Torn up tracks

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Content:

Introduction

A few years ago, when the 300 Club was first established, the financial community still held onto a belief that the economic and financial tools traditionally used for decision making would be more than adequate to navigate the global economy's return to safe harbour and rebuild the financial system. Professional investors and central bankers alike still looked to modern economic theory, including, Keynesianism and the Chicago School among other strands, and the 'scientific' modality of the financial theory it generated, from Markowitz and Sharpe onwards, to chart the map to the future.

That the model failed in 2008 is beyond dispute.

The Monetarist response of unprecedented monetary easing by central banks to the crises was in all probability the correct response for averting a financial and economic collapse. But it, together with the Keynesian response that now is the wrong time to be worrying about government debt, also involved a massive debt transfer mechanism from the failed financial system to ordinary citizens. This raises fundamental concerns about the systemic moral hazard embedded in the current economic world view. In turn that should lead to citizens questioning the purpose of the financial system, and to 'professionals' questioning the efficacy of the 'traditional' view of economics and the financial theory built on it.

Moreover, the 2008 crises have resulted in a world locked in a cycle of super-low interest rates, underwritten by central bankers' put on interest rates above 3%. This places inordinate strain on the concept of discount models, and calculating future liabilities. Even seven years on, there is still a question mark over the degree of possible future growth in developed economies as many still flirt with deflation.

Among other things, the economic result in developed economies, so far, has been an increasing disparity between the 'haves' and 'have nots' which is beginning to stress the political fabric of society.

At the same time, Malthusianism has re-emerged, not so much in the classical sense of a fear of a strain on resources by increasing populations as a product of economic growth (if anything the problem in developed economies and China is an ageing population – which is creating its own political tension), but by a growing realisation that the current carbon-based economic growth model, if unchecked, will in all probability present a real danger to our species and our environment.

1. Torn up tracks

Since the 2008 financial crises, three main trends have slowly gathered pace:

1. Financial theory is flawed

First, there is a growing realisation that modern financial theory is flawed[1]. Post 2008, professionals talked of the crises as 28 standard deviation events, but we now know such talk was errant nonsense and merely reflected flawed models. Most accept that markets are not efficient in discounting more than what is currently known, and that not efficiently due to behavioural distortions, nor are they efficient in predicting future movements. Behavioural finance has moved from the periphery[2], if not to the mainstream, then at least to a place where we are at least re-evaluating how financial markets work[3]. Likewise, there is now wide acceptance that volatility is not a good substitute for risk. As Dr Barry wryly observes in his book[4], all swans in Australia are black.

2. Neo-classical economics is flawed

Second, there is a burgeoning appreciation that neo-classical economics might also be flawed, although the alternative of viewing the economic system as an adaptive complex system is yet to mature into mainstream use[5]. Nonetheless, there is a reluctance to drop the CAPM model, partly because many believe that for all its flaws, it still represents the best available model and partly because the story of modern economics has been one of trying to adapt and build on the rigid foundations laid by Jevons, Walras and Marshall in the 19th century, rather than an attempt to re-evaluate its very foundations (as has occurred elsewhere, such as in the field of physical sciences). However, there is some movement today, particularly in light of the environmental impact of carbon and the societal impact of Friedman economics, to challenge even the basic idea of whether GDP calculations are the correct way of understanding and evaluating growth, to which I shall return[6].

3. Concentrating on purely nominal returns is flawed

Third, as a result of all these concerns there is a greater awareness that concentrating on purely nominal financial returns ignores the environmental and societal cost of investment decisions and is therefore flawed as a means of allocating capital. In this regard, Aspinal, Jones et al submitted an interesting review of academic literature to the IFoA[7] that calls for further assessment of the sole use of discount rates, which in turn has a deep impact on how we calculate future liabilities and, I would argue, what we should seek from our investments.

[1] Amin Rajan, "The Death of Common Sense: How elegant theories contributed to the 2008 market collapse", 2012
[2] "See How We Know What isn't So" by Thomas Gilovich first published in 1991
[3] "See An Engine, not a Camera" by Donald Angus MacKenzie published 2006
[4] For a concise history of economic theory, see Ross Barry, "Crisis and Complexity Volume I, An Inquiry into the Nature and Causes of Economic and Financial Crisis", 2015
[5] ibid
[6] Robert Costanza et al, "Time to leave GDP behind", Nature, Vol 505, January 2014
[7] Aspinal, Jones et al, "Sustainability and the Financial system: Review of Literature 2015", presented to the Institute and Faculty of Actuaries, London, May 2015

2. Time for a rethink

For those concerned with long-term investment, under normal conditions these three trends would gradually lead to a re-examination of the methodologies we use in investment decision making. However, we are not living in normal conditions; and the need for us to rethink our investment beliefs and methodologies is now time critical.

The period of super-low interest rates caused by the unprecedented amount of monetary easing since the 2008 financial crises distorts all future and current valuations by altering the inter-asset valuation matrices. This distortion of asset valuation is evident in the breakdown of the relationship between yield and growth assets, and the resultant quest for higher yields from non-growth strategies.

The extended period of super-low interest rates, which looks set to last for a long time yet, is contorting the normal methodology for investing along a time horizon by fueling a rush into higher-yielding assets to generate income for beneficiaries who will live much longer than anticipated. This is also underpinned by the focus on generating nominal financial returns. A recent academic paper presented to a conference in Australia argued retirement lump sums should be invested much more heavily in growth assets than hitherto accepted to make up for the super-low interest rates[8].

Furthermore, unless one is a Baptist Creationist Republican, there is a growing acceptance that the world is rapidly and irrevocably progressing towards 2° warming by 2050, which will have catastrophic consequences on the environment and our survival as a species[9].

Therefore, we as an investment community cannot afford the luxury of waiting until academic literature on the financial and economic system catches up with reality. It is time for us to start applying a more holistic approach to investment. We need to acknowledge that traditional valuation matrices between asset classes do not work in a super low interest rate environment. We need to incorporate long-term environmental and societal outcomes in our investment decisions and we need to re-examine how we should invest the lump sums generated at the end of a working life, tilting them much more towards growth strategies.

[8] David Schneider Paul Newfield and Jeffrey Chee, "Determining the optimal investment and consumption strategy for an Australian Retiree", presented at Fiduciary Investors Symposium, Lilianfels, May 2015
[9] Myles Allen, "The science of climate change and the impact on asset owners", presented at Fiduciary Investors Symposium, Oxford, April 2015

3. A suggestion for an alternative viewpoint

The irrationality of the current system

1. One of the cornerstones of behavioural finance is that humans are hardwired to use pragmatic, but suboptimal approaches (or 'heuristics'). This has been exacerbated by an increased siloisation of the financial system. Thus we have reduced the problem of providing future cash flow for retiring beneficiaries from their current savings into a simple matrix of 'real returns' expressed as a simple excess over nominal GDP or inflation. Yet, the composition of GDP inflation is fundamentally different from the inflation basket as experienced by the retirees whose savings we are investing. Data from the ONS shows that while food and energy make up only 25% of the GDP inflation basket, they make up almost 50% of an average retired person's inflation basket[10]; therefore even if we were to accept this simple heuristic, we are using the wrong matrix.

2. Professor Kay pointed out in his review on long-term investing[11] that stock markets are no longer fulfilling the role of raising capital for large capitalisation stocks that they were designed to do in the 19th century. Yet, most of the beneficiaries' assets being managed by the investment community are invested in the shares of these companies either through an increasingly dwindling allocation to active managers or through an increasing allocation to index funds (including smart beta). And while it may be perfectly true that these companies no longer use the stock markets alone to raise substantial capital (beneficiaries also lend them money through the credit markets) the actions of these companies, nominally owned by the retirees, have a profound impact on the long-term wellbeing of their owners.

As an extreme example of this, the actions of financial companies prior to 2008 have resulted in a long-term deterioration of the financial wellbeing of their owners by transferring the deficits they amassed to those owners via public debt. Those owners now face the prospect of unwinding this debt through less funding for the public services available to them for at least a generation. Another example of the profound long-term impact of these companies on their owners is reflected in the carbon debate. A less extreme example would be companies' use of legal structures to reduce tax payable and thus increase the financial burden indirectly on their shareholders as citizens.

3. The entire financial industry, but more specifically the investment industry, bases all its models and analysis on an implicit assumption that they are exogenous to the financial system, observing it, as it were, from a distance to make allocations that exploit inefficiencies to enhance returns. However, the fact that collectively the investment industry controls the $87 trillion that makes up the markets means they are not only indigenous, but that they actually ***are*** the system and therefore their own behaviours, beliefs, models and even assumptions on valuation methodologies (CAPM, EMH, etc), shape that system.

A More Holistic Approach

I would argue very strongly that we as a financial community have lost sight of the fact that the beneficiaries whose money we invest are the customers of the companies we invest in on their behalf. We all have to live in the society shaped by the sum of the actions of these companies, as well as of governments. It may be true that public stock markets no longer fulfil the function they were designed for in the 19th century, but companies owned by the beneficiaries ultimately control the architecture of the society these savers live and will retire in.

[10] Office for National Statistics, Consumer Price Inflation Index, June 2015
[11] John Kay, The Kay Review of UK Equity Markets and Long-Term Decision Making, July 2012

Surely part of the investment discourse has to be an empowerment of these savers to have a say in that architecture in the same way they have a say in government policy via the democratic process?

In other words, investment should not only look at short- or even medium-term financial return, but should incorporate within it an attempt at designing an optimal societal outcome for savers from their investment holdings holistically, which may very well entail a forfeiture of short-term nominal return.

This is not as outlandish a statement as it may appear. The Benelux countries already prohibit investing in the financially lucrative business of cluster bombs because of their societal impact. The normal repost by the financial community is that they concentrate on nominal returns within the bounds of the law (the Friedman argument that the purpose of companies is to maximise profits within the bounds of the law).

This argument is both morally repugnant – do we really approve of modern slavery as practiced by some companies in developing markets? – and financially flawed. Had investors questioned the unnaturally high Return-on-Equity ratios (ROEs) of universal banks in the run up to 2008 we may have averted the crises by directing them to a more ***sustainable*** business model. Ultimately, sustainable business models in the wider sense serve all stakeholders and create a more robust and beneficial economic environment for all.

Likewise the argument about ***environmental*** impact is about the long-term sustainability of our economic wellbeing. Emotionally, I would point out that no saver really wants us to increase financial returns by 1% or 2 % if they retire in Gotham City. Rationally, I would argue that, unless we actively manage the impact of a carbon-based economy, we would have used our beneficiaries' monies to create an environmental and financial disaster for them in the future, which will negate any nominal financial return we may make for them.

If we allow ourselves to move away from the heuristic rule of using current savings to provide a theoretical 50% or 60% of nominal current earnings adjusted for inflation, to one in which we realise that the ***purpose*** of investment by savers is to have a retirement where they enjoy the equivalent of 50% to 60% of their current standard of living holistically (i.e. including soft issues like infrastructure, housing, wellbeing and convenience), we can start to change our investment targets without even jettisoning traditional economic and financial theory.

Thus even if we were starting to think about the inflation basket that affects savers in retirement, and looking to reduce or change it to their benefit through how we allocate their capital, we would have made a start. Even in specific company decisions, we can start to re-evaluate strategy. For example, a high street bank might want to close branches and shift to more electronic banking to increase ROE, but is that in the best long term interest of its shareholders who, when they retire, are unlikely to own a car to visit more remote branches? Or would they benefit more from a slightly lower ROE and a bank infrastructure that serves them better in their retirement period?

I would suggest we take this further and start thinking about the sum total of the societal impact of the economic decisions of companies on their shareholders, not only as financial stakeholders, but as customers, employees and citizens who will have to live in the society created by the allocation of their capital. And I emphasise ***their*** capital. If we continue to allocate their capital in a way that leads to global warming for example, how will that affect their well being as retirees? How will it affect their ability to pay for energy? For water? For food?

The asset management industry effectively controls the wealth of the world at some $87 trillion. As such we have a double responsibility. First, as the collective body of analysts who should know the most about how the system can function optimally, are we using our knowledge for the common good to ensure the sustainability of the system, highlighting to regulators and governments the flaws we can see (as we should have done in the run up to 2008)? Or do we simply concentrate like some 'Del Boy trader' on using the system by profiting from its flaws and creating strategies which 'do what it says on the tin' to further our financial gain, leaving the overall impact of these flaws for others to worry about?

Secondly, do we accept that as a profession we are bound by fiduciary duty (with a small 'f') to do what is best for our clients? The move globally by the CFA and the IA here in England towards a (much diluted) set of ethical standards suggests we at least feel uncomfortable about our previous stance. Should we not take this idea of responsibility one step further, beyond best pricing and transparency of strategy and structure, towards thinking about holistic outcomes rather than the best return for the minimum cost, which is where the argument currently stands?

The fallacy of the heuristic of best nominal risk adjusted outcome for the least cost lies not only in that we do not really account for risk in our models, only volatility, but in our misunderstanding of cost.

We think of cost as transaction cost (fees, frictional cost, etc) rather than long-term financial and societal outcome. We need, both as asset managers and as agents of asset owners, to start to take into account both the true nature of risk and the true long-term nature of cost. For those who were part of Lloyds, the true cost of insuring asbestos was not captured in the simple matrix used to determine returns on investments by the syndicates at the time.

This brings me to the final element of such an approach. It is true that savers no longer provide the capital for most companies quoted on public markets, but it is a dangerous and short-sighted approach to abrogate all responsibility of ownership and reduce all such ownership to merely owning pieces of paper – whether they be shares or factor derivatives based on shares – to participate in the financial directionality of markets without attempting to ***engage*** with the executives and boards of these companies about the long-term impact of their business models. Doing so results in a world where companies operate in an environment of absentee owners and encourages management to concentrate on harvesting short- or medium-term rents.

Agents of asset owners owe a duty of care to beneficiaries to exert proper ***governance*** over their assets. Thus index funds cannot abrogate their responsibility to try to understand the businesses they own in depth and engage their boards and managements to ensure the optimal outcome for their owners. This was a truth recognised by Alastair Ross Goobey and others here at Hermes in the early days when Hermes was one of the first investors in index funds in Europe and seems to have found an echo with Larry Fink recently. Taken to its ultimate conclusion, it implies index funds would have to employ banks of analysts and engagement professionals to engage more deeply with companies rather than simply using a 'tick box' voting mechanism, which would imply a rise in the nominal cost of index funds, but a reduction in the much larger cost of not doing so in the long term.

4. Conclusion

There is a growing consensus that modern economic theory needs improvement, although we still lack consensus for the alternative. Likewise, there is a growing consensus that modern financial theory is flawed although, again, we lack consensus for an alternative. At the same time there is an increasing awareness that we need to recast the accepted model for capitalism, shifting to a model more in line with the McKinsey/CPPIB long-term capital initiative or the Blueprint for Better Business initiative here in the UK. At the periphery, there is more awareness of sustainability, environmental and governance factors in the investment discourse used by agents of asset owners and asset managers alike.

The problem is the inertia of an entrenched perspective within the investment industry and the business model of the financial system.

We need to rethink the purpose of investment from the perspective of the individual savers whose capital we hold in trust. We need to move away from concentrating solely on nominal financial returns and shift to thinking in terms of holistic outcomes for the beneficiaries.

This would require us as a group to do two things: First, to break out of our silos where we are only concerned with providing a stream of cash flows to meet nominal liabilities if we are agents for asset owners, or for meeting or beating nominal benchmarks if we are asset managers employed by the agents, to think of holistic long-term outcomes for the owners of the capital we are allocating; Secondly, it requires us to incorporate non-financial factors into our decision marking processes, recognising perhaps that unlimited financial growth is unsustainable in the context of the environment or societal cohesion.

In other words, we need to re-evaluate the social science of economics and finance, and subject it to as much revision as other sciences have been subjected to. We also need to rethink about the purpose of our actions as investors. There was a time when the discipline of economics was called the discipline of political economy. Perhaps we should recognise that, academically, that was a more accurate description.

The 300 Club

The 300 Club is a group of leading investment professionals from across the globe who have joined together to respond to an urgent need to raise uncomfortable and fundamental questions about the very foundations of the investment industry and investing. The mission of the 300 Club is to raise awareness about the potential impact of current market thinking and behaviours, and to call for immediate action.

Current economic and investment trends will change the investing landscape over the next two decades and we are at a crisis point which presents huge risks to investors, according to the 300 Club. Moreover, the 300 Club believes that current financial and investment theory and practice run the risk of failing investors at their time of greatest need.

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