Roundtable on Fostering Retail Investment in Capital Markets (07 February 2017) – Keynote speech by Daniel Godfrey

Good morning ladies and gentlemen.

It's a great honour to be invited to deliver this opening Keynote. As an Englishman, I can assure you I understand how great an honour this is. And I was quite relieved to find that no travel ban had been imposed.

But I'll also always be proud to be a European and aware that I'm a citizen of the only planet we'll ever have. That's why I believe that competition between nations should end on the sporting field and that when it comes to business, it's the job of nations to provide a level playing field on which all companies can compete fairly with each other.

Whether in sport or in business, fair competition spurs us to invest in getting better every day. To the ultimate benefit of all. Unfair competition creates complacent winners, mistrust in the results and poorer outcomes for us all in the end.

And investing every day in getting better has to be the key to Europe's long-term success.

I'm sure everyone in this room has been profoundly worried by the decision of British citizens to vote by a very narrow margin to leave the EU, by the election of Donald Trump in the US and the rise of populism in many other parts of Europe and indeed the world.

There isn't much doubt that this is happening because millions of people haven't seen improvements in their living standards for many years.

Instead, they are having to run faster to stand still. Now people don't mind working harder if they can see that they are making a better world for their children. But they don't see that. What they see is a small elite capturing the wealth created by their hard work.

This leaves people vulnerable to exploitation by populists who promise to change things. But we know how this movie ends. The policies fail and we move to a new and even nastier phase of blaming others.

I believe that the only way to avoid this scenario is more growth, shared more fairly. But much of the world, including the EU is suffering from a crisis in productivity growth.

And the only way to change this is healthy, long-term investment.

Making this happen is the historic responsibility of capital markets, investment managers, business leaders and the political and regulatory establishment

But the investment industry is not currently fit for that purpose.

Let’s take a step back for a moment and ask ourselves “What is the purpose of the investment industry? And why is that important?”

I’d say that the purpose of investment management is take pools of people’s savings and to invest them in enterprises that are capable of creating wealth sustainably over the long-term.

And it’s important because this wealth creation provides returns that enable investors to withstand financial shocks, to do the things they dream of and to have a decent standard of living as they get older. But it also preserves and creates jobs both within companies and within their supply chains. It benefits the communities in which those enterprises are located and it generates tax revenues that pay for education, medical care, and infrastructure.

But if we look at the business model of the investment industry and the capital markets today, as a whole it is not being run to fulfil this purpose. Instead, the objective of the investment industry could better be described as being “to beat the market.” This is not about long-term wealth creation, but about short term profit-maximisation. The clustering of most of the active investment industry around goals that are related to outperforming index-benchmarks is the primary reason for the rise of passive funds.

It’s very hard to beat the index consistently over 12 month rolling periods. Especially when you try to beat the index. And that’s why the vast majority of active funds fail to do so over the long term. But it’s very easy not to fail by very much. And this leads to index hugging and obsession with tracking error and relative volatility.

Now a consumer would probably find words like tracking error and relative volatility hard to understand.

But let me translate the meaning of an underweight position and tell a consumer that it means they're paying an investment manager to buy and hold shares in a company that the manager thinks is going to do badly. The consumer would rightly think that was crazy. But most active funds do it to some extent or another.

Going underweight also creates a stewardship conflict of interests – if you are an investment manager with an underweight position, engaging with a company to help it perform better damages your relative performance and helps a competitor with an overweight position. When investment managers are likely to be more conscious of their relative performance than their clients’ absolute performance, then something is very wrong.

John Kay made the point brilliantly in his book "Other People's Money" when he pointed out that there is no clearer example of an industry that has lost its purpose than when the some of the finest mathematical and scientific minds on the planet are tasked with devising algorithms for the computerised trading of securities for the sole purpose of exploiting the weakness of - other algorithms!

But even more than excessive costs being borne by savers, the bigger harm caused to society is the way in which the structure of capital markets leads to shorter and shorter time horizons and is infecting enterprise in the non-financial sector. Hillary Clinton called it quarterly capitalism when almost every CEO surveyed said they would not make a new investment with a 5-10 year payoff projection if it would take a penny off the share price.

The pressure coming from investment managers and investment bank analysts largely is about short term numbers. This inhibits long-term investment, and encourages share buybacks and outsourcing.

And this, ladies and gentlemen, is why we have a productivity growth problem and why the capital markets need to be made fit for purpose before it is too late.

Of course, the irony is that advisers and investment managers are supposed to be agents, acting as the champion of the investor. But they operate in a system in which they might well lose their jobs if they even tried.

There are many fine people and fine firms in investment management, but the system itself is strong and incredibly resistant to change.

Catalysts for reform may need to come from outside the system.

Karl Marx described capitalism as being the exploitation of labour by those who owned the means of production.

But in 2017, we now have a situation where $36 trillion dollars globally sits in pension funds whose ultimate beneficiaries are those very workers! The ownership of the means of production has substantially transferred to ordinary people.

And despite that transfer, the rewards of labour are now being largely captured by capital market participants and a CEO-ocracy.

So in my view, we now need a capitalist revolution. A revolution from the roots-up, where the interests of the new owners of the means of production, are represented by agents of integrity who can really champion their long-term interests, investing in sustainable growth that benefits their clients and society and so creating Capitalism 2.0.

To do this, investment managers need to stop worrying about beating the market and instead focus on identifying and nurturing long-term winners.

In this way, investment managers would rediscover the true purpose of investment and back enterprises that they truly believe are capable of creating wealth for the long term. Stewardship, engagement and responsibility would necessarily be core to success in this operating model.

Even though some investment managers would inevitably fail to beat the market it would be easier for Darwinian processes to take their course. But the crucial point is that all ships would rise on the tide of long-termism.

Companies would be encouraged and supported by investment managers to invest in their people, in innovation and in new markets, and they would also be encouraged to be transparent on tax, to protect the environment and to lobby only with integrity and with evidence-based argumentation.

We’re going to focus in the coming session on whether supply is fit for purpose. My argument would be that we have the tools we need to deliver supply that is fit for purpose in UCITS, AIFs and ELTIFS, including listed investment companies but without a long-term approach that meets consumers' needs, we are not using them in a way that's fit for purpose.

It's not only short termism, but distribution models need reform.

The biggest cause of consumer detriment in European finance is captive distribution networks. And really, the clue is in the word. Captives are told what they are going to have, when they are going to have it and how much they are going to pay for it. There are funds in the U.K. Available at three quarters of a percent which when repackaged by an Italian bank cost 4% plus a performance fee.

If the EU is going to play its part in creating a market where citizens can feel they can entrust their hard earned savings to long term, value for money, investment funds, we need to break captive distribution and deliver a marketplace where consumers can make informed choices about long-term investment opportunities through simple and transparent disclosure of objectives, strategies, costs, measures and timeframes.

If the EU can do this and set the context for a revolution in savings that prioritises long term and sustainable wealth creation and commercial success through genuinely putting the customer first, then financial services really will make the world a better place.