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Responsible Capitalism: Chapter 1

Responsible Capitalism and our Society

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At the height of the classical age, the ruler of Parthia, the King of Kings, passed an old man planting olive trees in a field. Knowing the tree would not bear fruit until long after the old man had died, he asked, "Old man, you will be long gone by the time the tree sheds its first fruit, why do you bother?" "Sire", the old man replied, "those who came before us planted so we could eat. I plant so that those who come after us can eat".

This insight from the era of classical antiquity has yet to make its way into the financial markets of the postmodern era. Most notably, in the world of asset management, whose role it is to put savers' money to work for their long-term benefit, an increasingly siloed view focussed on financial, rather than societal, returns is creating contradictory and harmful behaviours that jeopardise those savers' very future.

The capital controlled by the investment management community is derived from the aggregation of ordinary workers' savings and decisions about how that capital is spent drives and shapes the society these savers and their children will live in; yet remarkably little consideration is given to the ultimate outcomes of capital allocation on their future lives, with a concentration instead solely on nominal returns.

While our survey of over 100 institutional investors into responsible capitalism reveals a growing awareness that focusing purely on financial gains is not enough, it also shows a dangerous tendency to behave in contradiction of this. The focus on measurement leads naturally to more short-term thinking and decisions that often miss the whole point of investment, to the detriment of the savers the industry is supposed to be serving.

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The level of awareness around the importance of ESG issues is definitely increasing. Our survey shows 79% consider significant ESG risks with financial implications as sufficient reason to reject an otherwise attractive investment. 90% believe fund managers should price in corporate governance risks as a core part of their investment analysis, alongside financial metrics.

This is a marked improvement upon fifteen years ago, when ESG was considered to be distinctly left field. Today it has become a more mainstream way of thinking. The belief, for example, that women have a valuable place on company boards is accepted by everyone except knuckle-dragging Neanderthals.

However, it is also clear from the survey results that investors still consider ESG as a 'nice to have' on the whole. Less than half (46%) of investors believed companies that focus on ESG issues produce better long-term returns for investors.

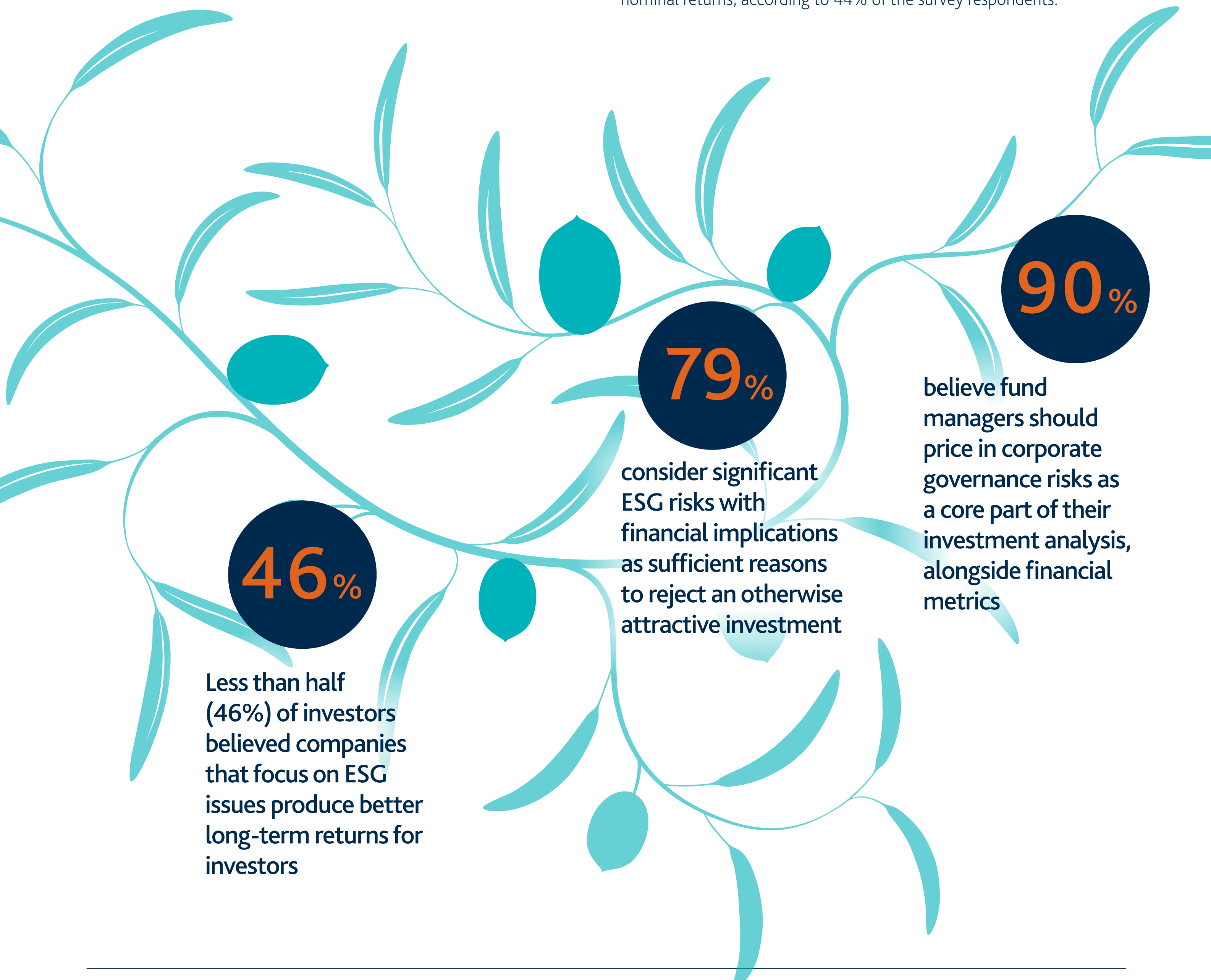
So while there is a shift underway, ESG is clearly being regarded more as a risk to be mitigated, rather than as a positive driver of investment performance.

Furthermore, as the flow of assets into passive mandates continues, the opportunity for investors to effect change is quickly decreasing. By moving towards index-tracking strategies, investors are giving up their voting rights and thus their influence. 61% percent of institutional investors surveyed believe large shareholders are likely to 'become unaware' of the companies they invest in. Many investors appear comfortable with this because of their primary objective of beating an inflation target.

Yet, the risk-centric approach to ESG and the inevitable decline in engagement born of the shift to passive are both symptoms of the same failing – measuring performance by the wrong benchmark.

The lack of importance attributed to ESG factors stems largely from the obsession in the investment management industry with performance measurement. This breeds an increasingly siloed view of the world, lacking a wider societal context, which is inherently short-term focused.

Trustees and asset managers are not entirely to blame for this. Regulations such as IFRS17, the triennial valuation cycle and modern portfolio theory are driving pension schemes to think in short-term nominal returns, according to 44% of the survey respondents.



The result is a siloisation, where they see problems in the context of a single duty – making sure there is cash flow available when it needs to be paid out, and doing that in the most cost-efficient way possible.

However, there is an idea creeping into markets that this is in fact the wrong goal as it threatens the long-term sustainability of financial markets and, in fact, the species.

In particular, Aspinal, Jones et al[1]. point to the negative implications of using discount factors as the driver for allocating capital. This forces a focus firstly on financial, rather than societal or other metrics and secondly on the short term as the "far future may appear worthless". Their paper urges actuaries to recognise the limitations of discount rates in investment decisions given the potential for unintended negative consequences for sustainability.

It is not just actuaries who need to recognise the shortcomings of focusing on financial returns, however. Given the vital role which asset management plays in allocating vast sums of savers' money, it has a pivotal role to play in bringing about positive change in capital markets.

If investments are made in a way that increases the prices in the inflation basket, for example, that is directly detrimental to savers as it reduces the value of their future capital and therefore their quality of life. And if those investment decisions ultimately feed into global warming, the consequences could be disastrous.

It is already well acknowledged that the world is on a rapid journey towards a 2°C increase in temperature over the next 35 years, which would be nothing short of catastrophic for the environment and, by extension, society and ultimately the species.[2]

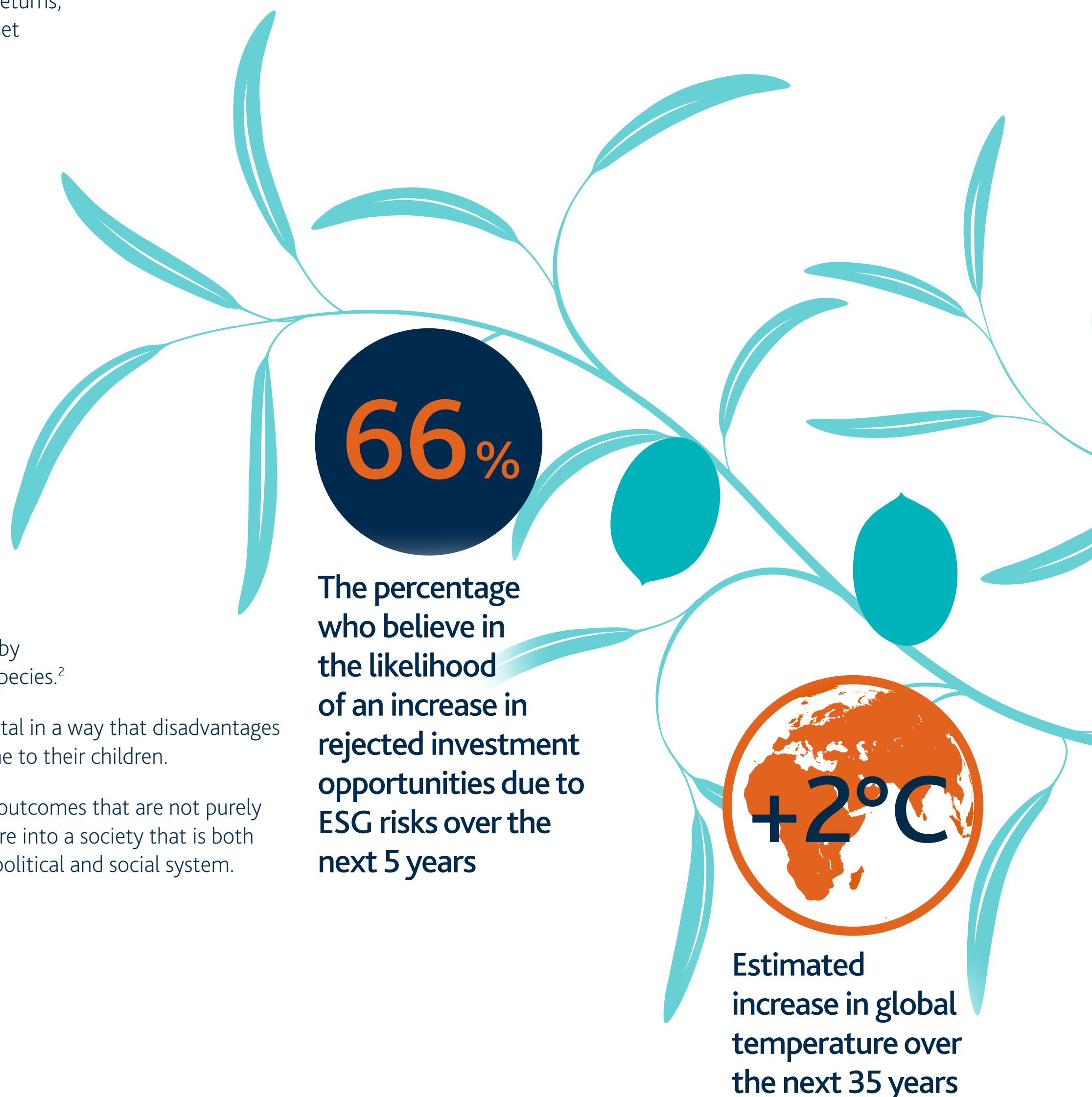
It is insulting to savers to use their capital in a way that disadvantages them when they retire or does the same to their children.

Investment decisions should be about outcomes that are not purely nominal, but which allow savers to retire into a society that is both pleasant and functional, with a stable political and social system.

If the focus on financial returns leads to the destruction of people's ability to retire, as well as the planet they live on, that is surely the wrong metric to focus on.

Instead, the job of those responsible for allocating savers' capital should be to provide an income that allows a saver to retire at 60% of their current lifestyle. This approach means placing factors that impact our long-term quality of life, including environmental, social and governance factors, at the very heart of investment.

Sadly, there is a long road to walk before this can become reality for the majority of savers. Our survey shows 58% of respondents believe the number of investment opportunities rejected by pension schemes because of ESG risks will increase only slightly over the next five years. Only 8% believe we would see a dramatic increase, while 6% think it will decrease slightly.



[1] Aspinal, Jones et al, "Sustainability and the Financial System: Review of Literature 2015", presented to the Institute and Faculty of Actuaries, London, May 2015
[2] Myles Allen, "The science of climate change and the impact on asset owners", presented at Fiduciary Investors Symposium, Oxford, April 2005

The current siloed view of fiduciary duty and the shift to passive will certainly support the latter direction unless corrected with extreme urgency.

Perhaps more worryingly, 47% of respondents continue to believe pension funds should focus exclusively on maximising retirement incomes rather than giving greater consideration to whether their current investments will improve or detract from the overall quality of life experienced by beneficiaries when they retire. Only 37% believe institutions should place a greater emphasis on quality of life factors.

This can only mean one thing: the asset management industry in general is behaving counter to its entire purpose to the detriment of those whose capital it means to allocate. Under this mindset, the old man 2,000 years ago simply wouldn't have bothered planting the olive tree. With hindsight, the impact on future generations is blindingly obvious.

Today's siloed and short-term investment approach is the antithesis of responsible capitalism. Change must come fast if we are to ensure today's savers and their children will be able to enjoy a fruitful world in the future.

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