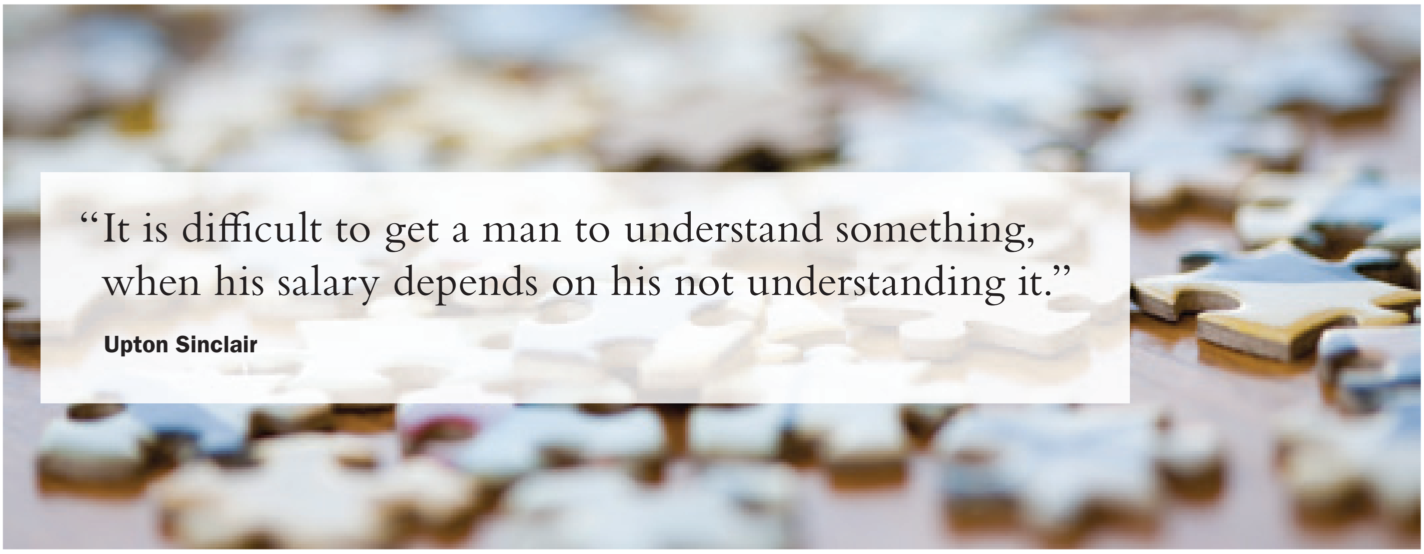
# Our industry has a problem

## The investment industry has been built by the intermediaries for the intermediaries

TOWERS WATSON

In this report, we present the results of a survey we conducted with asset managers in which we asked for their level of agreement with a number of statements about the investment industry.[1] To us the message from the results is clear – that our industry has a problem, in that we are not serving our end customer as well as we ought (where the end customer is an individual – either a retail customer or the beneficiary of an institutional asset owner). While this report majors on the survey results it is possible to get to the same answer, that our industry has a problem, from first principles.[2]



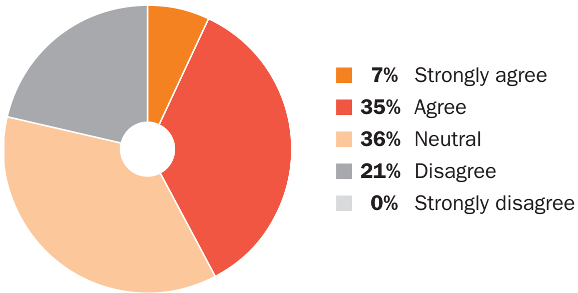
> "It is difficult to get a man to understand something, when his salary depends on his not understanding it."
>
> **Upton Sinclair**

## The need for change

The first statement we asked respondents to react to was: 'The investment industry is primarily designed to help the ultimate beneficiaries rather than the agents working within it'. We would hope that for a properly configured, customer-focused industry 90+% of participants would be able to agree with such a statement. For our industry the level of agreement was 42% (see **Figure 01**). This low level of support reflects very badly on the industry particularly when allowance is made for some upward bias. As Upton Sinclair suggests, when our salary depends on it we can often fail to see things as they truly are. On a more positive tack, 21% of respondents disagreed with the statement, despite it not being in the interests of their future pay cheques, suggesting that there is a core of people within the asset management industry who potentially see a case for change.

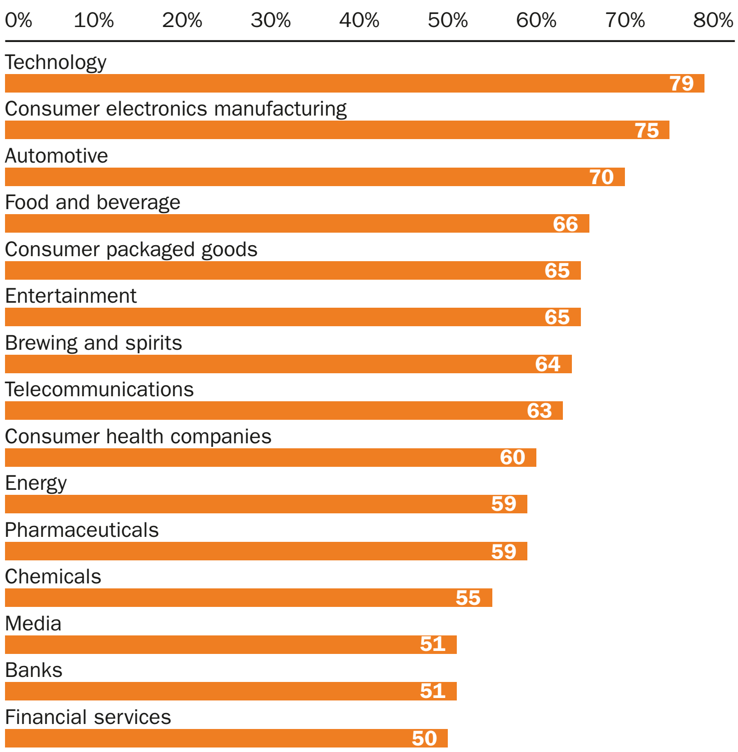
Our hope is that this core not only see a case for change, but also see an important if not urgent need for it, reflecting the low level of trust given to financial services firms. **Figure 02** shows the results from the 2014 Edelman Trust Barometer, a global survey. This shows that financial services is the least trusted industry, and there has been no change in the position or score from the previous year. In our view, it is clear that our industry is not providing a strong enough value proposition to the end saver, and it would appear that the end saver knows this.

**Figure 01. The investment industry is primarily designed to help the ultimate beneficiaries rather than the agents working within it**




**Source:** Towers Watson. 212 responses to our iX Investment Manager update pre-conference surveys, 2014.

**Figure 02. Trust in industries, 2014 Edelman Trust Barometer**



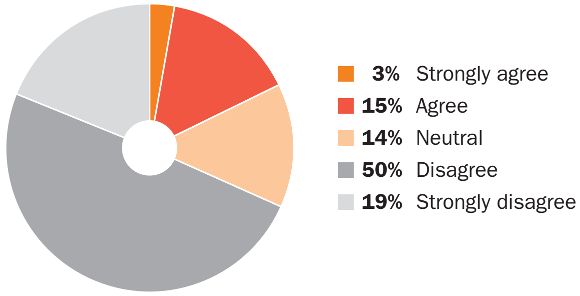

**Source:** Edelman

## What is the problem, exactly?

**Figure 03** shows the responses to the statement 'Too much effort is spent searching for alpha', where 'alpha' is a return above that of the general market generated by asset manager skill. By definition alpha cannot be positive in aggregate because for each asset owner earning a return higher than the market, there must be an asset owner earning a lower return. However, there is cost involved with trying to beat the market, and the more active managers there are attempting it then the greater the total cost burden and the further behind the general market the average return of all asset owners will fall. Unfortunately the search for alpha suffers from the Lake Wobegon effect[3] in that active managers can legitimately believe they are above average but, because of the fallacy of composition highlighted here, will be overstating their capabilities. Yes, some asset owners through skill or luck (or usually both) can do better than the market, but most asset owners cannot. It follows that asset owners would be better off if less effort (or, strictly, expense) was spent trying to outperform the market.[4] Again, there is a core 18% of respondents who agree with the statement suggesting that a significant minority of industry participants understand this.

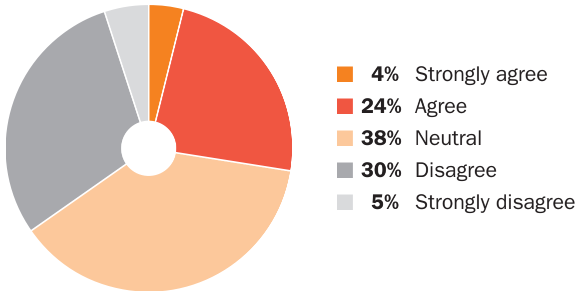
The flipside of this train of thought is that more effort should be expended on trying to improve general market returns, which would benefit all asset owners. In this case the minority in agreement with the statement is slightly larger at 28% (see **Figure 04**). More striking though is the larger proportion that are neutral in respect of this idea (38%). Perhaps this implies that these respondents were unsure whether market returns could be improved, or how they could be improved. As this has not been a strong focus of our industry up to now, that would be an understandable position, but we note that there is a growing focus on sustainability and stewardship and we believe that this will bring important improvements.[5] In addition, improved market returns will also come from ensuring that as much of the value produced by investments as possible passes down the chain and ends up in the asset owners' portfolios. In turn this would imply looking for sources of 'leakage' and expending effort to minimise them. Prime candidates would include much greater engagement with corporate management (whether to enhance strategic value or minimise excessive management compensation), and a fresh look at how much is paid to the sell-side of the industry and what value is received for those payments.

### Figure 03. Too much effort is spent searching for alpha




**Source:** Towers Watson. 212 responses to our iX Investment Manager update pre-conference surveys, 2014.

### Figure 04. Too little effort is spent trying to improve market returns




**Source:** Towers Watson. 212 responses to our iX Investment Manager update pre-conference surveys, 2014.

## Short-termism

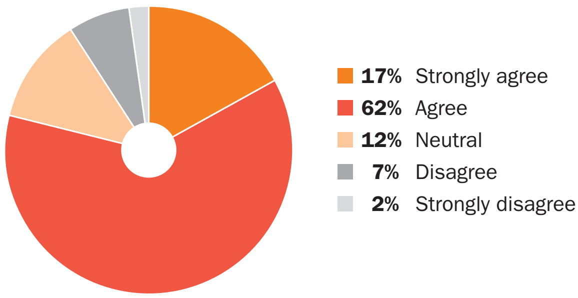
In addition to the misallocation of effort discussed above, the investment industry also has a problem with excessive short-termism, which is value destructive.[6] Excessive short-termism can be seen in dramatic decline in the average holding periods for equities[7] shown in **Figure 05**. As for the value destruction component, we note that investors in aggregate cannot become wealthier by trading more frequently with each other. In fact, as trading involves cost, more frequent trading destroys wealth for investors (but creates it for the intermediaries). Much has been written on the subject of short-termism by various parties over the past few years. In particular we would recommend the UK's Kay Review[8] as a good place to start for anyone wishing to go deeper with this subject. For our part we show the responses to two statements we posed to the respondents. In **Figure 06**, 79% of the respondents agreed that there is too much short termism and that this is due to the behaviour of asset-owners. In fact only 9% came to the defence of asset-owners (or disagreed there is too much short-termism). Is this fair, or is this casting blame on someone else? In this case the empirical evidence would suggest that asset owners tend to destroy value by acting too quickly in some areas, such as firing underperforming managers that go on to subsequently outperform.[9] However, respondents were even-handed in this regard. They also thought that excessive short-termism was caused, at least in part, by themselves – the intermediaries (or perhaps the other intermediaries, not they themselves!). **Figure 07** shows that a similar-sized proportion (63% versus 79%) count the intermediaries as bearing some of the blame. So a merit for good self knowledge, and a de-merit for being part of the problem.

**Figure 05. Excessive short-termism**

| | 1960 | 1970 | 1980 | 1990 | 2000 | 2010 |
|---|---|---|---|---|---|---|
| Average equity holding period (months) | 100 | 63 | 33 | 26 | 14 | 6 |

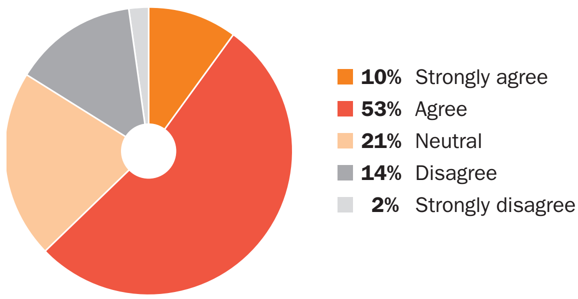
**Source:** NYSE Factbook

**Figure 06. There is too much short-termism, and this is due to the behaviour of asset owners**




**Source:** Towers Watson. 212 responses to our iX Investment Manager update pre-conference surveys, 2014.

**Figure 07. There is too much short-termism, and this is due to the behaviour of intermediaries**




**Source:** Towers Watson. 212 responses to our iX Investment Manager update pre-conference surveys, 2014.

## Conclusions

Taken together these responses show that asset managers believe that there is room to improve our industry in order to provide a more compelling value proposition to the end saver. In our opinion the value proposition that customers need is well-structured, fairly priced, and honestly and skilfully delivered investment outcomes. We believe the industry is falling short in all of these aspirations. In addition, the external Edelman Trust Barometer provides further evidence that there is much work to be done in improving the perception of the financial services industry in the eyes of the general public (who are the end savers). It is also clear that there is not a *single* problem – there is too much focus on alpha, not enough on improving market returns, and both asset owners and asset managers are too short term in their behaviour – and therefore there will need to be a variety of solutions. We would argue that Towers Watson has been working on several solutions for a number of years now (see **Figure 08**), but we believe there is much more that could be done. As a consequence we have revised the charter of our team to a new purpose and focus, hence the new name Thinking Ahead Group 2.0. But we will need more than ideas, we will need to make active changes and so we are also committed to working with all industry participants who share our vision to change the investment industry for the benefit of the end saver.

**Figure 08. Initiatives to improve the industry**

| | |
|---|---|
| **Smart beta** | Pioneers in the smart beta industry starting in 2003 |
| | Worked with asset management industry to create new products that are substantially cheaper and more transparent |
| | Towers Watson clients have invested over $30 billion in 500 mandates |
| **Fees** | Influenced the industry to better align interests |
| | Introduced the 'share of alpha' concept to fee modelling |
| | Used Towers Watson's bulk buying power to drive fees down in all asset classes |
| **Long-term equity mandates** | Started the debate in 2003 |
| | New way of monitoring success (balanced scorecards, updated in 2012) |
| **Transparency in the industry** | Pushed 'alignment of interests' with managers |
| | Send research view to managers and engage in open and frank feedback |
| **Sustainability** | Project Telos in conjunction with University of Oxford, asset owners and asset managers |
| | Signatory to the UN Principles for Responsible Investment (PRI) |
| **Risk** | Pioneered risk budgeting concepts and the use of Value at Risk (VaR) |
| | Recent work on risk dashboards, regime change, complexity theory and extreme events |

## Footnotes

1 The survey was conducted in early 2014. We received 212 responses from employees of UK- and US-based asset management organisations.

2 See *There are too many active managers*, Towers Watson, 2014; and/or *The winners' game* by Charles Ellis, Financial Analysts Journal, July/August 2011.

3 Lake Wobegon is a fictional town in the USA created by Garrison Keillor for his radio show. In the town all the children are above average, highlighting the natural human tendency to overestimate one's capabilities.

4 We have written specifically on this topic in another paper. Please see *There are too many active managers*, Towers Watson, 2014.

5 For our part, we have published a statement of our philosophy and beliefs on why sustainability and stewardship will be increasingly important. See *Sustainable investment and stewardship*, Towers Watson, 2014.

6 We first wrote about the problem of short-termism in *Remapping our investment world*, Watson Wyatt, 2003, and suggested that 'ten-year mandates' were a partial solution.

7 http://www.forbes.com/sites/greatspeculations/2011/01/21/stock-market-becomes-short-attention-span-theater-of-trading/.

8 *The Kay Review of UK Equity Markets and Long-Term Decision Making*, 2012.

9 *How much value should you expect to gain or lose by replacing your investment manager?*, Towers Watson, 2011.

## Thinking Ahead

This publication is written by members of our Thinking Ahead Group 2.0 (TAG 2.0) who are part of Investment at Towers Watson. Their role is to identify and develop new investment thinking and opportunities not naturally covered under mainstream research. They seek to encourage new ways of seeing the investment environment in ways that add value to our clients. The contents of individual articles are therefore more likely to be the opinions of the respective author(s) rather than necessarily representing the formal view of the firm. No action should be taken on the basis of any article without seeking specific advice. If you would like to discuss any of the areas covered in more detail, please get in touch with the consultant who normally advises you at Towers Watson, or:

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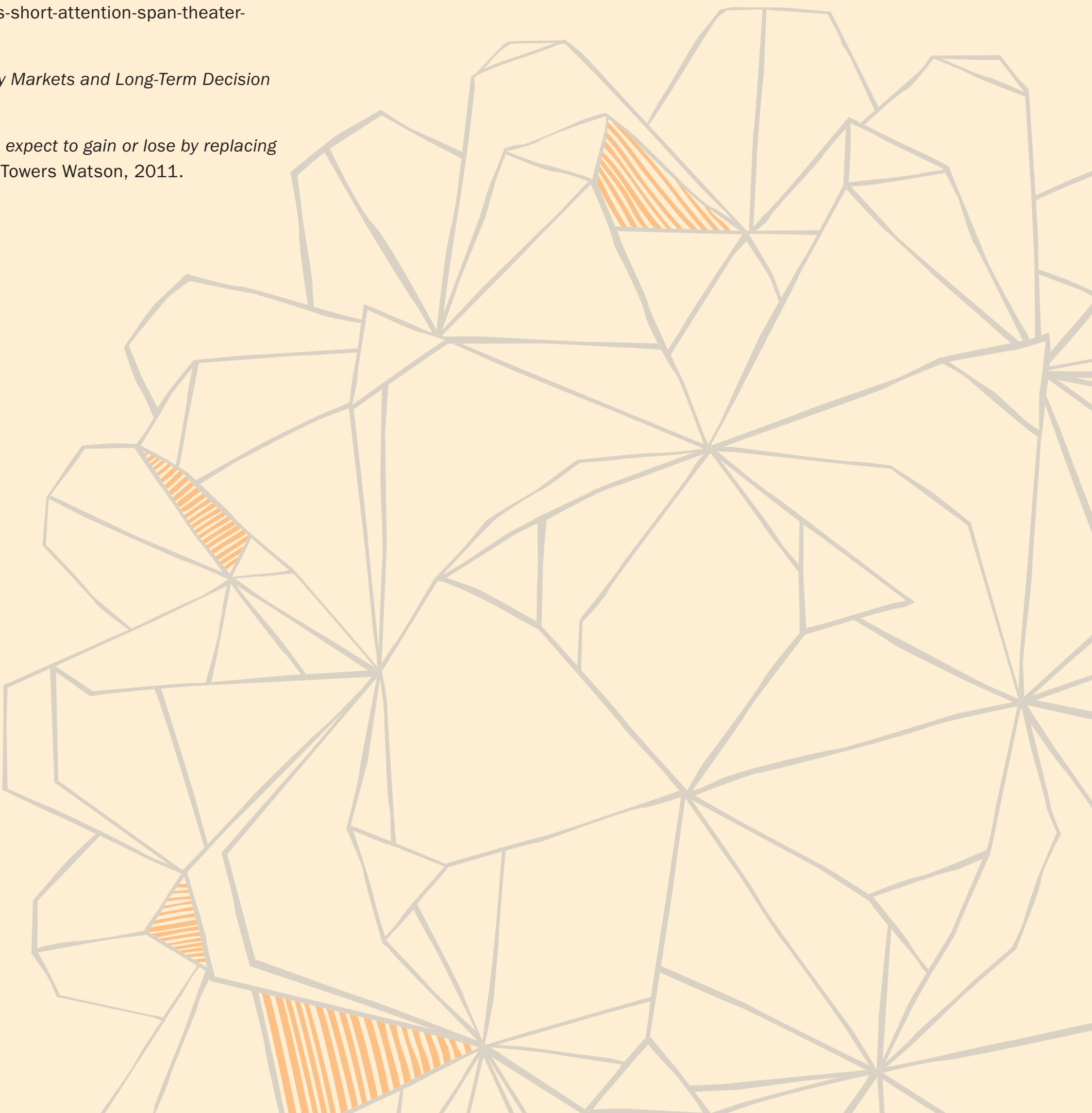

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