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GLOBAL INVESTING — INNOVATING FOR SUSTAINABLE GROWTH

After several decades of rapid growth, financial services and the investment management industry, in particular, are facing significant challenges arising from changes in the macroeconomic environment, the sources of investment pools and the types of investment that clients are seeking. The industry needs to address the strategic issues raised by these trends if it wants to continue prospering in the post-crisis economic and financial environment.

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The changing macroeconomic environment

The economic backdrop for the financial services industry has fundamentally changed in the space of a few short years. The boom conditions of 2003 to 2007 have given way to recession in many countries, followed by only modest growth as private sector deleveraging takes hold. Inflation in most countries remains relatively subdued, held in check in the advanced economies by large output gaps and high unemployment.

The macro policy environment has also undergone radical change. The initial policy response to the global financial crisis was very Keynesian, relying on large budget deficits to support activity. Not surprisingly, but far too belatedly, this has given way to concerns about government debt levels and a reassessment of the use of fiscal policy to support the economy.

Fiscal tightening and austerity are now the properly prescribed medicines. Pressure has been most acute in the eurozone and the policy debate in Europe is now shifting, also far too slowly, to how to support growth via structural reforms in the labour and product markets.

Credible medium-term fiscal policies are needed urgently to address major structural issues such as ageing populations and the pressures that they will place not only on retirement incomes but also on health spending. And, as a critical part of these policies, welfare must be made less attractive for the good of all, not least for many of the welfare recipients themselves.

The stark fact is that southern Europe must regain competitiveness either through an increase in productivity and/or through a fall in real wages. We are seeing some progress along these lines in Ireland, where appropriate policies are being implemented. However, in the majority of European countries, acknowledgement of the 'sacrifices' needed to regain competitiveness is still scarce and politicians — often hamstrung by coalition governments — are not keen to engage in such debates as they fear losing consensus.

All of this is likely to make the adjustment process longer and this is not good for investors. With these constraints on fiscal policy, monetary policy has undertaken the bulk of the countercyclical response. But it is running into the issue of a zero 'lower bound' on interest rates. As a result, quantitative easing has now sadly become the orthodox approach — the central bank expands its balance sheet, buying government and private sector bonds to directly affect longer-term interest rates.

There is nothing conceptually new in this policy approach as it was initially proposed by Keynes. But this new orthodoxy is starkly different from the traditional one of 'appropriately firm' monetary policy that dominated not so long ago. Policy then was directed at lowering inflationary expectations to underpin progressively lower inflation.

Now, policy is addressed at underwriting inflationary expectations to avoid a lapse into deflation. Money multipliers are still depressed, at least for the time being, and central bank actions to meet demand for liquidity from banks are not yet encouraging a rebound in lending. In essence, monetary policy is being asked to play a much broader macro and prudential role in sharp contrast with the sole focus on inflation of recent decades.

All of this is worrying — it creates dependency of the financial sector on central bank monetary support in the short term and increases the risk of a serious inflationary surge over the medium- to long-term.

Australia is not immune to these trends but we are confronted by a somewhat different set of problems. Excess, rather than deficient demand, is at the core of the macro issues facing Australia. Broadly speaking, a two-speed economy has evolved as Australia adjusts to a 'once in a century' resources boom.

Monetary policy was tightened through 2010 to 'make room' for the booming resource-related part of the economy, with a stronger Australian dollar playing a critical part in the adjustment story. This has placed many non-resource related, trade-exposed companies under immense pressure. A poor productivity performance has also kept an upward bias to inflation as the economy closes in on full employment and the benefits from the micro reform agenda of past decades run their course.

As was the case in the 1970s, at the end of two decades of economic prosperity, the focus has unfortunately turned more to dividing up the pie rather than making it grow. Australia's adjustment process would benefit from a rebalancing of the macro policy mix. With a record terms of trade, 21 years of uninterrupted growth and near full employment, it is far from optimal that we still have a budget deficit at this stage of the economic cycle.

The proceeds of the resources boom have largely been spent. Between 2003–04 and 2009–10, government policy decisions, both tax and outlays, led to a $110 billion deterioration in the budget bottom line. This was a wasted opportunity.

The composition of the increased outlays has been a major issue as well as the lack of spending on productivity-enhancing infrastructure. This should change. Now there is clearly a conflict between these two objectives — funding infrastructure and further fiscal consolidation – although, with hindsight, this need not have been the case if government spending had been more restrained.

A focus on infrastructure with a re-ordering of spending priorities is a worthwhile objective and, over the medium term, this would enable the economy to strive for greater growth and provide a broader productive base. As others have said, few infrastructure products appear attractive ex ante but many look remarkably attractive ex post. The highway and rail spending in earlier decades in the United Kingdom is a good example of this.

Changes in the sources of investment pools

The global financial crisis has not changed the gradual shift in the centre of gravity of the global economy. Its move from mature economies to emerging markets, particularly in Asia, and to commodity exporting countries including Australia started in the last decade.

Thanks to solid macroeconomic fundamentals — low debt in the household and public sectors and no significant leverage in the financial sector — emerging market economies were able to cushion effectively the impact of the crisis and remain on a sustained path of economic growth throughout the global recession and in the following years. The low growth, deleveraging and low returns on capital in advanced economies are in stark contrast with the higher economic dynamism, rapid wealth accumulation and the rise of a new middle class in emerging markets. Together, these factors are leading to a shift in the source of global financial wealth and the emergence of new players in global capital markets.

In the 1980s and 1990s, Western countries' pension funds dominated the investment landscape. However, in the past decade, sovereign wealth funds and private equity funds have emerged as the new financial 'powerhouses'. Sovereign wealth funds, largely originating in emerging markets, already control nearly USD 5 trillion of funds and their assets are expected to grow to nearly USD 10 trillion by the middle of this decade. These state-controlled investment vehicles are something of a novelty for the global economy.

Following decades of public sector retrenchment from financial markets in Western economies, the state in these emerging markets appears to be regaining a strategic role in the allocation of global capital and the management of financial wealth. Add up the assets controlled by sovereign wealth funds, the foreign exchange reserves managed by central banks and all of the other assets controlled by state-owned corporations, and the share of global wealth directly or indirectly falling under the control of the state rises dramatically. And, it is likely to continue rising as emerging markets look set to continue outperforming advanced economies for the foreseeable future.

Sovereign wealth funds differ from other institutional investors such as pension funds not only in the public nature of their sponsors but also in terms of their investment style. Without (or with lower) explicit liabilities, sovereign wealth funds face less pressure from their sponsors on short-term returns and can adopt a longer-term investment horizon. Because of this, they benefit from their ability to access structural risk premia and to take advantage of secular macro trends.

Given their long-term investment horizon and the increasingly strategic nature of their investments, sovereign wealth funds often partner with private equity firms or turn themselves into fully funded private equity firms searching for the best direct investment opportunities in listed or unlisted companies in both advanced and emerging markets. In this world of low returns on listed equity markets, private equity firms now aim to capture the illiquidity premium and deliver it to end-investors searching for additional returns.

The increasing number of institutional investors and high net worth individuals turning to direct investment in search of additional returns appears likely to continue. This trend poses some new challenges for the asset management industry, which is often too focused on 'short-termism' and 'benchmarking'.

New investment trends

The global financial crisis put risk in the spotlight. It highlighted the asymmetric distribution of investment returns and the potential losses from tail risks, which are low-probability but high-impact events.

Risk is multi-dimensional and cannot be adequately summarised by a standard measure of volatility. Increasingly, asset managers and pension funds are looking to better understand the impact that these risks may have on their portfolios and the feasibility of hedging them. One response to this has been factor-based investing, where asset classes are analysed in terms of the factors driving their return not simply the asset class to which they belong.

Since the crisis, financial markets have experienced high volatility but have also been characterised by a marked increase in correlation across asset classes. This has brought clearly into focus the fact that true diversification comes from the minimisation of correlation between asset classes rather than the number of asset classes in which we invest. Many investors were lulled into a false sense of security by diversifying asset classes only to find that their true diversification was limited. A more dynamic approach to asset allocation is called for.

With the 'new normal' of shorter business cycles and heightened volatility and correlations, an overly passive approach anchored by a strategic asset allocation could leave investors vulnerable to evolving macro trends. Investors are realising that prospective returns are going to be lower than those experienced in the past few decades.

Ongoing private sector deleveraging, fiscal consolidation and deteriorating demographics all point to weak economic growth in the advanced economies. This, combined with a commitment to zero interest rate policies and quantitative easing, means the outlook for returns in fixed income markets is poor compared with recent decades. Equity markets also have the capacity to disappoint.

While priced on historically modest price-to-earnings ratios, the prospect of a significant market re-rating of stocks may be some time in coming, given the elevated risk premiums in the post-crisis world. Investors will have to focus on a true long-term investment approach.

Very few asset managers would resist the temptation to claim that they are 'long-term investors'. Yet when trying to define what 'long-term investing' means precisely, asset managers tend to talk about selecting companies with long-term potential. A distinct advantage of true long-term investment is the possibility of investing in less liquid assets such as private equity, real estate or infrastructure. One could extend the concept further by adopting an investment strategy based on 'long-term economic value' rather than 'short-term financial value'. This is a whole new area of research for the asset management industry and requires a much deeper look at those factors driving the long-term growth potential of countries and sectors.

The perceptions and the reality of what is a 'risk-free' asset are also driving post-crisis investment trends. There are now only eight countries with a triple-A rating that do not have either a credit watch negative or a negative outlook rating. The shrinking size of the pool of very high-rated sovereign assets is leading to the development of alternative global sovereign bond benchmarks such as GDP, fiscal strength or multi-factor weighted indices.

One way in which this trend is manifesting itself for Australia is the upward pressure on the Australian dollar as investors seek yield and relative safety. Net capital flows over the past two years have been dominated by foreign purchases of government securities. And, while the data is not granular enough to pinpoint the precise source of demand, strong demand has been coming from official sources overseas.

Australia's current 'safe haven' status is a significant turnaround from the more peripheral status in financial markets which the country tended to have until recent years. While it clearly brings benefits, it also brings a downside in the shape of currency strength that adds to the other adjustment issues I referred to earlier.

The challenges for the investment management industry

We can expect the current era of low real returns to endure with investors struggling to earn decent returns on traditional markets, Defined Benefit (DB) pension funds struggling to match their liabilities and the new players such as the sovereign wealth funds and private equity funds further expanding their influence in global markets.

These trends pose a challenge for the financial industry in general and the investment management industry in particular. After several decades of rapid growth, the investment management industry needs to address the strategic issues raised by these trends if it wants to continue prospering in the post-crisis economic and financial environment.

The increasing trend towards long-term investing among sovereign wealth funds and other institutional investors leads to increasing disintermediation — or internalisation — of some investment capabilities. This reflects the fact that asset managers have only recently started considering new approaches to asset management. It also reveals the weak alignment that sometimes occurs between the interests of investment institutions and their external managers with regard to factors such as time horizon, liquidity profile and short-term benchmarking.

One emerging trend is a desire by institutional investors for more targeted absolute returns and less reliance on targets relative to benchmarks. This requires a rethinking of asset managers' relationships with these institutions through the introduction of innovative structures that, while taking advantage of the expertise and market access of professional investors, also offer more control and flexibility to their sponsors. Such structures could include co-investment with external fund managers, the establishment of funds with the explicit aim of making long-term investments and better alignment of client–manager incentives with regard to benchmarking and compensation.

The shift towards long-term investing also requires greater activism by shareholders, including asset managers acting on behalf of their clients. With institutional investors more concerned about long-term value creation, asset managers will increasingly be required to work alongside their clients in exercising ownership rights and with the investee companies' managers to develop long-term goals and identify long-term risks.

So far, asset managers have generally been reluctant to engage more with the companies they invest in; fearful of the fiduciary responsibilities and the costs involved. This is likely to change as the incentives of the asset manager and the clients become more aligned. And, I can foresee that, in future, a requirement to exercise ownership rights will be more frequently included in investment mandates.

I would like to conclude by making a few observations on the asset management industry more generally.

Even one year ago, there was still considerable short-term optimism about the outlook for the industry. This was driven principally by growing evidence of the need for higher levels of retirement savings but other factors included the fact that: governments in many countries would be seeking to privatise their public age retirement systems; there was the continued but remarkably slow push to Defined Contribution pension schemes in Europe; and the heightened need for products for investment in retirement. All of these factors still pertain.

But, what was not identified, was the major downward shift in confidence about markets generally and mutual funds in particular. Increasingly, clients are questioning the fees for active management and they are suspicious of active management, more generally. Clients' concerns about active management and the general lowering of market returns are key factors behind the weaker outlook for the industry.

We in the asset management industry can rightly be accused of considerable hubris. We have been too lavish in our claims about how we will perform. By and large, we failed — just as badly as investment banks and others — in forecasting the global financial crisis and we failed to recognise some of the dangers in some of the remedial measures that were put in place in terms of how they would affect markets. The theoretical underpinnings of many of our claims were also exposed.

I am a great believer in a value-based approach to investing but I also now believe that this may be more useful as a much longer term approach to investing. It is not always the best approach for those who are investing with a shorter time horizon in mind. We need to be far more careful and transparent in discussing our products and approaches to investment.

At the same time, the push towards passive or near passive funds and ETFs (exchange-traded funds) has quickened on both the institutional and retail levels. ETFs have understandably raised some regulatory concerns but I suspect that these vehicles will become even more important in the future as investors, in retirement, increasingly and aggressively question fee levels and move towards self-management of their portfolios. ETFs facilitate this.

Yet, remuneration levels remain sticky and, understandably, we are seeing many firms in Europe and in the United States undertaking long overdue cost-cutting programs. The net result of these and other factors is that the outlook for profitability has slipped significantly.

This decline in the outlook for profitability and the effects of a number of regulatory changes both in Europe and in the United States have meant that many firms in the industry are looking to consolidate. This consolidation is taking many forms: smaller firms are seeking to combine; some banks are questioning whether asset management firms should be fully owned; and a number of boutiques are also finding the burden of operating in a more regulated world a less attractive environment than it was a few years ago. While significant consolidation has already occurred, that should quicken quite dramatically in Europe and in the United States in the next year or so.

I believe we are also entering a period in which investments will be selected more for income through dividends and interest payments. In some ways, this is a return to what was far more prevalent in the 1960s and 1970s. Capital appreciation will become a secondary — although still important — source of return. Products in the asset management industry will need to take this into account.

Related to the earlier points, I think the industry needs to re-educate itself — and its clients — as to what long term means. We have slipped — either consciously or unconsciously — into a thought process in which three years is viewed as being long term. Recent experience suggests this is not the case. The industry needs to understand, as most sophisticated institutional investors around the world already do, that the long term stretches beyond three years.

I do not know what is the appropriate length of time but it is more like seven to eight years at least. Commensurate with this, we need to produce fixed income and equity products that are suitable for longer-term investors.

Finally, performance fees continue to spread far more slowly than I would have expected and hoped. However, I do see things changing in this area. Performance fees are spreading into long-only products and, within hedge funds, we are seeing the first signs of downward pressure both on base fees and performance fees.

We are a rather strange industry in that we are remunerated regardless of whether we outperform. I wonder whether, as the years roll on, more people will question this remarkably generous approach to our industry. ■