The purpose of asset management

This paper is a short summary of a recent draft paper on 'The purpose of asset management' by Jon Lukomnik, the former head of the New York City pension scheme and corporate governance pioneer, and Jim Hawley, an expert in corporate governance and sustainable investing. It also feeds off a recent roundtable hosted by New Financial and meetings with senior practitioners and policymakers.

The paper is part of the Purpose of Finance initiative on which New Financial is collaborating with David Pitt-Watson, executive fellow in finance at the London Business School, and Pension Insurance Corporation. You can read a draft version of the paper here. The final version of the paper will be published in March, when we will be hosting a dinner with Jon, Jim and senior industry figures.

a) Setting the scene

1) Summary

While the asset management industry plays a vital economic and societal role, it is often distracted from its underlying purpose of managing risk and return for its customers and in allocating capital by two factors: its over-reliance on modern portfolio theory, and the structure of the industry itself. The paper suggests that by adopting a wider approach to investing based on systems theory, the industry can improve returns for its investors and have a more positive impact on society.

2) The importance of asset management

The asset management industry is a huge, hugely important and growing industry, managing trillions of dollars in savings and investments on behalf of many millions of individuals. In the UK, the industry manages roughly £6 trillion (nearly 40% of all assets under management in Europe), while global assets under management are forecast to hit more than $100 trillion in the next few years. The industry is also highly profitable, with pretax profit margins consistently above 35% in the decade since the financial crisis, and highly competitive, with many thousands of market participants.

3) The purpose of asset management

At its most basic level, the asset management industry has two clear purposes:

i) Risk mitigation and return generation: to pool and manage risk and to generate a relevant and reasonable return for its customers according to their needs.
ii) Intermediation and capital allocation: to move money from where it is to where is needed and can be most productively put to work in supporting investment, growth and jobs for the wider benefit of society.

The industry's record on this definition is mixed, and it is worth noting that making money is not a purpose in itself but a pre-condition for successfully fulfilling that purpose.

b) The role of Modern Portfolio Theory

4) The rise of MPT

Since the 1950s and the formulation of Modern Portfolio Theory (MPT) by Nobel Laureate Harry Markowitz, risk analysis has been transformed from an exercise in qualitative judgement on individual securities to a mathematical calculation based on the nature and construction of a wider portfolio. This focus on diversification has been beneficial to investors and the industry but has also led to unintended consequences. In an MPT world, the market return is a given and success is measured relative to an investment universe, which can distort the alignment between asset managers and their customers in terms of both returns and timeframe.

5) The impact of MPT on asset management
The three main asset management strategies are all affected by MPT: active managers try to achieve a better relative performance (or alpha); passive managers aim to replicate market returns (or beta); and factor investing aims to maximise or minimise particular systemic risks. In each case, outperformance relative to the investment universe or chosen benchmark is rewarded. For the end client, however, relative outperformance in a falling market (say, -8% compared against a benchmark of -10%) is less obviously rewarding.

6) The limitations of MPT
The paradox of MPT is that it assumes that the non-diversifiable elements of risk in a portfolio – such as financial crises, global warming and political risk – affect investments but are not themselves affected by those investments. As the dotcom boom and financial crisis showed, this is not the case. Under MPT, actions by an asset manager that might have a bigger impact on this wider systemic risk – such as focusing on climate change or governance reform - but which do not necessarily distinguish it from its rivals, receive less focus than actions to generate relative outperformance. The ever-shorter time frames over which asset managers are measured – eg. quarterly performance rankings on mandates when the client's timeframe may be 30+ years – help drive short-termism.

c) The structure of the industry

7) The institutionalisation of investing
Over the past 70 years, investment has switched from a predominantly individual to an institutional framework: in the 1950s roughly 90% of US equities were held directly by individuals, compared with less than 20% today. While this shift has benefited many customers who do not have the time, skill or resources to manage their own money, it means that the pendulum may have swung more in favour of the interests of asset managers than the underlying interests of their customers.

8) The cost of investing
In any market where a service is delegated, there are always costs. The complexity of financial markets and the large number of intermediaries mean that costs will, inevitably, be complex. A big challenge for the asset management industry and its customers is understanding these costs, the long-term impact they have on returns, and disclosing them in a clear and consistent way. It is also important to identify the nature of these costs (direct costs such as asset management fees, platforms, and distributors), and less direct but no less real costs (such as trading costs).

9) Product proliferation
One consequence of the focus on relative return is the proliferation in fund products. In the five years from 2011 to 2016 the number of open-ended funds available to investors increased by a quarter, from around 89,000 to more than 110,000. While many of these funds offer more tailored investment strategies to investors, if the success of a fund is measured by whether it has outperformed a benchmark, it is possible to create outperforming funds by launching lots of them (if you launch eight funds, after three years one of them is likely to have consistently beaten the market in each of the previous three years). This proliferation of funds adds costs and complexity to the industry.

10) The rise of scale
These factors combine to incentivise scale: in an increasingly complex industry, scale helps reduce unit costs; ad valorem fee structures can incentivise asset gathering rather than asset management; and the importance of generating new business encourages a focus on the sales and marketing of new products (and the small number of funds with longer-term track records of outperformance). While a sustainably profitable industry is essential for customers, it is important to maintain the balance between the interests of the industry and of its customers.

d) A new paradigm for asset management?

11) Getting ahead of regulatory reform
In the past few years, the growth, impact and profitability of the asset management industry has caught the attention of regulators and policymakers. At the same time, the reputation of the industry has been often been tarred by the behaviour of other sectors of the industry (outside of the City, asset managers are generically known as 'bankers'). There is plenty of recent evidence to show that regulatory reform is not something asset managers want to be done to them (see the introduction of KIDs and future performance expectations), which underlines the importance for the industry of getting ahead of the regulatory debate.

12) The rise of 'beta-activism'
If beta is the main driver of risk and return, what can asset managers do to improve beta instead of focusing their efforts on trying to generate alpha? Recent analysis shows that early adopters of a more active approach on environmental and social impact generate more value, implying that asset managers can work individually and collectively to increase beta for their individual and collective benefit. This 'beta activism' approach is not new, but points to how the industry – particularly larger firms – can improve market returns and have a more positive impact on society at the same time. There is a wide and confusing range of indicators to measure the impact of this approach, and developing a simple and standardised set of measures that is comprehensible to end users should be a priority for the industry.

13) From modern portfolio theory to systems theory
The wide range of examples of the limitations and distortions of MPT suggest that the industry could adopt an approach that better incorporates the broader impact that asset managers have while at the same time aligning them more closely with their customers. Call it 'systems theory'. This does not mean abandoning MPT but building on it, by including, measuring and rewarding the impact that asset managers can have on systemic risk. This approach has the potential to improve the asset management industry in the same way that MPT did in the 1950s.

14) It does what it says on the tin
The complexity and information asymmetry in the asset management industry and in wider financial markets can often obscure the undoubted expertise of asset managers and the benefit they provide to their clients. One response to this complexity has been a laundry list approach to disclosure with pages and pages of jargon and data to further confuse customers. An alternative response could be a 'nutrition label' that provides a simplified summary of the key metrics that customers should know about their investments. This would include basic information such as opening balance, final balance, gross return, net return - and all of the main costs that explain the different between the two.

15) The fiduciary role of asset managers
It is important for asset managers to remember that they are intermediaries acting on behalf of their customers, and not principals on their own account. This raises the question of their fiduciary duty to act in good faith and only in the interests of those customers. Given the impact that asset managers can have on environmental, social and financial systems, there is also scope for them to act as stewards of the wider health of those systems.

16) New incentives
This approach would inevitably have an impact on incentives and fees across the industry. Better 'beta' would benefit all investors and managers, so the size of the industry and the size of the overall potential fee pool would increase. Fees would be more likely to be calibrated to the outcomes for end users (using a fulcrum fee approach or a variation on performance fees). While different asset managers would continue to offer different products, strategies and performance metrics, asset managers may in future compete based on how much of a return their customers get to keep relative to their investment goals and timeframes.