The Purpose of Asset Management

This is a short summary of 'The Purpose of Asset Management' by **Jon Lukomnik**, the former head of the New York City pension funds and corporate governance pioneer, and **Dr James Hawley**, an expert in corporate governance and sustainable investing.

Debate facilitated by

PENSION INSURANCE CORPORATION

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.

2 The importance of asset management

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 highly profitable, with pre-tax profit margins consistently above **35%** in the decade since the financial crisis.

3 The purpose of asset management

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

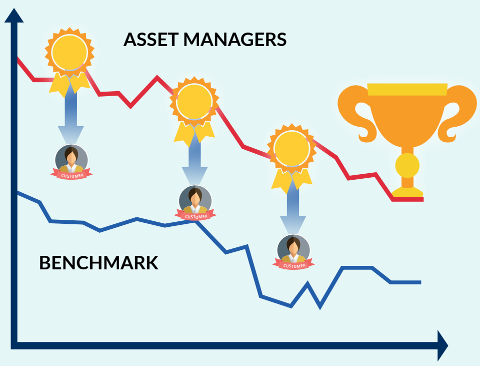
i) Risk mitigation and return generation: to pool and manage risk and to generate a relevant and reasonable return for its customers according to their needs;

ii) Intermediation and capital allocation: to move money from where it is to where it is needed and can be most productively put to work in supporting investment, growth and jobs for the wider benefit of society.

The role of Modern Portfolio Theory (MPT)

4 The rise of MPT

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.



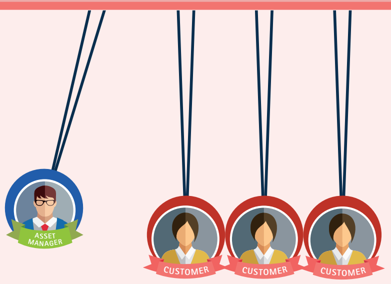
6 The limitations of MPT

The paradox of MPT is that it assumes that the non-diversifiable elements of risk in a portfolio affect investments, but are not themselves affected by those investments.

5 The impact of MPT on asset management

The three main asset management strategies are all affected by MPT: In each case, return is judged against a chosen benchmark that relates to the market, not necessarily the needs of the investor.

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. 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 has swung more in favour of the interests of asset managers than the underlying interests of their customers.

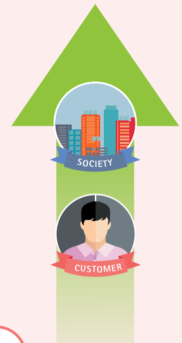
> In the 1950s roughly 90% of US equities were held directly by individuals, compared with less than 20% today

8 The cost of investing

A big challenge for the asset management industry and its customers is understanding the costs, the long-term impact on returns, and disclosing costs in a clear and consistent way.

9 Product proliferation

One consequence of the focus on relative return is the proliferation in fund products. While many 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. This proliferation adds costs and complexity to the industry.



10 The rise of scale

In an increasingly complex industry, scale helps reduce unit costs; and the importance of generating new business encourages a focus on the sales and marketing of new products. While a sustainably profitable industry is essential for customers, it is important to maintain the balance between the interests of the industry and its customers.

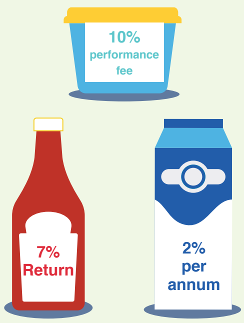
A new paradigm for asset management?

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. There is reason to believe that regulatory reform, especially from extreme political positions, is not something asset managers would welcome, which underlines the importance for the industry of getting ahead of the regulatory debate.

12 Turbo-charging returns?

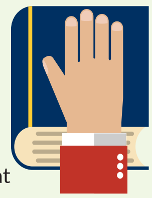
The industry could adopt an approach that better incorporates the broader impact that asset managers have while at the same time aligning them more closely with their customers. Call it 'systems-level investing'. It would build on MPT rather than outright replace it, but of course it would also change it significantly in the process. This approach has the potential to improve the asset management industry in the same way that MPT did in the 1950s.



13 Nutrition label?

The complexity in the asset management industry can often obscure the expertise of asset managers and the benefit they provide to their clients. A solution could be a 'nutrition label' that provides a simplified summary of the key metrics that customers should know about their investments.

14 A Hippocratic Oath for the industry?



It is important for asset managers to remember that they are intermediaries acting on behalf of their 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. We suggest that the industry adopt the investment equivalent of a doctors' Hippocratic Oath or a pledge to do no harm to the systems on which the capital markets depend.

15 New incentives

This approach would inevitably have an impact on incentives and fees across the industry. Fees would be more likely to be calibrated to the outcomes for end users. 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.

Change is coming

Produced with thanks to New Financial for the basis of the summary.

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The industry view

The industry response to Hawley and Lukomnik's paper suggest there is a profound difference in perspective between asset managers and other stakeholders as to where the industry goes from here. The rights and wrongs of MPT, the obligations of asset owners, and the issues of regulation, transparency and trust are all part of the ongoing debate about the "Purpose of Asset Management". Can the industry take the initiative and get ahead of changes that many believe are inevitable?

www.pensioncorporation.com | @PensionCorp | For more information please contact: Jeremy Apfel, Head of Corporate Affairs | 020 7105 2140 | apfel@pensioncorporation.com