position. I've rarely met an investor who isn't a five to 10 year investor because they all say that. But the ones who are genuinely there as long-term holders tend to be more focused and they make sure that they do the work before they go in to a meeting.

### **Sue Scholes:**

That's been our experience as well. In my time, we've had some short-term people who have decided to stay a very long time and equally some supposed long term investors who haven't stayed long. You have to assume that apart from people who are trading by the minute, anybody is a potential investor and how do you define long-term?

### **CFA UK:**

And you'd separate them from the activist investing crowd?

### **Ross Hawley:**

I think there are concentrated funds that you could view as being forceful and there are others that are certainly activist, but are not obviously concentrated.

**CFA UK:**

Do you have long conversations with the indexers?

**David Lloyd-Seed:**

There are some that are active on the stewardship side and others that I don't think I've ever talked to.

**Sue Scholes:**

With the UK indexers, they're more likely to have a meeting with the chairman because they do their stewardship on the basis they are going to have to invest in the company anyway, so they want to make sure that governance is where they want to be.

**CFA UK:**

Do you think that investors are sufficiently clear about their different strategies?

**Ross Hawley:**

I think companies would benefit from understanding better and having a more open dialogue with the investment community as to what their objectives are so that we can help meet them. What I mean by that is very specifically knowing what the fund is focusing on. If we can understand better what investors' objectives are, I think we can help the dialogue better.

**Sue Scholes:**

That's interesting because, in the past, as a corporate you would have gone to your broker and you would listen to their intelligence on the fund you were going to meet and you'd have believed it. Now you either don't go to your brokers because you organise the meeting yourself or maybe you just don't believe what they are telling you in the same way because they just don't have the same level of intelligence.



**Sue Scholes**

Sue Scholes was appointed Chair of the IR Society in June 2014. Most recently, Sue spent seven years as Director of Communications for AMEC plc and was an Executive Committee member during a period of significant and successful transformation. A CIMA-qualified accountant, she started working in investor relations in the late 1990s, at GKN plc. She was involved in the demerger of its joint venture businesses, the subsequent listing of Brambles Industries plc; as well as the later unwinding of this dual-listed company structure.

**Ross Hawley:**

I think funds have stopped talking to brokers because they are sensitive to the conflict there.

**Sue Scholes:**

There was an intermediary there that, for a number of different reasons is now not as strong.

**Sue Scholes:**

A specific comment that has come up a few times – from a governance and wider ESG perspective – is how do you find out what a particular institution is interested in? Investors say that they are not resourced for every single company to phone them up, so they try to put some stuff on the website. Those who are complying with the stewardship code now have what their policy is with regard to remuneration and all the other key issues on their website, but inevitably this ends up being in boilerplate language. I don't know what the answer is.

**David Lloyd-Seed:**

Perhaps some form of repository would help. I just think it would be useful for us to know when we're planning the meeting what their investment objectives are (particularly around your company), how they're thinking about the market, sector etc.

**CFA UK:**

Do you think that the executive teams make different decisions based on feedback from capital providers or thoughts about how capital providers might respond to plans?

**David Lloyd-Seed:**

Ultimately, I suppose yes because they're the shareholders. But you have to be aware that you have a wide group of shareholders and at one point in time you may have a type of investor that isn't necessarily going to be your long term investor. Those investors may be different from the type of investors you might get in the future with a different investment philosophy reflecting the changing nature of the underlying business. But I wouldn't say they change direction significantly because of feedback because good management has a clear idea of what they want to achieve and if a shareholder doesn't agree with them, then they can, ultimately, sell.

**Sue Scholes:**

You need to understand what your shareholders are thinking, but so often different shareholders have different views on things. If management were to jump every time an individual shareholder said something, I don't think they'd

be looking after the company for the long term in quite the right way. It's really important that every organisation has multiple relationships with shareholders, so that if there's a strong message coming through, the company is alert to it. The management team also need to be communicating clearly what it is they are doing and why they're doing it.

**Ross Hawley:**

It's also interesting to think about what kind of value the investment professional gives to the company. You could say that is precious little in terms of the ongoing operations because they're not really meant to be influencing strategy in that way, but you want their support and for that to be permanent there has to be a dialogue with them in order to make sure that is a strong relationship. It's interesting that the Investor Forum has been set up as a conduit to help investors better express their views/concerns to companies. It either reflects that they don't think that they do it particularly well or they don't know they have the means to do it.

**CFA UK:**

Do investors behave like long term owners or short term traders?

**Ross Hawley:**

There are degrees of them.

**David Lloyd-Seed:**

On the whole, long-term holders. I went through a turnaround in a business that was close to going bust and therefore had a lot of short term interest in it as well as some deep value holders who who bought the shares. About 40 per cent of the register was held by approximately five fund management firms who



**David Lloyd-Seed**

David Lloyd-Seed is deputy chair of the IR Society and a partner at Tulchan Communications. He was previously interim head of Investor Relations at Severn Trent and his experience extends to 10 years as IR and Corporate Affairs Director at Dixons Retail. He also enjoyed 18 years as a corporate broker, latterly as a Director with Citi and has advised companies on IR, market related activities, fund raisings, mergers and IPOs across various sectors. He is a member of the IR Society's Board and sits on the Finance and Policy committees.

were hugely supportive and did think about the long term.

**Ross Hawley:**

I think they're determined by what they're judged on. If you run a fund which is being reviewed that way [short-term] or it's got short-term performance criteria, it's natural that they're going to be much more focused on that.

**Sue Scholes:**

But it also depends on why somebody is buying into you. Do they care about your company or do they just need more exposure to the sector for example?

**CFA UK:**

Can you ignore short-term holders because you know your longer term holders well enough?

**David Lloyd-Seed:**

I've got experience of having value holders and hedge fund holders. We had a clear idea of what the turnaround strategy would be and where we could get to. We knew that if we got it right the short positioned hedge funds would lose out, but we did listen to what they had to say because we had to know how to challenge their arguments. We very much relied on dialogue with the long term holders and understanding why they were

holding and what they believed we could do. So we listened to them. They didn't influence the way we did things because that goes back to the point about management. If you trust in management, then let them do what they do.

Management tends to run its business for the long term. You do see some companies being run to meet quarterly objectives and that's the piece where people believe that institutional investors could play more of a role. If I was going to be harsh, you could say that investors as a whole just accept what the remuneration committees put in front of them. We know that's not entirely true, but that's the perception and maybe investors should take a more public stance on the fairness of pay.

**Sue Scholes:**

I endorse what David says about noise. There is an awful lot of noise out there and whether you like it or not you have to pay attention to the noise and know what it's saying because that will be having some influence on the views of your long-term holders as well. You have to understand it and be able to refute it or understand at least where it's coming from. I've been through a turnaround situation as well and we would regularly

meet investors to try and persuade them not to go short or to minimise their short position. You shouldn't dismiss those investors from your meeting schedule.

**David Lloyd-Seed:**

You can find the short story is talked about more in the market than the long story because often they've got an agenda.

**CFA UK:**

How much is the individual company's WACC affected by individual investment managers?

**Ross Hawley:**

I'm not sure. The market understanding the company and the company understanding how the market perceives things is a core IR skill and part of the dialogue between a company and its investor base. I'm not really sure how WACC is really influenced by the individual. Also, I struggle with this thing about hedge funds being negative. I have been in a position where a manager had a big short position, but they had that to offset a long position in a related tech stock. They weren't actively trying to get our price down; they were just hedging out a particular position as a pairs trade.

**Sue Scholes:**

That's an important point. It's about relative WACC isn't it, relative to your peer group. If you have a good reputation, whatever happens, your WACC is going to be closer to what it should be. Is there a pure WACC? No, because it's subject to economic conditions and all sorts of political risks that might be floating around. But if your company is doing a good job at communicating with its shareholders and understanding the shareholder environment, it can make sure that relative to its peer group it has a WACC that's closer to a view of what it should be. I don't think we ever had a situation where we felt we were wildly out relative to the market.

**CFA UK:**

One of the things that surprises us is the degree of interest in equity relative to debt.

**Sue Scholes:**

Equity markets are more public. In my experience, where we started to put significant debt in place, the conversations were a lot more with the rating agencies and that's all behind closed doors. Then once we parcelled out debt, there was more limited engagement from debt analysts. Typically, if you asked anybody from the debt side if they'd like to come along to the

results presentation, they'd say "Oh yes thank you, that's very nice". But then they'd sit there and they wouldn't ask a single question, but it probably ticked off some compliance measure.

**David Lloyd-Seed:**

I just find the whole rating agency thing a little odd. The company pays for it, but it's for the benefit of investors. There's a natural conflict in there. I think investors should be independent of the company, and perhaps paid for by the investor.

There often seems little interest in doing non-deal debt roadshows. There's no ownership knowledge and there's little willingness to engage on the other side. So there's a huge amount of our capital with which we have very limited dialogue and very limited feedback. So there is an imbalance.

**Ross Hawley:**

The equity response to news is more sensitive, so it is a good early warning sign for the debt guys. When you have a debt call, you halve the slide pack and you put in a few more cash flow charts and you talk about risk on the down side because that's what they're interested in and that's absolutely fine.

**Sue Scholes:**

Sometimes we underestimate the sheer amount of information that's available. So, they may not want the meetings, but it's not as if debt investors don't find out about the company because they can find out everything in real time – just as anybody can – through your website.



**Ross Hawley**

Ross Hawley is Assistant Director of Investor Relations at FTSE100 aerospace and defence business, Rolls-Royce plc. He is chair of the IR Society's Education Committee and deputy chair of the Policy Committee. Having begun his career in equity capital markets banking, Ross has over 18 years in-house corporate

experience - at Man Group plc, where he was involved in a very wide range of capital raisings and corporate transactions, UK-listed Playtech Ltd, NASDAQ-listed Edwards Group, and UK-listed Page Group, each time setting up the IR function.

**CFA UK:**

Is the extra effort of engagement with investors worth it for the access to capital that provides? Would it be easier to rely on internally generated funds?

**David Lloyd-Seed:**

Ultimately, investors provide access to the right capital and if we have the right dialogue with them that is going to make access to capital more readily available than if companies don't. They need to feel comfortable going to them for capital – that's not just our story, it's their story as well.

The first hurdle is the perception that you're going to the capital markets rather than any other form of financing, which more often than not is either distress or it's associated with some form of M&A, because otherwise essentially it's a less efficient form of financing a company.

**Sue Scholes:**

When we were sitting with lots of cash on the balance sheet, we did regularly hear investors say 'Why are you not giving it back to us? And don't worry because if you need it we'll give it back to you'. Management weren't entirely trusting that it would be coming back quite as easily.

**Ross Hawley:**

There is a sense that companies get the shareholders they deserve. If you don't have a coherent IR programme, you're going to get investors that either just say 'I get this space' or investors who are just a bit flighty. So, in terms of access to capital, if you have the dialogue and you do it well you will often get the benefit of the doubt at the time when the market is in the right place

**Sue Scholes:**

A good IR team can also help support fund managers with their stewardship obligations. If shareholders are not seeing best practice IR in the companies they invest in, they should put pressure on the management team and board, to make sure they realise that this could add value – for both parties.

**CFA UK:**

One of the companies that I have spoken to found it surprising that investors never asked them for their opinion of a meeting afterwards.

**Ross Hawley:**

I've been asked that once or twice.

**David Lloyd-Seed:**

The vast majority of fund managers generally want to do a good job for their clients. They're diligent and they make the effort and they're responsive when you ask them questions. If there's some way we can raise the two way dialogue a bit, I think it would make for better communication.

**Ross Hawley:**

Yes, we've been talking about value and actually there are some moments where the meetings absolutely add value and you walk out with the CEO or CFO going 'I would absolutely put my own money with that person' – which is a good rule of thumb – and 'that was a really interesting take on something'.

**CFA UK:**

What about stewardship? Most investors now seem to understand that though there's an extra cost, it is justified because it generates an additional return.

**Sue Scholes:**

Every time we sit down and talk to the buy-side, we are told that they are getting more comments and queries and feedback from trustees about their expectations on stewardship.

**David Lloyd-Seed:**

It rarely comes up in management meeting with fund managers though; I think it's usually dealt with in a separate area within the institutional investor.

**Sue Scholes:**

Very often we've had meetings with fund managers where these kinds of issues are not raised at all. Most fund manager meetings are about numbers and a little bit about other things if they're remembered.

Equally, we are seeing more companies organise meetings with the chairman and the NEDs plus fund managers and governance contacts, where you go in and discuss everything. Things could definitely be improved with more coordination between fund managers and their governance colleagues and from a corporate perspective, between the company secretary and IR.

**Ross Hawley:**

I guess in terms of stewardship, the Board structure, the RemCo structure, the pay structure, they are always there. The sustainability piece has fallen away a bit at present.

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