

New City Initiative



The Moral Case for Asset Management

About the New City Initiative

NCI is a think tank that offers an independent, expert voice in the debate over the future of financial regulation.

Founded in 2010, NCI counts amongst its members some of the leading independent asset management firms in the City and the continent. The NCI gives a voice to independent, owner-managed firms that are entirely focused on and aligned with the interests of their clients and investors.

Over the last decade, an old fashioned “client-centric” approach has enabled entrepreneurial firms in the Square Mile and beyond to emerge as a growing force in a financial industry dominated by global financial giants. Now, more so than ever, these firms play a key role in preserving the stability and long-term focus of the financial sector, which is of benefit to society at large.

About the Author



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Dr Turnbull is the Director of the Centre for Enterprise, Markets and Ethics, a think-tank and research centre dedicated to promoting an enterprise economy built on ethical foundations.

Dr Turnbull holds degrees in economics and theology. He spent 8 years as a Chartered Accountant with Ernst and Young in their City office and on the south coast. He is an ordained minister of the Church of England and served for ten years in the pastoral ministry. He was a member of the Archbishops' Council, the Chairman of the Business Committee of the General Synod and chaired a number of reports for the Church.

Dr Turnbull was the Principal of Wycliffe Hall, Oxford from 2005-2012, is the author of several books and publications and a Fellow of the Royal Historical Society.

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Contents

Foreword	2
Executive Summary	3
Setting the Scene	4
The Moral Purpose of Capital Markets	5
The Moral Challenge	8
The Moral Response	12
Conclusions	16
New City Initiative Members	21

Foreword



It is no secret that the public despises bankers. Throughout history, the concept of banking and investing has always been tarnished with an image of individuals profiting from speculation or human misery – fund managers (especially hedge funds) ‘don’t make anything – don’t do anything’ and that ultimately our industry is one which exists solely to generate profits for ourselves with no benefit to our communities or mankind at large.

However, in my mind, it is the fund managers - these allocators of capital - who make the whole system work. Without capitalism and the difficult task of putting money to work where it will generate the highest rate of risk adjusted return – we would have had far fewer inventions, human advances, and wealth creation for society as a whole.

This paper, written by Richard Turnbull, goes into great detail as to why this is true. Fund managers provide liquidity, expertise, risk reduction and are also better structured to create the right culture of service and long term thinking. This helps fund managers avoid exactly the accusations of short termist speculation that are often levelled against us. Our ability to retire with dignity or fund new technologies depend upon our industry flourishing in the right way.

The problem with capitalism, as we are seeing with current events such as the vote against the EU by Britain, is that it means in many cases, brutal changes for those areas of the economy which cannot deliver the efficient returns. This means people’s lives change and this can be both incredibly painful and has long term social and financial ramifications too. To respond to these valid issues, a more sympathetic approach to investing which understands the effects of these changes (such as ESG investing) is now being pioneered, by the investing community and we at the NCI welcome this. This does not negate the need to generate returns for investors – but an understanding as regards the effects of our decisions is a good thing.

Finally – there is a view that the people behind some of these firms carry less moral weight than someone in a more vocational profession. We would dispute this, believing that taking thoughtful and difficult decisions to allocate savers’ funds to generate the best possible returns, is in itself both a hard task and one with an enormous positive outcome for savers and therefore society. We all need to generate better cultures and the NCI has taken a strong lead on this – but at the end of the day I believe that fund management is a powerful force for good and it is time that we started to celebrate our contribution both to global finance and the world at large.

I would like to thank Richard Turnbull for his excellent work here and for the engagement he brought to our group through the interviews he undertook and the fresh perspectives he generated via his links with the Centre for Enterprise, Markets and Ethics. His Centre has an important task ahead of it and we welcome the partnership we have formed together.

Executive Summary

- **At the heart of the moral argument for capital markets and asset management is the case for capitalism**
- **The efficient allocation of capital into high quality investments encourages saving and growth and brings inestimable benefits to society as well as individuals**
- **Asset management provides the market investor with liquidity without affecting the capital of the company in which investment is ultimately made**
- **Asset management enables investors to pool risks, reduce transaction costs, benefit from expertise and to participate in a diversified portfolio**
- **The management of capital in the market brings moral challenges which the industry must face in order to secure its long-term reputation**
- **Diversity of ownership models is a virtue which allows for more choice, greater competition and encourages long-term perspective**
- **The development of boutique investment firms, partnerships based upon the principles of co-investment, is delivering an alignment of interests which ensures that managers, owners and investors share in the full consequence of their investment decisions**
- **Excessive regulation may stifle the diversity of the industry and not serve the consumer or society as a whole**
- **In summary, asset management:**
 - **Creates wealth**
 - **Efficiently allocates capital**
 - **Ensures liquidity**
 - **Manages risk**

Setting the Scene

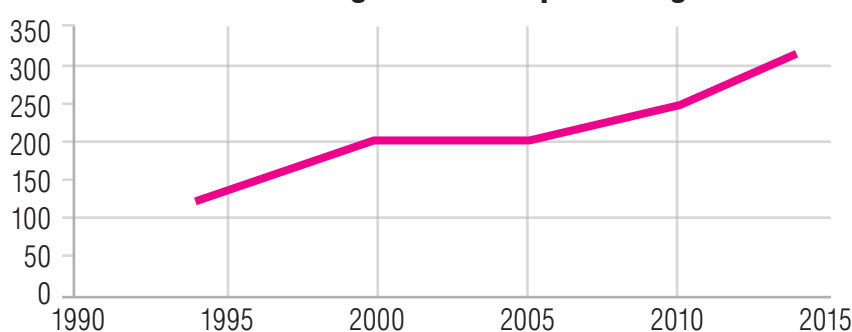
The significance of asset management

The moral case for capital and its management must be made. The asset management industry is a significant and vital part of the economy. The sector occupies a unique place within the financial system in that, alongside the management of sovereign wealth funds, family offices, high net worth individuals and foundations, a large proportion of the population has a direct interest in its performance and conduct of business through pensions and retail products such as life assurance and unitised investment funds.

There are around £6.6 trillion of funds under management in the UK, including £2.1 trillion of pension investments, £1.2 trillion of retail investment products and £1 trillion of insurance products.¹ The level of investment alone and the associated economic impact on the nation illustrates the importance of the industry and its conduct of business.

“The asset management industry is a significant and vital part of the economy”

Assets under management as a percentage of GDP



Although there were variations over time, in the UK, assets under management reached 316% of GDP by 2014, compared to 150% in France and 110% in Europe generally.²

The reputation of asset management

However, capital markets, with which asset managers are inextricably linked, have an extremely poor public reputation. This is partially due to a lack of understanding on behalf of the public (and sections of the media) of the nature and purpose of such markets - hedge funds, derivatives, secondary markets generate more heat than light for the casual observer. However, this reputational problem is also a consequence of both individual bad behaviour and practice and some characteristics of the capital markets.

Asset managers are not bankers. Indeed, asset managers have appeared infrequently in the roll-call of scandals. Many of these reputational issues which affect the wider financial services sector are linked to asset management more by perception than reality.

The New City Initiative (NCI) has been formed to bring about a structured response to this challenge, encouraging small firms, partnerships, alignment of interests through co-investment, bespoke products, quality investment and long-term thinking.

1 Financial Conduct Authority, Asset Management Market Study, Terms of Reference, November 2015, para 1.1.1, p5

2 Investment Management in the UK 2014-15, Investment Management Association Annual Survey, September 2015

The Moral Purpose of Capital Markets

At the heart of the moral case for capital markets and asset management is the case for capitalism. High quality, well-executed management of the assets of a society brings inestimable benefits to that society. The existence of an effective industry both enables and encourages the propensity to save, provides the means for the effective investment of pension fund capital and ensures investment in quality underlying assets (equities, bonds, property, infrastructure). The existence of capital markets enables investment in companies to be managed to the benefit of investors (by providing liquidity), companies (by ensuring the continuation of capital) and to society (by contributing to the welfare of people). The fund management industry participates in the lifecycle of companies and industries. As companies meet the demand for their products, so returns increase and so asset managers allocate capital.

The market, however, is not a guarantee of success for all, and there is nothing immoral about the existence of 'winners' and 'losers.' There is no moral imperative for equality. However, the reallocation of capital can have painful consequences – examples from coal to steel illustrate this reality.

“High quality, well-executed management of the assets of a society brings inestimable benefits to that society”

Wealth creation

The capital market, and the management of assets within the market, enables the creation of wealth through economic growth. This benefits individuals and families through personal investments, those of pension and life funds, enhances the tax base for the provision of public services and benefits society as a whole.

Michael Novak, in *The Spirit of Democratic Capitalism*, wrote:

“Of all the systems of political economy which have shaped our history, none has so revolutionized ordinary expectations of human life – lengthened the life span, made the elimination of poverty and famine thinkable, enlarged the range of human choice – as democratic capitalism.”³

This is reinforced by Milton Friedman’s comment that he knew of “no example in time or place of a society that has been marked by a large measure of political freedom, and that has not also used something comparable to a free market to organise the bulk of economic activity.”⁴

How is this achieved through an effective asset management industry?

First, asset management encourages economic growth. Economic growth is essential, but often misunderstood. Richard Heinberg asserts:

“From now on, only relative growth is possible: the global economy is playing a zero-sum game, with an ever-shrinking pot to be divided among the winners.”⁵

Effectively asset management is the evidence which contests this assertion. Without the wealth creation generated by the market, leading to economic growth, it is impossible to deal effectively

3 M. Novak, *The Spirit of Democratic Capitalism*, p13

4 Milton Friedman, *Capitalism and Freedom*, (40th Anniversary edition), University of Chicago Press, 2002, p9

5 Richard Heinberg, *The End of Growth*, Clairview Books, Forest Row, 2011, page 2

with issues of poverty and social welfare irrespective of the policy prescriptions. Technological development effectively combats the zero-sum game.

“Higher per capita income is strongly correlated with some undeniably important factors, such as longer life expectancy, lower incidence of disease, higher literacy and a healthier environment...”⁶

In the United Kingdom, for example, economic growth, measured as GDP per capita in international dollars (measuring comparative purchasing power) grew by 19 times from 1700 to 2008.⁷ There “is much evidence that economic growth in recent decades has delivered substantial improvements in living standards.”⁸

Asset management is the means by which capital is pooled, invested and managed so as to maximise the potential for economic growth. In this way, asset management contributes directly to social value and social utility. The idea that the social redistribution of wealth can be achieved without the necessary economic growth is illusory.⁹

Second, asset management encourages the propensity to save. If economic growth is the moral contribution of asset management to wealth creation at the macroeconomic level, then it is the encouragement to save which the industry supports that contributes to wealth creation at the microeconomic level. The savings ratio affects the amount of funds invested in savings accounts, investment funds and pension funds so is a significant source of capital funds. The investment of this capital through the asset management industry is a major driver of economic growth. In addition to that, the freedom to allocate savings is a basic human freedom that goes beyond the specific claims of asset management.

Efficiency of capital allocation

One of the principal tasks of the asset manager is to aggregate funds so as to improve the allocation of long-term investment capital into high quality companies. In this way effective growth is achieved. The aim is to place capital in the right companies at the right time. However, this efficiency of capital allocation assumes that:

- Managers have the skills to engage and place funds in the right companies
- Managers monitor investments and company management to ensure effective deployment of capital
- The investor has the information on which to base decisions

A crucial moral purpose which lies behind the asset management industry is ensuring the efficient allocation of funds into companies that will return effective and consistent growth in accordance with investor preferences. The allocation of capital is central to a capitalist economy. In the same way that the inefficient allocation of labour will lead to unemployment, so the placing of capital into companies which do not deliver long-term returns will make capital redundant and may even lead to its loss (with potentially painful consequences). Efficient allocation is central.

Providing liquidity

The origins of the capital markets lay in raising capital for new investment. In reality new issues now account for only a small percentage of market activity. The real moral benefit of the market is

6 Wayne Grudem and Barry Asmus, *The Poverty of Nations*, Crossway, Wheaton, 2013, page 47

7 Angus Maddison, *Maddison historical GDP data*, <http://www.worlddeconomics.com>

8 European Energy Association, *Continued Economic Growth?*, <http://www.eea.europa.eu/soer-2015/global/economic>

9 Daniel Pinto, *Capital Wars*, Bloomsbury, London, 2014, chapter 2

that it allows both institutional and retail investors the advantage of liquidity without any adverse effect on the company in which the investment is made.

For the individual the freedom to make liquidity decisions allows people to make free and voluntary decisions about their lifestyle, consumption, balance of current and deferred consumption, provision for families and so on. For institutions the liquidity that the market provides enables the efficient allocation of capital and flexibility in investment decisions. In both cases a decision might be made to realise a profit. This (provided the interests of the agent and the principal are appropriately aligned) realises value and capital gain and, once again, represents a moral gain for both individual and society. In essence liquidity allows for an exit from the market and for the realisation of value.

Managing risk

An individual investor is unlikely to have the expertise to hold a diverse portfolio range so as to reduce the risk profile to an acceptable level. The pooling of the investments of individuals and institutions enables a diversification that would be rarely possible for an individual investor and ensures that an investor can spread the risk of equity ownership across a sufficiently broad range of investments. Institutional investors are also keen to spread risk in this way. This, in itself, carries moral purpose; enabling the investor to participate in capital investment for return with a diversified portfolio to enable the management of risk.

The management of risk raises a number of questions. For example, a relatively risk-averse retail investor may be better served by an index-tracker fund than by active management. However, this approach may disguise fees which do not reward performance and indeed, as an index fund may contain both good and bad investments, there is little incentive for the manager. As a consequence, a manager might hide behind a benchmark and not face the consequences of the market for their investment decisions.

However, the asset manager offers scale, and through the principle of pooling, reduces transaction costs. The manager brings their skill and expertise to bear in constructing a balanced portfolio that matches the fund's stated tolerance for risk with the investment objectives. In doing so, the manager, on behalf of the investor, diversifies exposure to the unforeseen.

Summary

In summary, the moral purposes of asset management are:

- The creation of wealth and growth in a capitalist economy
- The efficient allocation of capital to achieve those ends
- The provision of liquidity to the investor and the manager to enable decision-making
- The management of risk through pooled investments so as to permit wide access to the capital markets

It is crucial that the basic moral principles of why asset management exists and why it should be considered not only a moral activity, but a moral imperative, are articulated.

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The Moral Challenge

What then are the moral challenges that face the industry?

Perhaps they could be summarised as transparency, pricing and reward. The consumer may consider other matters such as short-selling and secondary markets also to feature. Short-trading is not necessarily immoral in itself, and, it could be argued that all that this is doing is increasing liquidity, reallocating capital and, potentially at least, driving poor companies out of the market. Short-selling can signal to the market that there are significant problems with a company – resulting in the fall in share price. It is behaviour in those markets rather than the market itself which might raise legitimate questions.

Many of these issues illustrate the principal-agent problem. Funds are managed by an agent (the manager) on behalf of the principal (the owners). The moral questions emerge when the actions and interests of the agent diverge from those of the owners of the capital.

Underlying all of these symptoms are the deeper challenges of culture and character. The temptation to greed is not limited to asset management and financial markets. The tendency, however, towards greater regulation is, potentially, counter-intuitive to the development of a new, diverse and moral financial management industry. Regulation such as short-selling disclosure obligations can be problematic to the extent that they can result in other market participants copying hedge funds' trading positions or encourage short-squeezes.

There is clear evidence that such regulatory moves reduce market liquidity (in the region of 20-25%), increase transaction costs and make it harder for all market participants, including long-funds, to execute the trades they desire at a fair price.¹⁰

Regulators rule by fear; truly moral behaviour is an act of the will. That requires the highest quality of individuals, entrepreneurs who take a long-term view and share in the pain of failure as well as the joy of reward and who understand that there are reasons, moral, ethical, cultural - as well as legal, for turning away otherwise profitable business.

“Regulators rule by fear; truly moral behaviour is an act of the will”

However, the increased complexity of financial instruments can breed misunderstanding. Securitisation itself is not an issue – except when the interests of the securitisation issuer are divorced from those of the investors in the securitised product as is what occurred in the financial crisis. Risk retention requirements in the EU under the Simple, Transparent, Standardised (STS) securitisation rules will require issuers to retain a 5% interest in securitisation products.

The financial crisis of 2007-08 had greed, speculation, flawed characters, excessive debt and little understood complex securitised products at its core. Beneath the symptoms lay a distortion of the market and its purposes, including its moral purposes.

Ultimately, it is culture and moral purpose which shapes behaviour. The asset management industry has at its heart the long-term stewardship of value. Consequently, it is fundamentally interested in shaping that culture and purpose to the benefit of all.

¹⁰ See, Oliver Wyman report, 'The effect of short-selling public disclosure regimes on equity markets,' http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/files/archive/2010/OW_EN_FS_2010_ShortSelling_PublicDisclosureRegimes.pdf

Short-termism

Short-termism affects asset management and financial markets but is not restricted to them. The problems start with the corporate culture of the companies which are the depository of the investments of asset managers.

First, management is often short-term. The average tenure of a CEO of a FTSE 100 company is around 6 years. The consequence is a restricted horizon which may be reflected in bonus and remuneration arrangements. Why plan for the long-term if the self-interest of the senior management is dependent on short-term performance? This is a particular example of the principal-agent problem; the owners of the capital are, generally, interested in the long-term added value of the company, whereas the agents (management) may be more interested in short-term performance.

“Why plan for the long-term if the self-interest of the senior management is dependent on short-term performance?”

Second, the culture of the market analyst. The inexplicable pressure for improvement in earnings and performance quarter on quarter further reinforces the focus on the short-term. For publicly listed companies, the dominance of quarterly brokers' calls illustrates this problem.

All of this affects the asset management industry. Traditionally, institutional investors wished to invest for the long-term so as to match their long-term liabilities. All investors are, in a capitalist, economy, concerned for growth in the long-term value of a company in which they are invested – hence, a traditional 'long-fund' is an effective place for their equity investments.

Fees

Fees should be separated from the issue of remuneration. The usual approach for rewarding the manager is a percentage perhaps between 0.5% and 1% although in a hedge fund the rates may be considerably more. However, it should also be noted that fees are declining, particularly at hedge funds. A J.P. Morgan Capital Introductions Group study in 2016 found 37% of European investors and 35% of North American investors paid less than 1.5% in average management fees to their hedge funds compared to the traditional 2% management fee. Nearly 80% told the J.P. Morgan study they paid less than the once standard 20% performance fee to their hedge funds.¹¹

The issue of fees generates a number of problems.

- Transparency – when are fees not the fees?
- Asset managers being rewarded for mediocrity

“When are fees not the fees?”

These two factors are both significant in damaging the reputation of the industry.

The fee that a client is charged for the management of their assets is, in reality, very often simply one fee among many, but may also be the only one which is explicitly disclosed. Additional fees which an investor faces would cover things such as audit fees, legal fees, custody fees and dealing costs.

These fees are normally charged against the income of a fund directly before the reporting of performance and may not be disclosed to the client specifically as a cost over and beyond

11 Source: http://www.aima.org/filemanager/root/site_assets/research/2016-01-01_research_jp_morgan_institutional_investor_survey_.pdf, p31

the fund management charge. The consequence is a lack of transparency. This is reinforced when, for example, one fund invests in another fund, which might generate a rebate of fees which may not be passed on to the client. This is another example of the principal-agent problem - managers are tempted to act in their own interests rather than those of the client. However, rules such as the Markets in Financial Instruments Directive II (MiFID II) are bringing about enhanced transparency requirements for costs and charges at asset managers. Equally, the Securities and Exchange Commission (SEC) has come down strongly on perceived conflicts of interest in fee arrangements at private equity managers.

A further problem is the vagueness of the relationship between fees and performance. Funds under management (the usual basis for fees) might increase for a number of reasons:

- Good performance
- Inflation
- New money invested
- Short-term gains realised at expense of long-term performance
- A rising bull market

In other words, clients are charged the same fee for mediocre performance as good performance. Historically poor managers have been often well rewarded which was disguised in the wider fee inflation that occurred post 1980. This is an ethical issue. There is a good moral case for well-rewarded investment management firms (and individual managers) for exceptional market-beating performance. Unfortunately, this moral case is lost amidst the reputational damage that ensues from lack of transparency and the reward of poor (or at best, mediocre) performance.

“Clients are charged the same fee for mediocre performance as good performance”

Remuneration

High profile cases of excess remuneration within an already highly-paid industry is both an ethical issue and damaging to reputation.

Capitalism, or perhaps better, entrepreneurial, enterprise capitalism, does not assume market participants will all be paid the same. Neither does it assume any equality of wealth. These are important facets of the capitalist system which encourage innovation, creativity and enterprise, rewarding risk and success. Thus it is not unreasonable in any way, indeed it is deeply moral, for the individuals who invest capital funds at risk, in principle, to be well rewarded.

There is a criticism to be made. Simon Walker, the Director-General of the Institute of Directors, writing in *The Guardian*, in March 2015, noted that if “fund manager earnings continue to rise in line with assets, with little or no transparency about how they operate, then their reputations as prudent custodians of other people’s money could start to unravel.”¹² The problem is a combination of amount, lack of transparency and reputation. So pay does matter.

However, increasing moves towards managers investing their own capital and for the requirement of alignment of interests between managers and investors through remuneration policies may mitigate this problem. The Alternative Investment Fund Managers Directive (AIFMD) requires the avoidance of conflicts of interest and for remuneration policies to be consistent with sound and effective risk management and, indeed, to avoid excessive risk-taking. Remuneration issues may still feature in public concern, but both culture and regulation are effecting a different approach.

12 Simon Walker, *The Guardian*, 1st March 2015

The inability of the market to price non-financial returns

Economic and financial theory generally argues that the responsibility of the company is to maximise return for the shareholder. Since the shareholders are the owners of the company, this assumes that their only objective is the maximisation of shareholder value. This is very unlikely to be true. So the agent acts on an assumption which may not hold. Similar considerations apply to the investors of capital on whose behalf investment managers act. However, owners (and investors) of capital may have a wider range of objectives than purely financial return, including environmental, social and governance matters.

A proper appreciation of environmental, social and governance concerns is a normal requirement today of a very wide range of investors and, indeed, of asset managers. The industry is increasingly responsive to investor needs, not only through the provision of specialist funds (appropriate ethical criteria for equity investment, low-carbon property funds, for example), but also by the opportunities which asset management provides for a focussed approach to such shared concerns, directly engaging company management and ensuring funds support new technologies.

The market often fails to price externalities. This is true of both negative externalities (say, pollution) and positive externalities (for example, good corporate governance). How should carbon emissions be priced? An effective market and price for negative externalities would not only enable investors to properly assess whether they are receiving value (beyond financial return), but may also enable 'carbon trading,' benefiting society. The owners of capital may have particular objectives concerning investments in extractive industries, tobacco or aggressive armaments (for example) but how are these to be 'priced' into the returns from a stock? Indeed, an investor may actually desire a company to give a priority to, say, environmental concerns, over and above the maximisation of shareholder value.

The asset management industry has, in its product offering, made some moves towards the integration of environmental, social and governance into its portfolios. The ethical problem is that the market does not value (in a literal sense) a wider range of objectives that an investor may have beyond financial return.

The Moral Response

The basic moral case for asset management is often overlooked. However, we cannot ignore the force of some of the arguments advanced against the industry. In addition to that asset management has to deal with a permanently changed landscape – what EY refer to as a “permanent paradigm shift.”¹³ In other words the customer focus, efficiency and regulatory environments are continuing to change beyond recognition. Clients are increasingly sophisticated about their objectives and requirements and have less confidence in the traditional models of investment and management. Transparency and corporate governance are no longer optional extras, but core requirements. The successful asset manager of the future will be the one who can offer customised solutions to clients and can most openly demonstrate clear alignment of interests and practice between manager and client.

The City is changing, asset management is changing. How might the industry respond to these moral challenges?

Small is beautiful

Greater diversity in asset management is a virtue. The development of small, owner-managed, fully-aligned firms with customised, niche products, employing individuals of integrity and talent, is not the solution to all problems, moral or otherwise, within asset management, but it does provide a competitive, responsive alternative to the traditional models.

“Greater diversity in asset management is a virtue”

Large-scale asset management companies with the resources and capability to offer retail products to small-scale investors will still be needed. Index-trackers will, for some, provide a relatively low-cost method of equity and capital investment. The larger asset management firms will need to be flexible and adapt to the changing demands of smaller, retail clients.

However, the smaller boutique investment house may indeed be more able to meet the bespoke needs of investors – whether institutional, high net worth individuals, endowments or charitable trusts – than the traditional models. The advantages of these types of firm are:

- Allow for greater customisation of products
- Permit greater engagement with management of companies
- Reduces the principal-agent problem through co-investment
- Encourages long-term thinking and quality management

There are, of course, even for the smaller investment house, a variety of models. Some may run niche in-house funds and others may simply recommend the best external funds. A major advantage of these investment houses is that they allow for a significantly greater oversight of the investments. Often these firms will bring together highly intelligent and innovative individuals and their funds may contain 20-30 stocks. This is sufficient for purposes of diversification but allows for a more hands-on approach to the stock holding, regular meetings with management and a longer-term view towards the investment. It also allows the firm or manager to concentrate on stock selection and quality. Firms may be highly specialised, perhaps geographically, in emerging markets, or by sector, in, for example, small or mid-cap companies. These firms are more personal, relational and closer to the client. None of this is without risk to the investor.

13 EY Global Wealth and Asset Management, p8

Indeed research shows that smaller firms may indeed, on average, outperform the managers with larger sums under management. London's Cass Business School found a hedge fund with £200 million in assets under management on average outperformed a manager with £5 billion by 125 basis points (bps) between 1994 and 2014.¹⁴

Small firms may sometimes lack the resources and back-up of the larger players. However, these firms carry a further advantage in that this model usually involves the direct co-investment within the funds of some or all of a partner's personal wealth and capital. Increasingly, for sophisticated investors, there is now an expectation of co-investment.

Alignment of interests

The principle of alignment is that the interests of the investment chain, from the company receiving the investment, to its management, asset managers, asset management companies and the investor (the ultimate owner of the capital) should be matched by common objectives.

Asset management companies owned by their partners, and with the partners co-invested in funds with clients do not guarantee good returns. However, such an ownership structure does act as a significant incentive within the system to act in the common interest and prevents incentivising behaviour by the manager which is not in the interests of the funds, and hence the owners of capital.

However, it is not only in ownership structure that investment firms may be more aligned with the interests of market participants. The smaller firms also promote a culture which is customer focussed, quality orientated and gives time and space to thinking through investment and investment principles. Smaller firms will be more selective in their client base; good quality clients investing in high quality firms for long-term value, investing together. Certainly firms in which there is no co-ownership or co-investment will simply replicate the classic principal-agent problem.

However, the real strength of alignment of interests emerges from the extent to which the asset manager can also align these interests with those of the investee company and its management. The attraction for many boutique co-invested investment houses of smaller and mid-cap companies is that it is easier to bring these interests into line with each other.

A further strength of the co-investment principle (and co-investment may involve reinvesting a portion of the bonus as well as limiting the immediate receipt of bonuses) is that it also deals with the moral problem of the reward of poor performance. Managers who are also invested in their funds (or their recommended funds) will, by definition, share the pain as well as reward.

Alignment changes the frame of mind of the investment decision-maker, encourages long-term behaviour in the common interest and dis-incentivises 'disproportionate risk taking'.¹⁵ In that way alignment does not simply serve the interests of market participants but, by ensuring the proper, efficient allocation of capital for return in an aligned manner and reducing systemic risk, also serves society.

“Smaller firms also promote a culture which is customer focussed, quality orientated and gives time and space to thinking through investment and investment principles”

“Managers who are also invested in their funds... will, by definition, share the pain as well as reward”

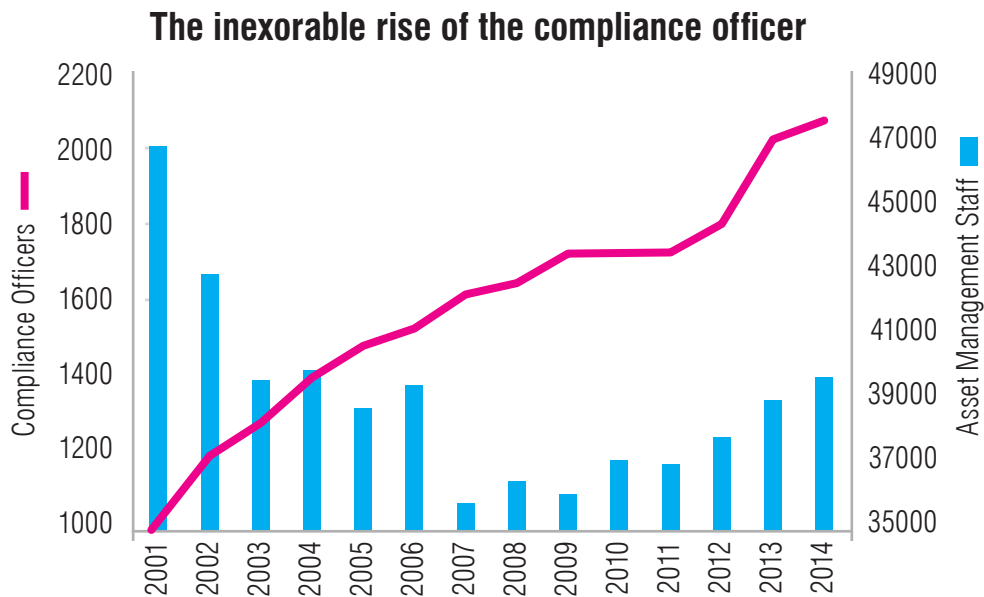
14 Source: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2630749
15 New City Initiative, Alignment of Interests: Fixing a Broken City, 2010, p4

Regulation may stifle

Regulation is necessary. However, in terms of reshaping or revitalising the City and the investment management industry, regulation, a regulatory framework and more importantly, a regulatory mindset, suffers from the problem of being an essentially ‘post-event response.’ There are negative, unintended consequences of regulation that may not be in the best interests of client, manager or society. Andrew Haldane, an Executive Director at the Bank of England, has argued that the main consequence of an increase in regulation is an increase in the number of regulators. This crisis, like every other, he suggests has been met “by a combination of more risk management, more regulation and more regulators.”¹⁶ In nearly 40 years, the number of financial regulators has risen nearly 40-fold. Haldane referred to “a steadily-rising regulatory tower” and that “new floors have been added in response to each crisis episode. Extra filing cabinets have been ordered and installed to house the explosion in regulatory returns.”¹⁷ This strategy, Haldane argues, “has comprehensively, and repeatedly, failed the crisis test.”¹⁸

The principal problem with regulation is that compliance becomes the prime objective of the asset manager. Compliance officers abound as the resources and objectives of the asset manager turn towards ‘negative compliance’ – tick all the boxes and do nothing that might jeopardise the investment manager’s status. The loser in all of this is the client, the investor, the owner of the investment capital.

“In nearly 40 years, the number of financial regulators has risen nearly 40-fold”



Source: FCA, Controlled Functions for Asset Managers

16 Andrew G. Haldane, Bank of England, ‘The Dog and the Frisbee,’ Speech at the Federal Reserve Bank of Kansas, August 2012, p7

17 Haldane, Dog and Frisbee, p12

18 Haldane, Dog and Frisbee, p21

Market participants believe by a margin of 3-1 that these regulatory moves add costs without significant value. The problem with regulatory frameworks is not that, no regulation is necessary, but rather:

- Regulation replaces judgement
- Regulatory compliance replaces client focus
- Regulation squeezes out entrepreneurship and innovation
- Larger asset managers have more resources for compliance
- One size does not fit all

It is axiomatic to this paper that greater, not less diversity will serve the asset management industry, the City, investors and the nation. Similarly, innovation and entrepreneurship should be encouraged, not discouraged. Regulation increases the cost base and transaction costs and the impact on smaller firms effectively reduces competition in the market which would not seem to serve the investor well. The structure and more importantly the culture that is engendered and publicly owned by a firm is significantly more important in protecting investors than much of the current regulatory regime. A simplified rule book will lead to less defensive behaviour. A smaller number of more experienced and qualified regulators exercising professional judgement would not prevent crisis or misbehaviour, but might indeed be more effective in its prevention. As Haldane argued it would “mean being brave enough to allow less to deliver more.”¹⁹

The point is not to say that no regulation is necessary, or that no sanctions should be applied against illegal and inappropriate behaviours in the market, but that the tendency to view regulation as a solution to the conflicts of interest, moral behaviours and structure of the market may in fact be counter to the common good and the national interest.

Restoring trust and confidence

How then can the basic principles of trust and confidence be restored in the City?

Most investment professionals are highly motivated, trustworthy individuals, seeking to discharge their responsibilities to clients in a competent and honourable way, receiving generous but appropriate reward, and acting in the interests of their clients, and serving society. In addition to the basic moral purposes of asset management two further principles should be noted.

The recognition that business is a vocation, a calling.

If business is reduced to a ‘job’ that pays ‘wages’, and the purpose is to ‘pay bills’ and ‘live a lifestyle,’ then all of those factors will work in the market towards the pursuit of selfishness, greed, a misalignment of the interests of market participants and encourage short-term behaviour and possibly even illegal or manipulative behaviour.

The principle is the recognition that business, financial services, asset management, should be seen in vocational rather than functional terms. To do so is the beginning of ethical behaviour.

Philanthropy should be encouraged

In recent years the paying of tax to the state has replaced the impulse to voluntary giving. True acts of the will, however, need to be voluntary. If those who are rewarded well in our financial and corporate sectors recognise that business and finance are vocations rather than functions, then this will also instil a sense of wider responsibility to society. The development of a philanthropic responsibility, through direct giving, endowments, social entrepreneurship and the development of

19 Haldane, Dog and Frisbee, p21

new asset classes for social impact investing can transform both individuals and society. Anyone who has spent any significant time in the USA will know that, for the most part, philanthropy is part of the DNA of the successful business person. In fact, the asset management industry has a long history with philanthropy. For example, ARK, a UK children's charity established by the founders of EIM, Marshall Wace and Aurum Funds, has raised hundreds of millions of pounds for various excellent causes.

Conclusions

There is basic moral purpose in managing capital and ensuring its efficient allocation to generate growth, value and wealth. The asset management industry serves this fundamental purpose for the individual, institutions and the nation. This moral case is absolute – asset management carries moral purpose.

Small, owner-managed firms are not panaceas, but are increasingly significant players in developing a 'new City.' Partnership structures, co-ownership and co-investment, aligning the interests of the participants in the market to achieve high quality investment in firms of long-term value are central elements to this response. Alignment of interests is central to a structural response.

Regulation, or at least excessive regulation, may not achieve its intended purpose by stifling innovation and focussing on external policing rather than culture and integrity. Culture is more important than regulation.

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