

The investment industry past, present and future

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Birthdays need recognition



Look back with sense of appreciation, look forward with sense of anticipation

The decade of the noughties



Noughties in finance: A decade of... Innovation? Challenge? Excess? Profligacy? Unsustainability? Winner and losers?



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Defining moments: events that with hindsight signalled big changes ahead

What we expected

Growth in specialisation

Organisational change

Growth in pension funds and endowments

Alternative assets

Volatility

What we didn't

Growth in complexity

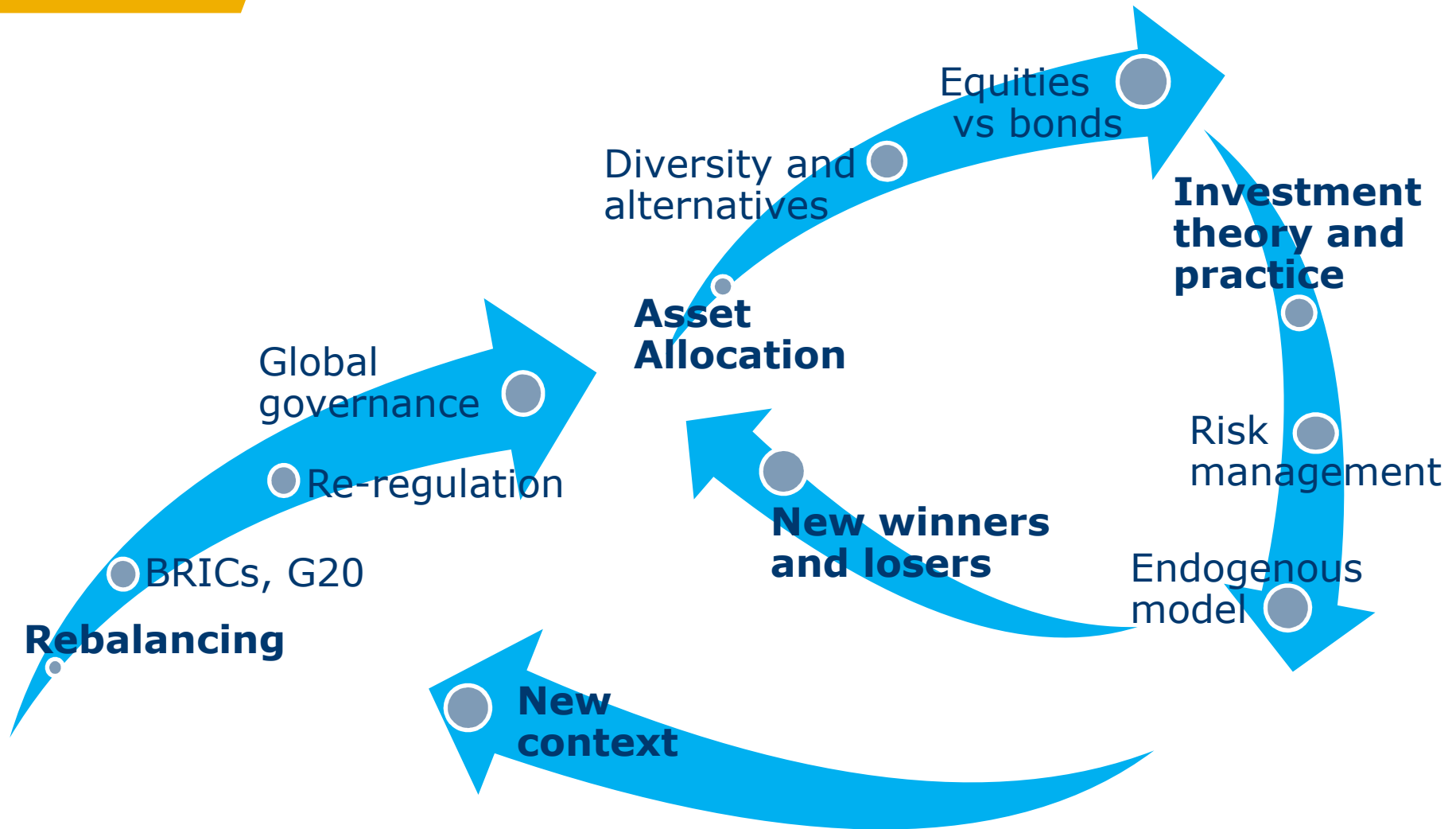
Theory change

Growth in DC and sovereign funds

Hedge fund institutional success

Crashes

Investment industry road-map today



Complexity is causing a very different type of industry evolution:

- ▶ Jumps not smooth transitions from one state to another
- ▶ Buffeting from unknowable extreme events – 'black swans'
- ▶ Extreme inter-connectedness

The GFC has produced new conditions

- ▶ Questions as to the efficiency and effectiveness of financial markets
- ▶ Challenges to the trust which is given to investment organisations
- ▶ The prospect of adverse economic conditions for an extended period
- ▶ Speed of change and inter-connectedness = more financial 'accidents'
- ▶ Bigger government and more societal touchpoints in investing

*New reality = new landscape, significant change, wake-up call
= big challenge + opportunity*

Next ten years - second bounce of the ball

Future change		Early examples
Investment content	Growing list of innovations: - beta creep, factor benchmarks - structured products, - solutions and absolute return, protection products	Norway Pension Fund – Global
Sustainability	New success measure for funds, employing induction of inputs from desired outputs, measurement adjusts for risk	North European pension funds
Better DC	The model needs: platform strength, better investment and glide-path design; and technology supported engagement	Australian superannuation funds

Second bounce = Further out, less predictable, more significant

Traditional managers

Certain

- The nameplates will change – a lot

Probable

- Only some ownership structures will prove sustainable
- Pressure on fees
- The business model will have to be more focused
- Globalisation will progress unevenly

Maybe

- Caught up in bank bashing

Hedge funds

Certain

- A lot of hedge funds will close
- But the hedge fund 'brand' is robust and will selectively thrive
- The funds of hedge funds model is very stressed

Probable

- Ground to be given on the "2" and the "20"

Maybe

- Window for getting mega-rich has closed

Asset owners

Certain

- Hard, painful choices will have to be made, and will often not be made

Probable

- The demand for solutions
- Demand for better benchmarks
- Talent migration back
- More passive, more beta creep

Maybe

- Alternatives appetite falls with simplicity rebound

- **Asset owners are still confused over legal context and investment beliefs - sustainability is currently bought not sold**

- **Universal ownership angle, taking an endogenous longer term view; fiduciary capitalism at work in collaboration**

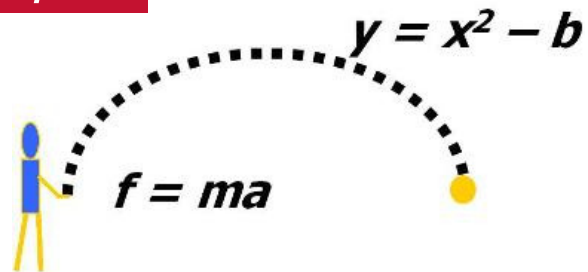
- **There will be growth in**
 - integrated ESG,
 - targeted/ thematic ESG,
 - ESG rating agencies,
 - new sustainability benchmarks



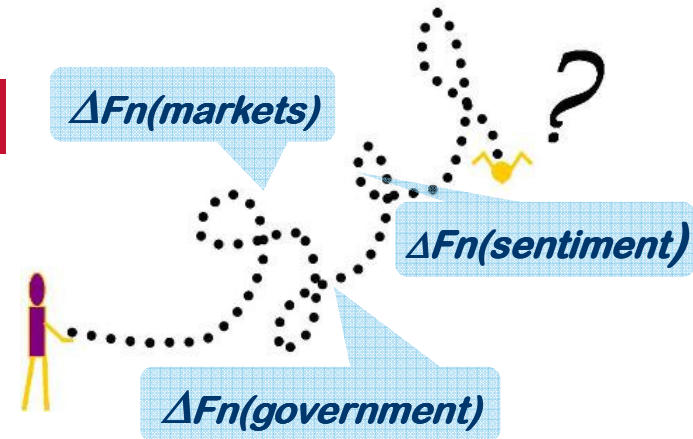
Direction of travel at a tipping point

Complexity model

Simple



Complex



The financial system as a complex adaptive system in which

- participant behaviours are critical to its properties
- the system moves in jumps
- there are multiple beliefs at work
- The system cannot be explained by summing the parts

Complexity: learning to recognise it and profit from it

- **The CFA has the challenge/ opportunity to**
 - **improve trust**
 - **work on corporate governance**
 - **work on a better long-term investment 'model'**
 - **address the gaps and surpluses in the industry**

Significant

Trust issues

Corporate governance

Client interests

Resource shift

Regulatory increases

Moderate

Systemic crises

Headcount falls

Long-termism

Investment theory

Headwind conditions

- **Focus on advocacy strongly emphasised**
- **Lifelong learning opportunity emphasised**
- **The mission with respect to ethical, educated investment professionals is getting harder - because of agency issues, greater complexity; and problems with the state of financial market integrity which will be challenging to restore**
- **Clear direction in the CFA globalisation agenda – we must do a better job looking East**
- **The move towards 'one CFA' is strengthening**

New investment theory and practice

- **Asset allocation - Dynamic SAA and parity portfolios**
- **Complexity and tightly coupled conditions forcing new thinking**
- **The integrity of investment excellence**

New winners and losers

- **Adaptability – organisational survival / adaptability**
- **Leadership – thought leadership and organisational leadership**

New context

- **The societal touch point – improving the value offered and the trust delivered**

Survival of the fittest





Supporting material

Two versions of 'beliefs'

Beliefs v1	Beliefs v2
Incredibly smart people in unbelievably simple situations Instant and equal access to news	Believably simple people in incredibly complex situations Fallibility and pricing misjudgements
Rational expectations about markets Markets 'add up' and are efficient(ish)	Rational beliefs about markets Markets have uncertainty/ indeterminacy
Markets and marketplaces bring together price and quantity Transparency and symmetric information	Markets and marketplaces incorporate complexity and reflexivity Agency and incentive issues
Theory based evidence – Supportive arguments for most theory	Evidence based theory – Stronger discipline on good theory
Markets can have fat tails But explainable within core statistics	Markets suffer tight coupling 'accidents' Not explainable within a model framework
Markets know best/ Fundamentalism Light touch regulation/ self-regulation	Market can't be trusted More regulation to off-set negatives

Two versions of 'risk'

Risk v1	Risk v2
Return gets more attention than risk	Risk and return are equally weighted
Risk is separated into risk function	Risk is integrated with return function
Risk is developed from study of past	Risk is considered from a prospective view
Risk involves anticipating unlikely high impact events	Risk involves positioning the fund to deal with unlikely high impact events
Normal models <ul style="list-style-type: none"> - Normal distribution of returns - Calculate risk from history - Risk comes from exogenous sources – created by external factors -- Linear thinking -- Rational thinking on risk 	Extended models <ul style="list-style-type: none"> - Fat tails. Black swans - Assess risk prospectively - Risk includes endogenous sources – created by participants' actions - Complexity thinking - Cognitive errors in framing risk
Use of MV optimisation to set asset allocation	Use of multiple factor / utility based approaches to set asset allocation
Use of one quantitative measure of risk (like VaR)	Reliance on several quantitative risk measures, qualitative overlay, stress tests

Pressure on talent	Talent needs to stretch more in both breadth and depth with some talent shortages continuing
Governance change	Recognition of the return on governance feeds through in increased attention, and models like FM
Product proliferation	Product specialisation leads to proliferation; with risk, style and scope of mandates getting broader
Extra-financial factors	ESG considerations grow as indirect performance influences and as desirable end attributes
Pensions design, DC	DC dominant global model, with its individualisation, risk transfer and ownership vs control tension
Organisational change	Scaling, specialisation, HR, expansion globally and in adjacent spaces
Multi-period design	New success measures, induction of inputs from desired outputs, measurement adjusts for risk
Better DC	The model needs: platform strength, better investment and glide-path design; and engagement
Food chain	The big moves are away from reliance on the Board/ Committee towards CIO role with lower costs
Investment content	Growing list of innovations: porting alpha and beta, beta creep, structured products/ solutions
Crisis contagion	Given excess complexity and compensation, more frequent, prolonged periods of distress likely
New players / order	Under more performance pressure, organisations sustainability becomes harder
Governments	Industry has to respond a series of new regulations in areas of control, transparency, position limits
New framing for risk	Risk management framework evolves into wider qualitative understanding alongside enhance quant



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Limitations of reliance

This work reflects the opinions of the author rather than representing the formal view of CFA Institute, Towers Watson or MSCI Barra