Investment Management Review

Responsible investment achieving a strong position in asset management
Progress hampered by lack of clarity

Plus

Innovative techniques generating investment insights
New tools making a difference in financial markets
Hollywood and sports combined in powerful investment theme
Chinese push helped by data analytics and top international investors
FROM THE EDITOR
PASSIVE OR SOCIALLY RESPONSIBLE?

A big question in fund management is how far passive will rise to displace active. Another important force, however, is the rapid increase in investor interest in socially responsible investment (SRI). It is all well and good to measure the performance of standard active funds against that of passive indices. But the latter as a yardstick for SRI does not make sense, as like would not be compared with like. The problem is that the construction of a universally accepted benchmark for SRI might pose considerable challenges.

Going just by the significant proportion of investors expressing an intention to invest in SRI, or at least an interest in doing so, the problem of benchmarks might seem to be pressing but is actually not yet so. The more relevant statistic is the actual exposures in percentage terms to SRI portfolios. The evidence is that these exposures across the investment community are still small, though reliable figures are not available.

Morningstar’s sustainability rankings are a step in this direction that allows investors to determine how much their portfolios are backing environmental, social and governance (ESG) principles or sustainable investing. But this research house points out that only 2% of funds have explicit sustainable or responsible investment mandates.

These ratings are being subject to the criticism that sustainability is not adequately defined and SRI activities occurring externally to portfolios are being ignored. Furthermore, it is difficult to see how the sustainability criteria used by Morningstar can be anything but subjective. For instance, there are bound to be widely different opinions on acceptable levels of gender diversity and labour standards, and yet all these variations can be still considered as within the SRI remit.

The actual criteria selected for any benchmark in terms of precise numbers will also be a matter for judgment. A universal consensus may thus be near impossible. Whatever particular benchmark is adopted and enforced, an unintended consequence could be to disqualify and discourage substantial and genuine SRI investments, merely because they do not fit this particular set of criteria.

That the total investment in SRI is apparently still small in proportionate terms across all investors is not surprising given the hindrances. The UN, at the forefront of the SRI drive, attacks the investment community for the use of jargon and acronyms that confuse investors. More seriously, there are issues to do with definition of a wide variety of SRI investments. Morningstar only measures a subset, those portfolios that invest in ESG-supporting companies.

But there are vast numbers of other projects that would be classified as SRI, such as green bonds and impact investments. Even in these other sectors the proportions invested are not huge. For instance, even after rapid growth, green bonds still account for only 1% of global bonds, at $140bn.

Thus, the problems of measurement are not yet acute. However, social and political pressures are gathering, and there is the potential for much bigger proportions being invested in ten years’ time, particularly because the G20 has put its weight behind removing the obstacles to more sustainable investments. For this class of assets to become really big, professional and objective standards of definition, measurement, monitoring and enforcement are required.

Trump’s election and his stance against climate change alleviation do not change the global picture substantially. Even in the US, presidential policies cannot override too much the gathering social and political pressures in favour of SRI.

In due course the growth of ESG and impact investments might overshadow the shift to passive, but a lot of work is required in the classification and definition of these new sectors.

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An agreed merger between two well-known global asset managers is interesting in itself, but it also has profound implications for the immediate road ahead for the active fund management industry.

The two merging companies, Henderson and Janus, are minnows in global asset management terms, each ranking well outside the top 60 fund managers. Janus ranked 90th prior to the merger, according to the consultancy Willis Towers Watson, and Henderson ranked 116th. Their combined asset pool of $320bn is still not huge in international terms, but is enough to take the new company Janus Henderson into the ranks of the world’s top 60.

The deal is expected to be finalised in the second quarter of 2017, subject to regulatory and shareholder approval. The transaction, which involves no cash but only stocks, will create one of the 20 largest independent fund management groups. The CEOs of the two companies, Andrew Formica (Henderson) and Richard Weil (Janus), will be co-chief executives of the new group.

**The rationale claimed**

The two bosses repeat the usual mantra in claiming that the merger is not about cost savings or other defensive reasons, but has as its rationale enhancement of growth prospects. Clearly, CEOs have to say such things, but industry commentators in general think otherwise, including the venerable Lex column of the Financial Times.

Just a few days before the announcement of the deal, Henderson was reportedly worried about a requirement for more capital in the wake of a similar call by the FCA for Aberdeen to strengthen its capital buffers. It is felt that the merger will reduce the need for this. But there are much bigger industry-wide concerns that make the merger almost necessary, undercutting the positive spin of the CEOs.

**The real reasons for the merger**

The active fund management industry is in for a dire period, with many not expected to survive in the next few years (see box).
There are several reasons for fund managers quaking in their boots. The most compelling of these is the onslaught of passive fund management, sharply cutting into the revenues and profits of companies that live by active management, as outlined in the next article, ‘Dangers, unfairness and exaggerated benefits of passive’ on page (5).

The invasion of the passive funds eroding active territory rests, as well known, on two strong legs. First, it is now widely felt that the vast majority of active managers do not earn their keep in view of their failure to beat their benchmarks, which is put forward as their primary raison d’être. The related second reason is that the much lower fees of the passive sector are alluring in comparison.

The consultancy McKinsey projects a fall in profits of more than 30% in the global fund management industry by 2018 unless costs are cut in a brutal way.

Synergies

This is not to say that there is no business logic behind the merger, though it is not considered to be the main motivation. Henderson, a leading Anglo-Australian investment firm, is much stronger in Europe and Asia, whereas Janus’s advantages are more in the US. This geographical complementarity is buttressed by asset class fits. Henderson is large in European equities and alternative investments, areas where Janus is weak or absent. But Janus is better established on the quantitative front and US fixed income. The latter is also bringing a new dimension to the table in the form of Bill Gross, who in his previous PIMCO life was regarded as the king of the global bond market.

The wider industry picture

The merger is regarded as the first real intimation that the embattled active fund management sector has begun its consolidation in the face of the pressures coming from the index sector. According to Amin Rajan, CEO of the consultancy CREATE-Research, this is likely to be the first of many transnational deals. The merger has raised hopes for many more similar deals and led to the share prices of other suffering groups rising. For instance, on the announcement of the merger, the shares of Franklin Templeton’s parent company Franklin Resources rose by 2%.

The consultancy McKinsey projects a fall in profits of more than 30% in the global fund management industry by 2018

There are more mergers in the offing. It is believed, for instance, that Pioneer Investments is in the sights of the French giant Amundi, already in the top ranks of global asset managers. This is not a reflection of the dire industry conditions. Amundi is here motivated by growth and climbing up the ranks, rather than being in any kind of trouble or pressure, as Henderson and Janus are considered to be.

Editor’s comment

Often two people sharing the top job can be a reason for concern, as lack of agreement might lead to a corresponding shortfall in clear strategic direction. The blending of two cultures in mergers and acquisitions deals is notoriously always difficult and often a cause of failure. On the other hand, the sharing of power at the top could smooth the transition in bringing the two companies together.

Much depends on the two men having a shared view and working well together. Andrew Formica has an outstanding record of taking over other companies and melding them, including the illustrious Gartmore and New Star. Though the jury should be regarded as out, the odds are in favour of Formica succeeding yet again, especially with the global asset class and distributional synergies in terms of complementary strengths and lack of too much overlap.

The sharing of power at the top could smooth the transition in bringing the two companies together

Bill Gross’s arrival may not be the plus hoped for by both the new group and Gross himself. Remember that his last years at PIMCO were marked by huge negative publicity and controversy, with his performance having dropped badly. Gross is widely feared to have lost his touch.

Despite protestations to the contrary by the CEOs of the new group, the fact that their motivation is defensive is clear to most others, but even as a protection mechanism the merger might be only buying time. The key question is whether, jointly rather than separately, they can halt the outflows from their funds towards passive.

One hope is that Janus Henderson produces compellingly superior investment performance, but it is hard to see how the merger per se could bring this about, as enhancement of investment processes is not part of the deal. A second hope is that, before too long, the industry-wide shift to index products subsides. Barring these two escape routes, groups might have to become really large to survive. Otherwise, mergers might be only a short-term solution.

A 30% drop in global fund management profits, as predicted by McKinsey, will not fall equally on all companies. Some groups will prosper and others such as Vanguard will mitigate margin reductions resulting from fees falling through extra sales.

The implication is that the 30% cut could lead to many companies going into negative profit territory and not surviving. If McKinsey is right, a bloodbath is on the way.

Sage and Hermes Research

This is the first of two related articles. Please see the next one on ‘Dangers, unfairness and exaggerated benefits of passive’.
DANGERS, UNFAIRNESS AND EXAGGERATED BENEFITS OF PASSIVE

The accelerating shift to passive investment is sparking off an intense debate on the possible dangers it might cause to society. Increasing numbers in the industry are voicing fears of the consequences, should the shift to passive go too far. Furthermore, for investors, technicalities of passive portfolios point to their benefits being overstated.

The scale of the shift

The seismic upheaval caused by the popularity of passive is reflected in key statistics. Passive assets under management (AUM) have grown by 230% globally to $5.7tn since December 2007, while assets in active funds have registered a much smaller increase of only 54%, to $24tn, according to Morningstar, the leading research provider.

Index funds represent a cheap way of investing, but they do suffer some disadvantages in performance terms

In the three years to August 31 2016, the flows tell an even starker story. Passive mutual funds and exchange-traded funds (ETFs) have gained more than $1.3tn, while a massive $250bn has been lost from active funds. The trend did not abate in 2016. Active funds specialising in US equities suffered outflows of $166bn in the first eight months of 2016, while $110bn of new money went into passive funds.

Index tracking funds have increased their share of assets in the US by $2tn since 2013. The passive sector now accounts for nearly 30% of mutual fund assets, compared with 25% three years ago, as reported by FTfm using data from Morningstar.

In some specific sectors and companies the move towards passive has gone even further. In the US, the employer-sponsored 401(k) retirement plans currently have 25% of passive investments, compared with 19% in 2012, according to investing consulting firm Callan Associates. Public pension plans have now allocated 60% of their US stock investments to passive vehicles, a dramatic increase from 38% in 2012, as revealed by Greenwich Associates, the well-known research consultancy.

Passive advantages overstated

On the face of it, the argument against active is incontrovertible. The widespread realisation that most active funds do not consistently outperform their benchmark is borne out by statistical evidence. For instance, according to a recent study by Standard & Poor’s, 99% of active managers in US equities underperformed their benchmark over ten years, during which time 86% of their European counterparts also fell short of their benchmark.

The momentum effect is caused by herding of passive investors all trying to buy or sell the stock at the time

The reality is a bit more complex. True, index funds represent a cheap way of investing, but they do suffer some disadvantages in performance terms, as they incur costs that active managers do not face. One such cost arises when a stock is added to the S&P 500 with a corresponding deletion of another. On the announcement of this change, the price of the stock goes up and the passive funds are obliged to buy it after the increase. Similarly, these funds are forced sellers of shares that fall out of the index, realising their sale only after the prices have fallen. Thus, passive funds are also likely to underperform the benchmark and it is suggested that the reduction in returns could be half per cent or more per annum.

Another problem is that stocks in the index tend to be overvalued relative to similar stocks outside, which again can eventually be translated into poorer performance over time. As Amin Rajan, CEO of CREATE-Research, a well-known consultancy, puts it, bigger inflows into passive funds expose them to concentration risk and momentum risk. The former is caused by a share price rising merely because of its index inclusion, irrespective of its intrinsic value. The momentum effect arises from the herding of passive investors all trying to buy or sell the stock at the time of an index change, which leads to overshooting in both upward and downward directions. It is akin to thousands of people trying to get in through a door at the same time.

Unfair loading of the dice

One of the strongest reasons for index funds being much cheaper than active funds is that they avoid the latter’s research and trading costs, while taking advantage of the fair price established by the trading of the active managers.
The passive funds are, therefore, considered free riders, as they could not function without the impact of their active counterparts. So the argument is that the playing field is tilted in favour of passive and there needs to be a balance. According to Inigo Fraser-Jenkins, Head of Global Quantitative and European Equity Strategy at Bernstein, if everybody owned index funds then nobody could figure out their underlying true worth and there would be no liquidity or market.

John Bogle, Founder of Vanguard Group, the company that launched the first index mutual fund 40 years ago in 1976, agrees that passive investing could become too large.

It is generally recognised that market efficiency depends on active management and without it capital markets would be badly hit. Even Burton Malkiel, Professor at Princeton University and author of the investment classic A random walk down Wall Street and the doyen of Efficient Market Hypothesis believers, acknowledges the paradox that efficient markets need active management. John Bogle, Founder of Vanguard Group, the company that launched the first index mutual fund 40 years ago in 1976, also agrees that passive investing could become too large.

Corporate governance
A major concern about passive investors is that their semi-permanent status prevents them from using the power of selling in order to discipline companies. It is believed that the threat of active managers undertaking large-scale selling exercises is an important influence on company management.

The largest index providers, including Vanguard and BlackRock, negate this argument by claiming that they exert influence over the companies that they hold through being massive shareholders and constantly engaging with the management.

Dangers to society
If the passive movement goes too far, the adverse effects will not stop with the workings of efficient financial markets. They will extend to all of society, which needs the efficient capital allocation delivered by well-functioning financial markets. A group of researchers at the University of Amsterdam in the Netherlands recently argued that the growth of giant index fund providers such as BlackRock and Vanguard could lead to an excessive concentration of ownership and control.

Eelke Heemskerk, a political science professor at the University of Amsterdam, suggests that the growth of index funds may fundamentally reshape the organisation of corporate ownership. His research team estimates that the two largest index fund managers, BlackRock and Vanguard, currently own at least 5% of more than 2,600 and 1,800 worldwide companies respectively.

Fraser-Jenkins is credited with a perceptive criticism of passive investment. He points out three ways in which society can allocate capital and thus organise itself. His first option is capitalism, with efficient markets and active managers as a strong force. The second option is marxism, where there is at least an attempt to optimise the flow of capital, whether or not it is done well. The worst scenario, in his opinion, is that meaningful capital allocation will break down if passive investment removes reallocation from weak to strong companies, freezing capital and not allowing upstream technologies to be funded.

The key question is how high passive can go in its share of the market before the various dangers are triggered.

Threshold
It is clear that the relatively small proportion in passive, generally around 15–20% now, has not caused the problems outlined above. The key question is how high passive can go in its share of the market before the various dangers are triggered. The threshold that is tolerable is a subject of intense debate. Some have suggested that a level as low as 50% could be problematic, while others consider even a figure of 90% acceptable.

Editor’s comment
It appears that while active funds generally underperform the index, even passive funds fall short of the benchmark performance by more than half per cent per annum. This narrows the gap between the two types of funds, but still probably does not remove the case for passive.

The low fees charged by passive funds are undoubtedly a lure. Given that investment returns are generally expected to be lower in the future than in recent decades, there is likely to be even greater resistance to high active fees which will take a bigger slice of the lower returns.

The market share threshold at which passive will cause problems is subject to several uncertainties. As the share rises, decreased efficiency and lower liquidity will lead to higher volatility. This in turn will attract more traders and talented fund managers who can exploit this. So the passive share is unlikely to settle at a precise figure (see box).

As active fund management in the mainstream markets gets squeezed, the possibility of fund managers being doomed is often mentioned (also see box). The chances of this are remote. Talented fund managers are unlikely to become extinct, particularly because investment management is beginning to shift towards longer-term vehicles such as infrastructure, impact investment and some private equity. The mindset and skills needed by these managers, however, might be different.

Sage and Hermes Research
This is the second of two related articles. Please see the previous one on ‘Merger of two famous fund managers signposts the industry’s future’.
ROBO-SAVINGS BETTER THAN ROBO-ADVICE

Editor’s introduction

While robo-advice is the cheap way of investing, robo-savings, a different concept altogether that caters for the financially illiterate, is considered to have more potential for society. The dangers faced by robo-advisers are now actually becoming a reality.

Robo-savings solution to retirement crisis

A solution to a substantial proportion of Americans not saving for retirement or any other contingency lies in robo-savings, according to Ashby Monk, the Executive and Research Director of the Global Projects Center at Stanford University.

Monk presents savings statistics that add up to a very dismal picture. One in three in the US has zero savings, while nearly two-thirds of Americans do not have enough money even to cover an unexpected $500 outlay. The consequences of this parlous level of savings are compounded by the population being expected to live much longer than previous generations, with no money available to pay for the long retired lives ahead of them.

Employers persuading more of their staff to save in retirement accounts is a possible solution, but this seems unlikely, as 64% of Millennials (the 18-34 age group) do not have a retirement account. Two-thirds of Americans still cannot pass a basic financial literacy test. Monk deplores the authorities promoting consumption for economic growth at the expense of savings.

Robo-savers, another new breed of computerised systems in the retail financial arena, will assist people to save in an automatic way. The programs use creative behavioural tricks to maximise savings. Among the companies already operating in this field, Digit monitors people’s current accounts (checking accounts) and makes automatic withdrawals that are not very noticeable, transferring them into savings accounts. Qapital shifts spare change into objective-orientated savings products. Acorns converts the spare change when people transact and automatically invests it in the stock market. Monk points out that there are many more robo-savers on the way.

It is robo-savers, not robo-advisers that will solve Americans’ savings crisis

Monk’s opinion is that, though relatively unknown at the moment, these robo-savers will be much more important than robo-advisers for finance and asset management. It is robo-savers, not robo-advisers that will solve Americans’ savings crisis.
While many of the solutions currently being adopted for the retirement crisis are not working, Monk’s strong view is that the answer will be provided by these robo-savers, using automation and behavioural tricks. People consequently saving money for objectives later on could be game-changing. The real innovation is, therefore, not in the creation of cheap retail investment products by robo-advisers, but in the potentially vast expansion of retail investors.

Editor’s comment

Much is said about the global growth prospects for asset management, based on middle classes growing and the poor coming out of poverty. But, if they cannot be drawn into long-term savings, the potential growth will remain an illusion for fund managers. Robo-savings could make a big difference.

‘We, robot’, Ashby Monk, Institutional Investor, September 2016

Robo-adviser problems mount

Two of the highest profile robo-advice start-ups of a few years ago are now running up against problems. Nutmeg, UK’s pioneer robo-adviser, is still to make profits three years after launch. In fact, its losses increased by about 70% in 2015 at £9m, compared with £5.3m in 2014. According to the company, assets under management (AUM) had doubled, though exact figures were not issued. The UK wealth manager SCM Direct predicts that most UK robo-advisers will go out of business before reaching a size that makes them viable.

In the US, Betterment, a pioneer in the field of robo-advice with $5bn AUM, suffered the severe embarrassment of having to freeze trading for thousands of clients in the few hours following the Brexit result. The Massachusetts State regulator has expressed serious concerns about the inconsistency surrounding Betterment having informed only some clients of its trading halt, as reported by The Wall Street Journal.

This incident has also created dissatisfaction among advisers whose clients use Betterment’s platform. Compounding the start-up’s problems are the large institutions going ahead with setting up robo-adviser services, including UBS and Fidelity. Allianz provides a silver lining in that, rather than competing with start-ups, it has acquired a minority stake in MoneyFarm, which claims to be one of the largest robo-advisers in Europe.

Despite Schroders having taken a stake in Nutmeg, it is by no means certain that it will keep supporting it … Time is not on Nutmeg’s side

Editor’s comment

The pressures on robo-adviser start-ups are not surprising (see box).


The upstarts may not last. While the robo-advice model is likely to thrive, the entrepreneurial start-ups have less hope. Many of them are unlikely to survive. They are destined to either be swallowed up in the maws of the bigger predators or die a natural death as is often the way in new industries.

Despite Schroders having taken a stake in Nutmeg, it is by no means certain that it will keep supporting it … Time is not on Nutmeg’s side

NEW DATA TECHNIQUES GENERATING INVESTMENT INSIGHTS

In trawling the vast pool of data worldwide for possible investment insights, new techniques are being brought into play for the purpose of finding subsets of the much-hyped big data monster. Most of the data is of limited use for security price prediction, rendering the task of hunting for ideas challenging. But some of the subsets could prove to be lucrative gold mines, though the awesome task of extracting the nuggets of value would need to be carried out.

It is not just online data that gives rise to creative research. Other types of unorthodox sources, including some mundane and some around for decades, are also being exploited.

The most enterprising investors no longer confine themselves to traditional sources of investment research, but are sedulously searching for special clues regarding companies and economies in such previously unexplored territory, well away from the traditional research channels. They go for all sorts of information, referred to as ‘alternative data’ which might affect investment decisions but is not included in traditional market statistics and company financials.

The very wide variety of information that is sifted through in order to spot value, ranges from hanging around conferences to exploiting satellite data as well as analysing CEOs’ speeches and monitoring social media opinions on companies.

It is not just online data … Other types of unorthodox sources, including some mundane and around for decades, are being exploited

The value of much of this is criticised as biased or inaccurate, but there is evidence of successes produced by alternative data hunting, justifying the cliché ‘the proof of the pudding is in the eating’, as outlined later in this article. Finding the nuggets of investing success amongst the abundant raw data is made difficult by the very wide variety of information that is sifted through in order to spot value.

Many different types of users have recognised the value of the special ideas they get, and are willing to lay out large sums of money to receive the results of data investigations. The users
range from hedge funds to more staid companies such as insurance groups, banks and mainstream investment houses. The processes do not come cheap and demand huge outlays.

The extraction of the original data involves both high tech and more mundane manpower. High costs are not only in technology. Hiring people also requires massive expenditures, as highly talented and creative investigators are needed. Much technical expenditure relates to the use of satellite-based information. Though the costs of launching into space are coming down fast, investments as much as hundreds of millions of dollars are still demanded and obviously depend on a large number of users who find it profitable to pay for this.

The initial data extraction is not enough on its own. The key is the more awesome task of analysing in order to spot the tiny fraction that might have predictive value. Thus, there is a three-stage process, involving data extraction, analysing the data and finally making predictions leading to money-making opportunities.

The process clearly has to be preceded by judgments as to which aspect of the vast big data pool worldwide might be of benefit. For instance, the ability to survey the entire planetary land mass from space is a remarkable technical development, but focusing on the prior selection of specific areas such as farmlands and shipping is what potentially creates investment alpha (see box). Such selection is the fount of entrepreneurial research success.


It is estimated that 90% of global trade is transported by sea. CargoMetrics, a technology-driven investment company, uses very high frequency radio transmissions to track the movements of more than 120,000 ships across the world, monitoring where they dock to gauge the type and volume of the goods carried. It links satellite signals, both historic and current shipping data, and proprietary analytics.

The company sells its research to hedge funds and dealers for trading, mainly in commodities and sometimes currencies and stocks using algorithms. It also runs its own hedge fund to profit from the process.

Scott Borgerson, CEO and founder of CargoMetrics, stated that his vision is to map, in real time and on a historical basis, actual developments in economic supply and demand around the world … Borgerson built a firm employing physicists, software engineers and mathematicians including those with PhDs, that manages a database of hundreds of billions of historical shipping records and carries out trillions of calculations on hundreds of computer servers.

Operators

There are several different types of companies that have entered the game of data trawling. Planet Labs, a San Francisco-based company founded by three former National Aeronautics and Space Administration scientists, builds satellites and launches them, using companies such as SpaceX. Its constellation of 12 tiny satellites, each the size of a shoe box, is able to produce much more frequent images of sensitive economic spots worldwide, such as farmland and parking lots, than larger satellites could previously do.

It has entered into an arrangement to provide images to Orbital Insight, a firm based in Palo Alto, California that analyses these satellite images in order to supply investment ideas. If Planet Labs succeeds in increasing the number of its orbital satellites to 40 in 2017, it will have daily access to images of every bit of land on the planet.
At the analytical stage, machine-learning techniques are coming into play to extract value. Descartes Labs, founded by several former scientists at Los Alamos National Laboratory, focuses on agriculture. On 9 August 2016 the company issued its US corn production projection for 2016 based on analysis of one petabyte (one million gigabytes) of image data processed through 30,000 computers.

The Orbital Insight-Planet Labs axis has visions of shedding light on less transparent economies, such as that of China, where government statistics are widely considered to be unreliable.

Some hedge funds have their own in-house analytical teams to spot value. WorldQuant, a quantitative hedge fund in Connecticut, analyses hundreds of data sets every year to identify value, using its staff of scientists and mathematicians to try to predict company revenues and other market-sensitive information.

Not all investors can afford to have their own teams, and the analytics specialists such as Orbital Insight and Descartes Labs make it feasible for other investors to tap into these sources of data. Quandl, based in Toronto, makes available a platform combining traditional market data with several sources of alternative data. This company has agreed to find out the car types covered for insurance every day from a large insurance company, as this information is regarded as a possible indicator of auto manufacturers’ sales. Such practices are widespread, whereby information on various companies is obtained by analysing other companies that are linked in some way.

In another deal, Quandl gets information from a company that reviews construction permits by municipal offices, a proxy for construction activity. The aim is to supplement the Government’s not very frequent updates. Obtaining information indirectly is also believed to be helpful in giving investors insights into the revenues at well-known companies such as Uber and Airbnb.

A mundane but unorthodox method of data gathering is carried out by Erik Haines, Head of Data and Analytics at New York-based Guidepoint Global. He travels worldwide to fish for data of use to hedge fund clients. A favoured strategy is to attend conferences such as the Association for Healthcare Resource & Materials Management Conference in San Diego, and the National Industrial Transportation League event in New Orleans. At these conferences, he talks to companies in order to find out who might be collecting data that sheds unique light within an industry.

**Corporate performance**

New data techniques are introducing additional perspectives on corporate performance. Traditional financial statements are infrequent, and represent a rear-view mirror approach, giving no indication of current performance. But a few dozen firms, mainly in the US, are now finding alternative data from new types of sources. The growth of low-cost satellites and machine-learning in combination allows the cheap analysis of millions of satellite images a day. For example, photos of car parks outside companies such as Walmart provide an idea of daily revenues.

These alternative data methodologies are particularly useful in the case of private companies, such as unicorns that have not been quoted yet. For instance, Second Measure collects data from credit card transactions and claims that it can show how many subscribers Netflix had in any month or Uber’s performance relative to a rival, Lyft’s.

Despite a lot of scepticism, there have already been successes vindicating these huge expenditures. In early 2016, Jeff Glueck, Head of Foursquare, the company providing recommendations on restaurants and other outlets, used his company’s foot traffic data to predict that sales at Chipotle would decrease by 30%. The share price accordingly fell by 6% when the news was reported. In another example, Haines discovered a mobile advertising company that collected data on the type of device being used when an advert was being displayed to anybody. This data allowed estimation of iPhone sales ahead of Apple’s 2011 and 2012 announcements. The result was lucrative for Haines’s old company, Quanton Data.

**Editor’s comment**

There are several stages, just as in a food supply chain, comprising the extraction of raw data, then the analysis for the derivation of special insights and finally reaching the end-investor who tries to make some money. The most telling statistic about the value of this data is that many enterprising investors are putting their money where their mouth is, by shelling out millions of dollars on an ongoing basis on data expenditure.

The new data techniques throwing light on the opaque emerging market economies such as China are of inestimable value. Particularly since whatever their short-term problems, emerging markets are destined to remain of deep interest to global investors.

From the perspective of the investment community as a whole, there are limitations to the value of alternative data. Undoubtedly, short-term traders such as hedge funds are making a killing, but for long-term investors the value is less, as all this data mining can only spot immediate changes that may not be a part of an underlying lasting trend.

This is not to say that all these creative techniques are of no use to mainstream managers. Even when investing for the longer term they need to take care not to overpay in the short term. But there are more constraints on what they can and should pay for the research, given that there is no immediate profit, unlike in the case of hedge funds. It may be different in the longer term should costs come down and usage and volume produce economies of scales. It could then revolutionise mainstream investment research.

It is interesting that the data hunting techniques outlined all arise from highly creative micro level initiatives of talented and visionary individuals with a strong entrepreneurial mindset. In contrast, the idea of big data conjures up crunching vast volumes of data at a macro level. Perhaps focused micro-based new data might be a better description of the revolutionary information gathering that is occurring.


‘Tiny satellites: how hedge funds are keeping an eye on data’, Bradley Hope, Financial News, 22.08.2016

‘Brave new worlds’, The Economist, 27.08.2016


This is the first of two related articles. Please see the next one on ‘New tools making a difference in financial markets’.
NEW TOOLS MAKING A DIFFERENCE IN FINANCIAL MARKETS

Editor’s introduction

High profile organisations including Facebook, the Organisation for Economic Co-operation and Development (OECD), the World Bank, AXA Investment Managers, various governments and the Securities and Exchange Commission (SEC) are creating new data methodologies that are likely to impact significantly the workings of financial market participants.

Converting news into money

The giant French investment house AXA is taking the monitoring of news to a new level in endeavouring to predict market movements and analyse the performance of companies. Jeremy Baskin, CEO of AXA Rosenberg, AXA’s quantitative investment division, stated that he had considered this move previously. But now the lower costs and ready availability of natural language analytics and technology make it more effective. He pointed out that AXA had already been examining data from credit cards and transactions and is now hoping to start on news items.

AXA has begun discussions with a data analytics firm based in California and is testing a system designed to monitor news releases. In the past, mainstream fund houses had lagged behind banks
Some quant managers remain dubious. Matthew Stemp, Head of Client Relations at Berenberg Bank, questioned the value of big data tools by saying that they merely track events without analysing the underlying reasons.

‘AXA tracks news to beat the market’, Aliya Ram, Financial Times, 08.08.2016

Facebook, World Bank and OECD helping to enhance economic forecasting

The World Bank and the OECD are partnering with Facebook to develop a new approach for monitoring the global economy. In late September, the three organisations announced a pioneering method of collecting data, and established a new measure to assess the sentiment of small and midsize businesses worldwide.

The process is based on the Future of Business Survey which gathers opinions from companies that use Facebook pages to connect with customers. This survey has been tested since February 2016, and has received responses to 15 queries from a total of 90,000 enterprises. The first public release of the survey shows that these businesses are more optimistic than other companies approached through more traditional routes.

The real intention of the three groups is to analyse the factors influencing small business growth. Hitherto, this process has taken many months, requiring face-to-face interviews, and could be updated only infrequently. According to Augusto Lopez-Claros, Director of the Global Indicators Group at the World Bank, this method is a potentially powerful tool for obtaining information quickly and much more cheaply than previously. While quick up-to-date information on very small businesses is not easy to produce in developed countries, the situation is even worse in developing ones. So this new process could make it more possible to get an accurate picture of what is happening. This might also allow some smaller emerging countries to avoid the necessity of enlarging their statistics departments. Even more usefully, it could assist in identifying obstacles to the expansion of small businesses, thus fostering economic growth.


Radical government improvements from machine learning

All arms of government decision-making are on a path to undergoing massive improvements through the AI technique of machine learning. The new approach derives predictive insights from unexpected sources of data. The raw material comprises developments at a granular level of the economy. Hitherto, it has been too cumbersome to gather this information and form conclusions in a timely way. However, machine learning that can compress vast amounts of big data and spot patterns makes a difference. For instance, restaurant hygiene management in Boston is benefiting from this approach. The system identifies factors, some quite obscure, that can point to hygiene dangers. Once the machine program is trained, the risk that a restaurant is dirty can be easily assessed.

The Boston Mayor’s Office has embarked on a trial to test this technique, using data from restaurant reviews. The result has been a 25% rise in the number of hygiene violations spotted. The methodology is coming into wider use in the state sector worldwide. An algorithm to predict who might become homeless is under development in London local government, while Microsoft is helping the Indian schools to identify students who are more likely to drop out.

The World Bank and the OECD are partnering with Facebook to develop a new approach for monitoring the global economy

This technique is seen as having the potential to provide government services earlier and target them better, across all sectors of government including the judiciary. It is pointed out that, with the same number of judges, crime could be reduced by 20%. Without this technique an extra 2,000 police officers would be required.

There are issues to do with the transparency of government decision-making as a result. Some complain that decision-making can become more of the tick-box type without any explanations. But, on the other hand, excessive transparency could be damaging. For instance, if it is revealed that five-star reviews assure less inspection, then restaurant owners could be tempted to fake them. But, overall, if this approach becomes widespread, government decision-making could be revolutionised.

‘Data analytics – the power of learning’, The Economist, 20.08.2016

Tech giants teaming up with regulator threaten Wall Street

Amazon and Google are seeking to assist the SEC to establish the storage of a massive pool of data that might help the regulator with tasks such as analysing what went wrong in flash crashes, including the one on 6 May 2010, when US stocks lost and gained up to $1tn within a few minutes. The idea is to learn how to prevent such crises in the future.

If either or both of the two internet giants end up working with the SEC, they will be more trusted within the US Government and consequently become a serious threat to the banks by making one of the biggest invasions into the financial industry. Jo Ann Barefoot, a former official at the Office of the Comptroller of the Currency and currently teaching financial technology at Harvard University, feels that the tech giants will present a formidable danger to the incumbents.

The SEC is asking exchanges to help establish a massive database of stocks
and options trading data in a system referred to as the consolidated audit trail (CAT). The SEC does have access to trading data, but aggregating it is labour-intensive and time-consuming, according to Stephen Luparello, Director of the SEC’s Division of Trading and Markets. Often the data has to be put together from different systems run by the exchanges and the Financial Industry Regulatory Authority (FINRA).

With CAT, regulators could see data from a day’s orders by noon on the following day. Luparello states that the initial phase is expected to be in place by end-2017.

Fidelity National Information Services has combined with Google to bid for the CAT contract. Amazon is joining FINRA on another bid and has already been used by the regulator to migrate 90% of its data.

There is concern about the security of the data which could include the names and addresses of many millions of customers. The Securities Industry and Financial Markets Association, representing the biggest broker-dealers, has made a lobbying effort about the potential costs. The Investment Company Institute, the trade body for fund managers, has also expressed its worries by saying that cyber criminals and others might be able to access the data to the detriment of funds and their shareholders.

According to Steven Randich, FINRA’s Chief Information Officer, Wall Street companies have been asking for information on how FINRA outsources its data. He says that the move cuts costs while bolstering security, and the resistance to the new system is decreasing.

‘Fintech – putting the market’s history in the cloud,’ Benjamin Bain and Elizabeth Dexheimer, Bloomberg Businessweek, 12.09.2016

Machine learning or artificial intelligence

The term AI conjures up visions of computers having superior intelligence or at least equalising human beings. This is a far-fetched notion, as analysed by Dr Ewan Kirk, CIO of Cantab Capital Partners, a London-based multi-billion-dollar asset manager. He points out that the reality is much more prosaic. Admittedly, AI has had spectacular successes, as with the board game Go in 2016. These successes have always occurred in dealing with problems with specialised features, and AI is designed on the basis of a well-defined goal such as ‘win the game’ or ‘supply Netflix users with films they will probably like’.

The Investment Company Institute … has expressed its worries, by saying that cyber criminals and others might be able to access the data

In finance, the problem is very different. The goal is often more complex and, between the extremes of 100% in cash and betting all on one stock, there is a huge number of conflicting and complicated restrictions and targets. Furthermore, randomness dominates finance, unlike in Go where there is just one opponent with one move at a time. In finance, 30 currencies, 50 commodities, 10,000 stocks and 2,000 bonds with all their prices frequently changing present a much more formidable challenge.

Kirk claims that, when using the expression AI, people really mean machine learning, which is actually a workable process. He points out that even a simple moving average signal that guides investment decisions can be considered as machine learning. But in general it is much more complex. There is a vast range of techniques that can identify patterns and rules from data and update them with fresh information.


Editor’s comment

The overall methodology outlined in the above section, ‘Radical government improvements from machine learning,’ looks set to take off worldwide in the state sector. But it need not stop there. Even large companies with far-flung and complex operations, particularly at the retail level, could get early warning of potential problems and respond long before the difficulties become public, by which time remedial measures might be much more difficult or even too late.

The various techniques in the five sections above provide an interesting study in contrasts with those outlined in the previous article, ‘New data techniques generating investment insights’ on page (8), with important differences and similarities.

In both articles, the techniques are not based on a blockbuster approach to data, but involve a prior selection of the specific type of data that might lead to the objective. In the previous article, even after specifying the data, only a tiny fraction of it is used to achieve the objective of investment profits.

In this article, the five techniques are also aimed at specific data, but with two big differences. First, the objectives are much wider than making profits out of particular shares. Instead by and large, they might have a significant impact on how financial market participants, not just investment traders, do their work. Second, in most of the cases much more of the data that is examined or handled is actually used for the final objective.

But while both sets of techniques have in common is that they are targeted at micro sectors. Such intelligent and focused targeting of data looks the way to go. Interestingly, the BlackRock-Google tie-up referred to above does not seem to have yet materialised. On the other hand, Eric Schmidt, the executive chairman of Google, has actually taken the practical step of backing up a micro start-up in the data arena (see box 2).

Perhaps Google might end up owning and backing portfolios of many enterprising data start-ups and eventually find a way of connecting the dots.

This is the second of two related articles. Please see the previous one on ‘New data techniques generating investment insights’.
MiFID II RESEARCH RULES - DISPUTE AND UNCERTAINTIES

Editor’s introduction

Regulatory conflict and uncertainties still dog the new research regime demanded by the second Markets in Financial Instruments Directive (MiFID II). The most serious is the clash between the research rules applicable in the US under legislation in force over there and the new EU provisions. But even within the EU, in spite of the closeness of the deadline, there are concerns among official circles, not just in the industry, about the way MiFID will impact the workings of financial markets. Clarifications are being called for even at this late stage.

Clash between US and EU research rules

US legislation currently forbids broker-dealer banks from taking specific payments for research. But this is precisely what the new EU rules are insisting on by ruling out bundling together payments for research and execution in the cost of investment deals and instead demanding that research should be paid for separately.

The rationale for the US legislation conflicting with the MiFID rules is that broker-dealer banks taking specific payments for research could result in them being classified as investment advisors by the Securities and Exchange Commission (SEC). Such a status would restrict their ability to trade in their own right as a principal or market-maker, an issue of particular importance in fixed income markets.

European fund management firms ... need to buy research from US banks ... to obtain this research they will face the Hobson’s choice of violating either European or US rules

The EU rule is in direct opposition to the US stipulation. Investment managers need to make research payments either from their own money or from specifically identified research payment accounts funded by their clients. In either case specific payments are made for research, directly violating US requirements.

This clash puts global fund managers in a quandary. European fund management firms investing worldwide need to buy research from US banks. As the matter stands, to obtain this research they will then face the Hobson’s choice of violating either European or US rules.

Many buy-side and sell-side organisations on both sides of the Atlantic are working hard to resolve this extremely unsatisfactory situation. These include:

- the Investment Association (IA) – the trade body for fund managers in the UK
- the Association for Financial Markets in Europe (AFME)
- ICI Global – the global offshoot of the Investment Company Institute, the US trade body for fund managers
- the Securities Industry and Financial Markets Association (SIFMA) – also in the US.

These bodies intend to demand a form of ‘no-action relief’ from the SEC. The idea is to enable European fund managers to buy research from US firms while allowing both parties to meet their local regulatory obligations.

Ross Barrett at the IA stated that the IA and the AFME are together working on a specific proposal to obtain the necessary relief. He revealed that the IA is lobbying the UK’s FCA and other national regulators to liaise
with the SEC to ensure co-ordination. Barrett was worried, however, that it was not clear how the relief could be applied to the SEC legislation given the legal difficulties. Politics could also be a problem following the US election and a change of SEC Commissioners. Barrett reiterated that it is a huge problem for IA members.


Influential politician demanding clarification of MiFID confusion

A member of the European Parliament, Markus Ferber, who is one of the most influential on financial reform, has written to the EU authorities asking for resolution of fund managers’ concerns relating to research payment rules under MiFID II.

In his letter of 19 October 2016 to Valdis Dombrovskis, the EU’s Commissioner for Financial Services, cited by the Financial News, he has added his voice asking for a solution to the conflict between US and EU research regulations. More importantly, he calls attention to the problems affecting fixed income markets under the intended research rules.

In bond markets, the perceptions of research conflicts are not clear-cut and separating research payments is more complicated. Ferber wrote that many market players are finding it difficult to establish systems that reconcile effectiveness in fixed income markets with the demands of MiFID II. According to him, national authorities have not been able to solve the problem, and he, therefore, asked for guidance from either the EU or the European Securities and Markets Authority on fixed income research stipulations.

Ferber’s letter was wholeheartedly endorsed by Andrew Bowley, Head of Regulatory Response and Market Structure at Nomura, which has asked for fixed income research to be exempted from the rules. Bowley pointed out that fixed income markets work on a competitive pricing structure based on models. Banks facilitate trades for the buy-side by taking positions onto their own books and offloading them later. For this they charge a spread, the difference between the bid and ask price. Research does not have the same influence on choice of dealer or market levels as it does in equity markets.

In September, the UK’s regulator, the FCA, and its French counterpart, Autorité des Marchés Financiers (AMF), came up with updates on their methods of implementing MiFID II regarding which they have asked the industry for views. It appears that the FCA is intent on rigidly implementing the rules to fixed income research, whereas the AMF admitted to uncertainty as to how the rules should be applied to the asset class and has invited opinions.


French regulator opposes UK’s FCA rules

The French regulator AMF has taken dramatically opposite directions to the FCA in several important aspects of its implementation of MiFID II. Because this is a directive rather than a regulation, national authorities have leeway in implementation. In addition to the issue of fixed income research outlined above, the following are key highlights of the AMF’s 88-page consultation document issued on 12 September:

- The FCA bans research payments for corporate access whereby investment institutions are enabled to meet the executives of their investee companies with the help of the broker. The AMF, on the other hand, is much more tolerant when corporate access is accompanied by a service of an intellectual nature. It could be invoiced and paid for by the client through the research budget, but if the access is merely a concierge service without any substantial investment input, it could be classified as ‘minor non-monetary benefit’ under the MiFID rules and then be provided free. In either event, therefore, fund managers don’t have to pay for it themselves in contrast to the FCA’s demands.

- According to the AMF, macro research, not covering a particular issue or security but general in nature, would not be classified as research and a payment would not be required. The AMF states that, insofar as the research is widely disseminated, it might be considered that the provider has not allocated specific substantial resources to any given portfolio manager in order to produce such research. Hence, it is a minor non-monetary benefit and can be received by the investment firm free of charge.

- Sales contacts might have to be paid for. Regular business contact between brokers and asset managers might qualify as supporting an investment decision. Thus, much of the sales dialogues that takes place between brokers and their clients would have to cease unless paid for.


A member of the European Parliament … who is one of the most influential on financial reform … calls attention to the problems affecting fixed income markets under the intended research rules

Editor’s comment

Many of the leading European fund houses are global in their scope, and investing in the US is virtually compulsory for any asset manager looking to operate on a worldwide basis. So, the clash between US and European research rules need to be sorted out, as otherwise it will cause yet another disadvantage for European groups vis-à-vis their US counterparts.

Ferber is right to demand clarification of MiFID II insofar as fixed income is concerned. In fact, there is a strong case for exempting fixed income from the new research provisions, as the French regulator seems to agree. Unlike in equities, research appears to be just a byproduct thrown in free without affecting the prices at which deals are executed. Note that the rationale for the new research arrangements was that in equity deals more fees were paid to allow for research costs than warranted by execution only. It is not the case in fixed income.

The interpretation that sales contacts might have to be paid for could have a revolutionary effect on the relations between the buy-side and sell-side, putting serious constraints on sales/advice type personal contact.

This is the first of two related articles. Please see the next one on ‘Research rules leading to conflict of interests’.
RESEARCH RULES LEADING TO CONFLICT OF INTERESTS

The new research rules are supposed to reduce conflicts of interest, but in one area of equity markets they have introduced a new potentially serious conflict of interest.

A midsize French investment bank and brokerage, Natixis, has embarked on a novel approach to getting paid for its investment research, following the new rules leading to the buy-side cutting their expenditure in this direction. What Natixis is doing is charging companies for which it provides research coverage in order to report on them. The conflict is obvious, because the strong incentive is to be biased towards the company, ignoring the requirement of impartiality.

In September, Natixis analysts Jean-Jacques le Fur and Philippe Lanone issued their first report on Transgene, a French biotech company with a market value of $125m. Their note recommended that investors buy the shares, but carried a disclaimer that Natixis was paid by Transgene to produce the analysis.

On the day of the publication, the share price rose by nearly 8%, with the shares experiencing their highest trading volume since January 2016. A company paying for research itself is being described as highly tainted, though the practice has been prevalent for a long time in bond market ratings. Despite the credibility and conflict issues, brokerages the size of Natixis have little choice.

Sarah Jane Mahmud, a Bloomberg Intelligence analyst, suggests that banks might move towards a more à la carte pricing structure. For instance, they might charge flat annual fees for access to their research. But the fear is that the companies will pay only for the research houses with the best brands, and many of the smaller outfits will exit the business. On the other side of the fence, from the perspective of smaller companies, commissioning research might be the best way of getting investors’ attention.

It is not just the research rules that are causing a shrinkage in analyst cover. Even outside Europe, big banks such as Bank of America, Morgan Stanley and Citigroup are trying to extract more money from research and making it more difficult to transmit files to those who are paying clients.

In Europe, investment banks’ research efforts are being badly hit. Asset managers are planning to cut their expenditure by half on sell-side research, according to a poll of 30 global asset management companies and six investment banks. Job cuts for analysts and the closing down of entire research departments are expected. Some large fund management companies are switching to high quality independent research groups or doing more research in-house.

However, while the investment recommendation might be corrupted, frequently the value of broker research reports lies largely in the information provided. So, in an educational sense, even biased reports might be of value.

The overall reduction in bank research has other negative implications. It is not easy to tell in advance what research is good or bad, and a maverick analyst can often create a stir and a significant impact on the market in a particular share. There is a danger that the good might be thrown out along with the mediocre and the bad.

Editor’s comment

A company paying for its own research has some benefits for investors. It is not likely that a professional analyst working for a reputed house will write something deliberately biased or misleading, as the reputation of both the analyst and the brokerage would be put at risk. The bias will probably arise from sins of omission. Being paid by the company being analysed means that the analyst is apt to be less diligent in looking for negatives.

This is the second of two related articles. Please see the previous one on ‘MiFID research rules - Dispute and uncertainties’. 
NEW TYPE OF ANALYST SERVING UNCONVENTIONAL ASSET CLASSES

With more start-ups deciding against or deferring public listings, a glaring gap in research has opened up. Many investment houses are now establishing research teams to cater for this need. The type of research they carry out is very different from that needed for quoted companies.

Analysis is particularly challenging here, because the start-ups often do not publicly disclose financial metrics such as revenue or net income. Thus, traditional investment research techniques and financial analysis are impossible. Instead, the research is based more on sector-level analysis covering trends and the competition. Attention is also needed to news reports of leaked financial details.

In the non-transparent world of start-ups, the absence of traditional financial figures means that other sources have come to the fore. For instance, company filings in Delaware can reveal the share price of each financing round. Equidate, another broker in this field, has started to put this information online in readily accessible format. The idea of this new type of research is to bring more transparency to the sector, including giants such as Uber and Airbnb.

A growing number of companies are now launching research teams to analyse the pre-initial public offering (pre-IPO) start-ups. The demand for research in this area has expanded as investment has been attracted into ‘mini IPOs’, big late-stage fundraising rounds. Start-ups backed by venture capital and other sources of pre-IPO finance received investments of $60bn in 2015, double the level of three years previously, following the entry by mutual funds and asset managers. Greg Brogger, Founder of SharesPost which deals in shares in the private market, points out that these same companies would have in prior years raised money through the IPO route at an earlier stage in their life rather than resorting to pre-IPO finance.

SharesPost has launched a new division catering to this type of research. Other private market brokers include Scenic Advisement. The latter has appointed Peter Christiansen, a former BlackRock director, to mastermind its research in this area.

Editor’s comment

Many of these start-ups have little or no profits and are being backed for their potential. In this connection analysis of past data can be much less important than assessing the growth prospects of the company. This is always a difficult exercise even for established quoted companies, underlining the heavy risk that pre-IPO companies pose, given the paucity of information.

WIDESPREAD ASIAN EQUITY ACCOUNTING MISDEEDS EXPOSED

A wide swathe of companies across Asia, embracing Japan, Hong Kong, mainland China and Taiwan, some of them very large, are being attacked for poor accounting and valuation practices that are misleading investors. For instance, Yuki Arai has, through his firm Well Investments Research, publicly criticised the accounting or valuation of three Japanese companies, including the trading group Marubeni Corporation.

It is difficult and costly for activist campaigns to persuade local shareholders to insist on reforms, given their close ties to the families having major share holdings or the governments.

Arai was inspired by a public research report that identified alleged accounting problems at Noble Group, a big Asian commodities house listed in Singapore. As early as five years ago, questionable accounting and stock valuations were highlighted. Muddy Waters Research had made a successful attack on the Chinese timber company Sino-Forest Corporation.

Now such reports amounting to short selling recommendations are widespread throughout Asia.

Eight short selling campaigns through these reports were targeted against Japanese companies in the period 1 January 2016 to 24 October 2016, the highest ever recorded by Activist Insight. 13 similar campaigns have been aimed at Hong Kong groups since January 2015.

Following Arai’s December 2015 report, Marubeni’s share price has fallen by 16%. These short selling reports are believed to be more effective in Asia than traditional Western style shareholder activism. It is difficult and costly for activist campaigns to persuade local shareholders to insist on reforms, given their close ties to the families having major share holdings or the governments.

Organisations such as Well Investments Research sell their short selling reports to hedge funds. But other groups, including Glaucus Research Group, use their own cash to short the stocks.

These short selling campaigns are not popular with regulators. For instance, in Hong Kong many stocks cannot be sold short and the list of short positions that have to be reported is due to be expanded in March 2017. At a Hong Kong tribunal in October, Andrew Left of Citron Research who made this name in shorting Valeant, the drug company, was banned from trading in Hong Kong for five years for spreading false information about Chinese property developer, China Evergrande Group. In 2015, Glaucus was ordered to pay about $18m for having the intention to manipulate the stock price of Taipei-listed Asia Plastic Recycling Holding Limited.

Some researchers are fearful of annoying regulators, and one is considering relocating from Hong Kong, because of a growing climate of fear.

Editor’s comment

Global investors pile into emerging markets from time to time in view of their growth prospects. In doing so, they often ignore political and governance risks. Japan is a developed country and a democracy and poses much less political risk than emerging countries do. But its governance practices are just as questionable.

The above accounting problems provide a salutary reminder of the care needed in emerging country investment and the dangers of just indiscriminately backing growth prospects.

‘Short sellers shake up Asia’s clubby investing scene’, Mia Lamar and Julie Steinberg, wsj.com, 24.10.2016
Hollywood, Data Analytics, China and Sports – A Potent Investment Cocktail

The production of Hollywood films and world of professional sports seem far apart. However, the power of data analytics and Chinese entrepreneurial insights is bringing the two fields together to constitute a strong global investment theme of the future. Top international investors are already attracted.

Hollywood’s connections with data analytics and the Chinese are encapsulated in the story of a single film.

Sports worldwide, including European football, holds the promise of eventually becoming an important investment sector. The Chinese in particular have already invested large sums of money in this area (see box 1).


Top flight European football has the characteristics of a tiny but fast-growing and lucrative asset class. Not only is it interesting in its own right, but it has the potential as a holding in a global sports portfolio, a sector that could grow in importance.

Serious professional investors worldwide are attracted by the rising profitability of European soccer clubs. The Chinese, in particular, are laying out large sums of money on various facets of the European game including clubs and related activities, though their motives are mixed, not entirely commercial…

Currently, the football sector amounts to many billions, but is a far cry from the trillion-plus needed for becoming a significant asset class. Who knows how far football can take off in a much bigger way worldwide? Furthermore, this sector could be a valuable jewel for investing in a global sports portfolio.

Hollywood’s connections with data analytics and the Chinese are encapsulated in the story of a single film. Warcraft, a fantasy film based on a computer game, turned out to be a flop in the US, relatively speaking, with takings of just a little under $50m in the summer of 2016.

It proved to be a huge success in China, however, where it pulled in more than $220m.

The secret of success in China lies in the powerful techniques of data analytics. Matthew Marolda, Chief Analytics Officer of Legendary Entertainment, with its data team of 70 based in Boston, used these techniques to good effect to create the powerful ticket sales momentum in China.

While huge outlays on television occur in the US to advertise films, the approach in China is much more digital.
The multinational corporation Dalian Wanda, which bought Legendary for $3.5bn in January 2016 and is owned by China’s richest man Wang Jianlin, made a big contribution to Marolda’s achievements. Marolda explained that Legendary got advance ticket sales data because of this link. Price incentives encourage the population to buy tickets in advance. Based on these advance sales, Marolda’s team was able to focus on a database of other likely fans.

He pointed out that, while huge outlays on television occur in the US to advertise films, the approach in China is much more digital, with the costs substantially lower. According to him, the US film industry has been backward in compiling data on people who like its productions, instead basing decisions on gut instincts and surveys of viewers of pre-relief screenings. Marolda’s team, in contrast, analyses the real-time reception of film trailers, allowing it to produce new messages that could attract more ticket sales. The team has to respond rapidly to new data in the typical two-month run of a film, before and during the release, in order to exploit the short opportunity available.

In the US, Legendary has invested heavily in establishing a database blanketing the whole country, as well as analysing the population in small groups. Dozens of sources are used. It does not target individuals, but clusters them in microsegments, and it then reaches them through various channels such as social media, search engines, display advertising and television. Legendary’s ability to enhance box office sales has come to the attention of the entire entertainment industry, as well as other consumer sectors, and Marolda’s team’s services are now much sought after externally.

Bill Franks, Chief Analytics Officer at Teradata, a US-based analytics company, feels that the Hollywood studio should aim to access the huge amount of data processed by Netflix and Amazon Prime. While some in Hollywood are still slow to focus on data, investor interest in audience potential is gradually shaping attitudes.

Clearly, the Chinese are playing a pivotal role in the digitalisation of Hollywood’s marketing methodology. But this is not all there is to Chinese interest in the US film industry. Incentivised by the prospect of marrying Hollywood’s talents with the vast potential audience in China, other well-connected Chinese firms, not just Dalian Wanda, have a foot in Hollywood.

Chinese investment has taken place in almost all the major studios, including Twentieth Century Fox Film, Walt Disney, DreamWorks Animation, Imax, Paramount Pictures, Universal Studios and Warner Brothers. In addition to Wang Jianlin’s Dalian Wanda, Jack Ma, the well-known chairman of Alibaba, is reportedly interested as a purchaser of Paramount. On Hollywood’s part, these new Chinese partners are seen as the access route to what is expected to become the world’s largest entertainment market by box office sales.

The involvement of Li Ruigang, considered to be the most connected individual in Chinese media investing in Hollywood, is another strong sign of the attraction Chinese investors have for the US film industry. Li is regarded as the public face of media in China, given his strong connections with the Chinese Government and his effectiveness in the business world. He does not flaunt the deep trust that the Chinese Government reposes in him.

In 2009, Li set up China Media Capital (CMC), a specialised media investment fund with official approval. He has capitalised on his experience and received backing from both the Chinese state and foreign investors, many without any experience of China. In 2010, he obtained support from state-owned enterprises, including the investment arm of China Development Bank.

A few years later, international investors were drawn in. He established a US dollar fund with the participation of various players around the world comprising Japan’s SoftBank, WPP and Time Warner. Institutional investors also came into the fund, including Singapore’s high profile wealth fund Temasek, the Netherlands’ AlpInvest and the UK’s Partners Group.

Wang Jianlin, Jack Ma and Li Ruigang not only share interests in Hollywood entertainment, but are also backers of European football, with Li having a 13% stake in Manchester City Football Club in the UK. The dual interest in Hollywood and European football by the powerful Chinese magnates is no coincidence. The Chinese fascination with global entertainment and sports assets reflects the rising demand for leisure activities and entertainment in the world’s second largest economy.

A consequence is a gradual loosening of the state’s tight grip on the content available to the Chinese public. There is a fear of an ultimate clash between the Government and the private sector.

The big media players in China are not merely investing abroad but are competing as well as co-operating in mainland China. Furthermore, they have links with the high tech groups. Jack Ma’s Alibaba needs no further explanation. Li in particular has established ties with Tencent, one of the leading internet companies, thus combining CMC’s content and Tencent’s online channels.

While the private sector is strongly pushing ahead in entertainment and media, a consequence is a gradual loosening of the state’s tight grip on the content available to the Chinese public. There is a fear of an ultimate clash between the Government and the private sector, but individuals such as Li, with a foot in both camps, provide reassurance.

The ambition of these Chinese moguls is that the rest of the world will one day seek content from China, in addition to the current flow in the opposite direction. But this is not expected for the foreseeable future. Li points out that Hollywood has a storytelling talent, and that, although the Chinese can buy assets, they have to be patient and show humility about what they cannot yet do.

**Editor’s comment**

The Chinese tycoons have shrewdly spotted the connection between Hollywood and sports as a way of meeting the leisure entertainment...
needs of the vast Chinese multitudes. But the common ground between these two disparate sectors does not stop with China. They could also be a part of the solution to the problems that might be caused by robots (see box 2).


Editor’s comment

The anticipated robot revolution could have a consequence for more leisure, in the same way the agricultural revolution had centuries previously released people from land. Growing numbers of both professional footballers and those spending time and money watching them could be one of the answers. The same could be true of other professional sports, such as basketball in the US and cricket worldwide.

China’s support and enthusiasm might be a powerful catalyst in bringing the two entertainment sectors onto the global investment radar screen. Of the two, it is in Hollywood that Chinese ambitions are more grounded in reality.

They have two jewels to offer the glamorous US film industry. One is the massive Chinese audience. The second is China’s powerful commitment to the digital approach and data analytics which puts its population well ahead not just of the US, but also most other countries.

In sports it is different. China’s plans to be top nation by 2050 do not have credibility currently, but infusion of Chinese money and access to the Chinese public will certainly help to make sports more attractive to investors.

The fact that globally well-known institutional investors such as Temasek and Partners Group are already involved as investors alongside the Chinese tycoon Li points to the strong potential offered by Chinese interest in entertainment.

‘Film studios select movie-fan data for starring role to drive ticket sales’, Malcolm Moore, ft.com, 07.09.2016


SUSTAINABILITY PROGRESSING AS CRITERION FOR MAINSTREAM PORTFOLIO SELECTION

Editor’s introduction

Increasingly, mainstream fund managers are taking sustainability more seriously in their selection of investments but several hindrances are in the way of general adoption of the concept.

Controversy surrounding the investment performance of sustainable portfolios remains a key issue. Another debatable matter is what sustainability is exactly, as is how it can be assessed. On the positive side, fund managers are devoting more resources to the concept, and a measurement system indicates that it has now arrived in mainstream asset management.

Confusion surrounding the sustainability concept

Fund managers are being held back on sustainability, because of the excessive use of jargon and acronyms by pension funds and other asset owners, which is causing confusion as to what sustainability means. This attack is contained in a report by the Principles for Responsible Investment (PRI), an organisation backed by the United Nations representing about $60tn in assets and with the duty to promote sustainable investments.

Justin Sloggett, the author of the report and a senior manager at the PRI, said, “If you talk to investors about environmental, social and governance (ESG) generally, their eyes start to glaze over.” He went on to point out that they pay attention only when specific topics are discussed, such as climate change or cyber security, which pose tangible risks to portfolios.

Eugenia Jackson, Head of ESG Research at Allianz Global Investors, and Nick Anderson, Head of Equity Research at Henderson Global Investors, agreed, saying that the various acronyms can be difficult to follow and it is important to avoid them.

Against a background of pressure from organisations such as the PRI and the UK’s Financial Reporting Council for fund managers to invest more ethically, asset managers such as Jackson assert that specific questions about what actually affects portfolios are what is required, rather than broad terms. Sloggett reiterated that, if topics such as cyber risk and water scarcity are highlighted, investment managers will relate to them more readily and even find that they are already following ESG principles without actually realising it.

‘UN body: drop the jargon on green investment’, Andrew Pearce, Financial News, 05.09.2016

Mainstream portfolios adopting sustainability

An increasing number of leading asset management houses are integrating sustainability into their investment processes and portfolio selection. But many in the industry are not convinced yet.
A primary question is the effect on investment performance of focusing on more sustainable companies. The evidence is mixed, with studies pointing to both underperformance and outperformance as a result of a bias towards green investments.

Fund managers are being held back on sustainability, because of the excessive use of jargon and acronyms

Gbenga Ibikunle and Tom Steffen showed in the *Journal of Business Ethics* that European green mutual funds had underperformed their rivals in the years between 1991 and 2014. On the other hand, at the company level, BlackRock found that, from March 2012 to April 2016, firms that reduced their carbon emissions the most, outperformed the MSCI World Index by 4%, and those that reduced them the least, underperformed the index by almost 5%. The implication is that any portfolio based on the sustainability criterion will have benefited accordingly.

BlackRock has established a new responsible investment unit and has launched passive funds with ethical screens applied to stock selection. State Street, the third largest global asset manager, has similarly established responsible passive funds.


Ranking system encourages sustainable management

An ever-increasing number of institutions are showing an interest in sustainability. Though funds that have explicit sustainable or responsible investment mandates represent only about 2% of the fund universe, as of January 2016, nearly 1,500 firms managing in excess of $59tn have joined a global network of investors working to promote responsible investing. However, these numbers don’t say anything about actual sustainable weightings in portfolios, the statistic that really matters.

Asset managers’ commitment to sustainability is now being measured in a new service from Morningstar that is being attacked as unfair by some investors. Its sustainability (defined as commitment to ESG) scores, introduced early this year, rank funds by criteria such as labour standards, executive pay, gender diversity and carbon emissions of their portfolio companies. The research house found that one in three of the 20 largest equity portfolios in Europe have below average or low sustainability rankings.

Morningstar bases its scoring on research carried out by Sustainalytics, a leading provider of company-level ESG research and ratings. This company has 250 staff covering 4,500 companies in 14 countries. In addition, as part of its scoring, it covers more than 10,000 companies for controversial incidents that might affect its ESG ratings. Company-level ESG scores reflect the firms’ systems, practices and policies relative to ESG issues. A high company ESG score is better than a lower score. In the assessment of a portfolio by Morningstar, a high score indicates that more of the portfolio is invested in companies with a high ESG rating.

The research house found that one in three of the 20 largest equity portfolios in Europe have below average or low sustainability rankings.

The criticism from asset managers of this ranking system is on the grounds that the rankings... ignore corporate activities

The criticism from asset managers of this ranking system is on the grounds that the rankings, based as they are on underlying holdings, ignore corporate activities, such as using shareholder voting rights and engaging with companies. According to Matt Christensen, Global Head of Responsible Investment at AXA Investment Managers, even funds ranked favourably find it hard to identify what sustainability means.

The Standard & Poor’s rating agency has a parallel process that will examine the sustainability of projects financed by corporate bonds, as opposed to Morningstar’s focus on equities. FTSE Russell has also come up with a measurement system, but instead of ESG criteria the focus is narrowed to green revenues (see box). Here too, the problems of definition and subjectivity in assessment remain.


Increasing pressure on investment institutions to consider greenness is hampered by the lack of suitable data. FTSE Russell has now come up with a data model and an index series based on it, which it claims will allow indexers to measure the impact of the global transition to a green economy on their portfolios.


‘The Morningstar sustainable investing handbook’, corporate1.morningstar.com

Editor’s comment

Morningstar and Sustainalytics need to be commended for their efforts, but whether their rankings will receive universal acceptance is another matter. The criteria which they use to score ESG are highly subjective. Other players in the industry might well go by other criteria and still be considered to follow ESG principles.

Furthermore, the actual measurement of the selected criteria can also be a matter of contention. Investors could easily have differing views of how the factor should be assessed. For instance, consider gender diversity. Clearly, 100% women or zero would not be satisfactory from this perspective. What number in-between would be suitable?

This is the first of a group of related articles. Please see the next three on ‘Asia bidding to be a leading force on corporate social responsibility’, ‘Green bonds on course to become substantial asset class’ and ‘Impact investment – Asset management’s future’. Please also see editorial ‘Passive or socially responsible?’ and ‘The Trump card for sustainable investments and ESG’ in the ‘Contributions from Industry Experts’ section.
Are your staff equipped to combat the growing risk of Cyber Crime?

"Cyber is not just about technology. People matter. More often than not attackers may seek to exploit potential weaknesses in personnel, to establish a bridgehead for attacks. It is therefore essential that firms have the right arrangements in place so that all staff understand cyber risk and their responsibilities for information assurance."

- Andrew Gracie, Executive Director, Bank of England

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ASIA BIDDING TO BE LEADING FORCE ON CORPORATE SOCIAL RESPONSIBILITY

Asian companies are shifting their emphasis in corporate governance to sustainability. While the momentum comes from investors, the latter are themselves being encouraged by exchanges and regulators. According to Jamie Allen, Secretary General of the Asian Corporate Governance Association, there has been a significant change in environmental, social and governance (ESG) sustainability reporting. He pointed out that there is now much focus on ESG factors such as pollution, water scarcity and social problems.

Asia’s top exchanges are now integrating sustainability into their reporting requirements. The Singapore Exchange and Hong Kong Exchanges and Clearing have now made such reporting a ‘comply or explain’ obligation, whereas previously it was voluntary.

Increased shareholder activity is a driving force, with companies being pressured to reform. Following the UK’s example of a stewardship code demanding more active engagement by investors, the same approach is spreading in Asia, with a new code in Japan to start with, followed by Malaysia, Hong Kong and Taiwan in 2016. Singapore and Thailand are next in line.

This report identifies specific national interest reasons for policy makers to embrace ESG in the investment process

Regulation is another source of pressure. Allen states that Asia has been very top-down in being regulatory driven. Investor participation has been a long time in the coming. A study by the Principles for Responsible Investment together with two other organisations, the United Nations Environment Programme Finance Initiative and the Generation Foundation, argues that the biggest obstacle to ESG not progressing much further is that there is no clear requirement to do so. The idea of responsible investment is still nascent. This research identifies specific national interest reasons for policy makers to embrace ESG in the investment process. These include air pollution reduction, diminishing inequality and attracting international capital.

The report’s recommendations vary by country. In China, for instance, pension funds are urged to consider ESG issues and the authorities are urged to implement a stewardship code. In India and Hong Kong, national regulatory clarification is what is being asked for.

Editor’s comment

Poor corporate governance bedevils many companies in emerging markets, and Asia is no exception, as outlined in ‘Widespread Asian equity accounting misdeeds exposed’ (p.18).

The authorities and exchanges in Asia pushing for more ESG are not sufficient to guarantee satisfactory implementation. Several obstacles remain. Even in the West, with its much more developed corporate governance standards and enforcement procedures, many companies and investment managers are believed to be paying only lip service to and not really adopting the practices needed. This problem could be more acute in emerging markets with lower governance standards.

Burgeoning Asian populations achieving higher living standards is set to become a major source of pollution. It is encouraging, therefore, that increased environmental standards are being demanded across the continent.

‘ESG to the fore in Asia corporate governance’, Chris Wright, Euromoney, September 2016

This is the second of a group of related articles. Please see the previous one on ‘Sustainability progressing as criterion for mainstream portfolio selection’ and the next two on ‘Green bonds on course to become substantial asset class’ and ‘Impact investment – asset management’s future’. Please also see editorial ‘Passive or socially responsible?’ and ‘The Trump card for sustainable investments and ESG’ in the ‘Contributions from Industry Experts’ section.
GREEN BONDS ON COURSE TO BECOME SUBSTANTIAL ASSET CLASS

Green bond issuance is accelerating, but their growth could be stunted unless market and institutional obstacles are removed.

In the first six months of 2016, $42bn of bonds was issued globally, already exceeding the $41.8bn figure for the whole of 2015, according to the Climate Bonds Initiative (CBI). This acceleration is partly attributable to China, where $12bn of issuance occurred in the six months to 30 June 2016. An important impetus in December 2015 came from the People's Bank of China, which released guidelines for green bonds, including criteria for classifying projects as green.

The G20 boost has helped. Since the Paris Climate Change Agreement in December 2015, the green bond market has seen strong growth. The Standard & Poor's rating agency considers green bonds to be the most prolific of green finance instruments.

Since the World Bank issued the first green bond paper in 2008, the market has exploded, and it now stands at roughly $135bn, according to the rating agency Moody's Investors Service. Though still tiny relative to the $150tn fixed income market as a whole, its rate of growth has been spectacular.

The sector is now broadening geographically, as well as by issuer type. The advent of issuers from large emerging markets such as China and India is a powerful force. Chinese banks have hastened to launch their own bonds, with the country accounting for a third of issuance in 2016. The French Government could become the first at sovereign level to launch green bonds, with an issue planned for 2017.

Asset managers are now beginning to consider the sector as an asset class in its own right and not just a subsector of mainstream bond markets. In April, AP2 of Sweden announced the creation of a stand-alone portfolio. In France, Ircantec, the €9.2bn public sector pension scheme, has decided to launch a dedicated green bond fund. By July 2016, it already had €300m in its general bond portfolio.

Substantial standardisation

Though the market is currently growing at a breakneck pace, substantial challenges remain. Market and institutional obstacles are constraints on development, but if these are addressed, the potential for scaling up is significant, according to a study by the G20 Green Finance Study Group. This group was established in December 2015 and it is co-chaired by China and the UK.

The big problem still lies in identifying what green bonds are, and many feel that a standard definition is needed. Different national authorities, such as those in Mexico, India and China, are establishing their own standards regarding what is defined as green in bonds. Moody's has also initiated its own process. Its Green Bond Assessment, launched in March 2016, scores bonds at the issuer's request, based on five key factors: organisation; use of proceeds; management of proceeds; ongoing reporting and disclosure.

However, there is serious opposition to defining green bonds too tightly. Isabelle Laurent, Deputy Treasurer and Head of Funding at the European Bank for Reconstruction and Development, a green bond issuer, is concerned that measures in this direction could go too far. She is particularly worried about governments such as China's supervising the process, and is of the strong opinion that it is a mistake to label bonds as either green or non-green.

With demand for green bonds outstripping supply, she fears strict standards and regulation discouraging issuers. While asserting that it should be about transparency and not about increased standards, she is in favour of the broad use of voluntary standards, as set out in the Green Bond Principles drafted by Bank of America Merrill Lynch, Citigroup, Crédit Agricole Corporate and Investment Bank and JPMorgan Chase & Co, and updated each year by the Zurich-based International Capital Market Association (see boxes 1 and 2).


The CBI has its own concept of ‘green’. It wants a single standard, but accepts that it is currently difficult to impose one. Its CEO, Sean Kidney, pointed out that issuers need to be clear about the definition they use, so that investors have a clear reference point to check against. The voluntary Green Bond Principles support certification of these bonds against fully developed and vetted standards. The importance of avoiding any ‘downgrading’ of a green bond is emphasised.
A consortium of leading banks, including Bank of America Merrill Lynch, Citigroup, Crédit Agricole Corporate and Investment Bank and JPMorgan Chase & Co, have published a set of voluntary guidelines for issuers, referred to as the Green Bond Principles. The goal of the principles is to encourage transparency in the projects financed by the bonds, rather than defining rigidly what exactly green is. This will allow investors to judge for themselves whether the bond issuer has delivered on its promise to implement a green project.

Asset managers are now beginning to consider the sector as an asset class in its own right and just a subsector of mainstream bond markets ... Though the market is currently growing at a breakneck pace, substantial challenges remain.

Editor’s comment
Currently, defining green bonds strictly is definitely not a priority, given the sector’s small size relative to mainstream bond markets. But should this nascent asset class grow to a significant level, investors could demand definitions and criteria. Otherwise growth could be stunted. In August, in recognition of this proclivity of the rich, the well-established UK wealth management group Rathbones entered into a partnership with Access, the Foundation for Social Investment, which was given £60m by the UK’s Cabinet Office to do social good.

IMPACT INVESTMENT – ASSET MANAGEMENT’S FUTURE
Undoubtedly, social and political pressures are pushing the corporate sector to do much more in doing good and avoiding the bad in the world. Impact investment caters to the former and, by and large, its cousin, environmental, social and governance (ESG), deals with the latter. Both aim at society’s good and are now fast becoming absorbed into mainstream asset management.

Catching on with the wealthy
Traditional asset managers have, in recent years at least, been backward in recognising the future until it stares them in the face. Family offices have become a different breed, more forward-looking and long-term-orientated, and the way they are moving is telling. About 32% of 242 family offices are now active in impact investing, with an additional 30% saying that they are planning to go the same way, according to UBS’s Global Family Office Report for 2016, issued in September. Almost half of these offices feel that impact investing is a better route to social good than philanthropy.

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Variety of impact – sustainability, social, social impact
Impact investment remains a broad concept, but some subsectors with specific aims are now identifiable, sparking off discussion about the relative merits of four particular types: sustainability bonds, social bonds, social impact bonds and green bonds.

Social bonds are clear-cut. The proceeds of these on issuance are destined...
for projects with a social impact. Sustainability bonds, on the other hand, allow the issuers to use the money for environmental and social projects, a mix of green bonds and social bonds.

In May 2016, Starbucks raised $500m in a sustainability bond to finance sustainable coffee supply chain management. In June, New York City Housing Development Corporation launched $590m of sustainable neighbourhood bonds, allowing investors to invest directly in socially beneficial projects.

Navindu Katugampola, Head of Green and Sustainability Bond Origination at Morgan Stanley, has said that the flexibility of sustainable bonds is likely to produce a larger market. In contrast, social bonds allow for a broader range of projects. He points to Starbucks, which initially planned to launch a green bond but decided that a sustainable bond made more sense, as some of the money was being used for financing farmers.

Social impact bonds are similar to social bonds except that the return on them is linked to a specific outcome (see box 1).

Benefit corporations

Michele Giddens, co-founder of Bridges Ventures which oversees £1bn of assets on behalf of philanthropic institutions, pension funds and wealthy individuals, warns the UK Government to provide more support for B Corporations, organisations that aim to benefit society as well as to make money (see boxes 2 and 3).


Andrew Kassoy, formerly at Michael Dell’s $12bn family office, co-founded the non-profit B Lab four years ago, which created the B Corporation certification. In the US there are now over 400 privately owned B Corporations, with revenues totalling almost $2bn per annum. Already, the universe of B Corporation investors includes venture capital investors such as Generation Investment Management, which has high return expectations.


The benefit corporation. This is a class of corporation that is required by law to create a social benefit while profiting its shareholders. It has to create a positive material impact on society, and to assess how its decisions affect its various stakeholders, the community and the environment. Its social and environmental performance needs to be publicly reported, using established third party measures. The entity lies between for-profit and non-profit organisations. More than ten US states have passed the necessary legislation since 2010. B Lab, a non-profit organisation, evaluates these companies and certifies those that meet the specified standards as ‘B Corps’.

In the US, the ice cream maker Ben & Jerry’s and the crowdfunding platform Kickstarter have received the B Corporation accreditation. There are now 1,000 certified B Corporations in 33 countries. B Lab says that 69 have been set up in the UK since it became legally possible in 2015. But Giddens feels that the Government cannot simply rely on B Corporations and other impact investors and that, rather than privatisation to purely commercial organisations, it needs to outsource key services to socially conscious groups, such as these corporations.

Should impact investing and ESG take off in a big way, a conundrum will arise concerning passive investment

Editor’s comment

The problems with both impact investment and ESG are that most of the terms are not clearly defined, and that whether or not any particular investment satisfies either concept remains fuzzy, a situation unlikely to improve in the foreseeable future. But, at some point, clearer metrics will come into play and the pressure on the asset management industry to go in these directions will intensify, whether they like it or not.

Should impact investing and ESG take off in a big way, a conundrum will arise concerning passive investment. Passive has come into being because active is considered not to add value. But the comparison derives from benchmarks that ignore investments motivated by social needs. If a large proportion of the active industry moves to impact investing, then comparing their performance with movements in traditional indices will be an apples-versus-oranges exercise.


‘Are sustainability bonds better than green?’, Helen Avery, Euromoney, September 2016

‘People demand more now of businesses’, Madison Marriage, FTfm, 10.10.2016

This is the fourth of a group of related articles. Please see the previous three on ‘Sustainability progressing as criterion for mainstream portfolio selection’, ‘Asia bidding to be leading force on corporate social responsibility’ and ‘Green bonds on course to become substantial asset class’. Please also see editorial ‘Passive or socially responsible?’ and ‘The Trump card for sustainable investments and ESG’ in the ‘Contributions from Industry Experts’ section.
PRIVATE EQUITY
SHIFTING TO A LONG-TERM ORIENTATION

A shift has begun in buyout firms’ investment horizons to a much longer time frame from the typical seven years. Recently, a number of buyout firms have been setting up funds to mature after up to 20 years. Blackstone, Carlyle and CVC Capital Partners, three of the largest firms in the private equity field, are now making available funds that will mature in 14 years or more. Significantly, they are also content with lower returns of 12–15%, even 10% compared with the typical 20% of the traditional type. Their fees are also substantially lower, at 1% per annum, compared with the more usual 2% before.

Blackstone’s longer-term fund is still open to new money after reaching $5bn. CVC Capital Partners, the largest buyout firm in Europe, closed its new 14-year fund to investors in the first quarter of 2016, having reached $4.4bn, and has a target of annual returns of only 12–14%. It has stakes in Moto, a UK motorway services network, and RAC, the roadside recovery firm. It is also considering investments in insurance, property, infrastructure and family-owned companies in the process of transition or expansion.

Carlyle has already committed about $1bn of equity to four companies, including a provider of corporate and private aircraft financing and an operator of specialist German hospitals. It has received $3.6bn for its first long-dated fund, and signals that many players in the buyout field are having to rethink old structures and allow themselves more time to achieve the lower returns that they are now targeting.

The main motivation for this shift appears to be pressure from long-term-orientated institutional funds, such as pension schemes or insurers, which have no requirement to get their money back soon. Neither do they want the hassle of finding another manager. According to a recent Preqin survey, more than 50% of institutional investors are planning to increase allocations to longer-term private equity, and the long-term funds are expected to garner a substantial share of the inflows. Sovereign wealth funds which have the capability to invest for indefinite periods are very comfortable with the increased illiquidity attached to these longer-term vehicles. So are endowments. The investors are keen on finding assets that can produce decent returns while interest rates are at low levels.

Jason Freedman, at the law firm Ropes & Gray, points out that, whereas one or two decades ago the buyout funds were much more standardised in their approach, this massive growth has meant that investors now want more bespoke funds, ranging from emphasis on specific sectors to a focus on particular geographical areas. He suggests that specifying longer time frames is a natural evolution.

There are, however, problems in the long-term shift. Ludovic Phalippou, of Oxford University’s Said Business School, worries that fee and incentive structures can be trickier. The charges are typically fixed for the lifetime of a fund at the outset, which may be initially suitable
but turn out to be much less satisfactory over a period of 20 years. Also, while low fees are clearly attractive to investors, they may not give the private equity firms enough incentive to manage the investments with due care. Furthermore, when the time horizon is shorter, new managers are usually attracted by the prospect of lucrative bonuses when investment is sold. Having to wait 20 years for the payoff might sharply reduce the incentive effect.

More than 50% of institutional investors are planning to increase allocations to longer term private equity

Conflicts of interest are another danger. The fear has been expressed that large private equity groups might keep the best companies for their short-term funds and pass on only the mediocre to the longer-term ones.

The problems are countered by smaller specialists in the long-term field, such as Altas Partners, which raised $1bn for its first fund in the spring of 2016. Andrew Sheiner, Altas’s founder, has announced that he intends to hold onto the investments for up to 15 years but will retain the flexibility to own each company only for as long as it makes sense. He might sell some sooner. This company claims support from investors, but also, more importantly, from the heads and owners of the companies that might be bought. Sheiner feels that many of these CEOs are weary of being passed as a parcel from one private equity firm to another.

Many others in the private equity field say that these longer-term structures will diminish the need for selling that is demanded by too short a time horizon, and that longer time horizons will reduce the number of transfers of portfolio companies between different private equity groups.

The Economist magazine says that the longer-term private equity funds are likely to remain a niche. While $384bn was committed to private equity in 2016, the amount invested in long-term funds is much smaller, with only 5% of funds having a lifespan of more than 12 years, according to Preqin. It is suggested that the larger sophisticated investors best suited for such long-term funds can often build internal private equity teams more cheaply.

Editor’s comment

The Economist magazine, in its opinion that long-term private equity will remain a niche, is committing the common forecasting error of extrapolating from current data. A more relevant statistic is that more than half of institutional investors are planning to increase their allocations to this new corner of the buyout market, clearly indicating that the future lies with these longer-term vehicles. The fact that in 2016 only 5% went into such vehicles means very little, considering the small beginnings of high growth investment classes such as exchange-traded funds, hedge funds and green bonds.

The Economist’s suggestion that the more likely longer-term institutional investors can build their own private equity teams much more cheaply is also flawed. The amount of effort, time and resources required to build up a highly talented team cannot be underestimated.

By the standards of the many active managers who are deplorably short-term, and certainly by those of hedge funds, the typical private equity term of seven years is already long-term. But, this period is still short-term when compared with the longer-term preferences of institutional investors such as pension funds, who would be happier with ten years plus.

There is now a strong case for saying that the future of fund management lies in the provision of long-term illiquid investments as opposed to the shorter-term quoted securities markets. Warren Buffett is the archetypal long-term investor but hardly a conventional portfolio manager. Really he is more akin to a private equity group, albeit with a very long time horizon. The current shift of mainstream buyout houses towards the long-term is thus very encouraging. Private equity might well be the future of fund management provided it overcomes its widespread image for capacity and becomes more unambiguously service-oriented.


‘Private equity takes a longer view’, Mary Childs, Financial Times, 01.11.2016

This is the first of two related articles. Please see the next one on ‘Blackstone moving in Buffett’s direction.’

BLACKSTONE MOVING IN BUFFETT’S DIRECTION

Editor’s introduction

Blackstone, the largest private equity firm, is no longer purely private equity, but is undertaking a range of different activities that make it difficult to classify. What is common to all these activities is that in every one of its different guises it is bringing off remarkable successes demonstrating a diverse range of skill and expertise.

Blackstone in a hot property sector

Blackstone has agreed to purchase a 12 million square foot portfolio of logistics centres for $1.5bn from LBA Realty, a California-based company, in a signal that this e-commerce-based sector is one of the hottest property areas.

Logistics typically includes warehousing and distribution facilities for shifting goods from manufacturers to stores and customers. Demand for these centres has been lifted by online firms such as Amazon that began to promise faster delivery and wanted facilities for processing individual packages for customers, rather than just big pallets for stores. Blackstone was one of the early movers of the upturn in this sector.

Big investors have also been attracted by logistics. Singapore’s GIC and the Abu Dhabi Investment Authority have been recent buyers

Earlier, it had built up a portfolio under the label IndCor Properties through 18 acquisitions and had sold it for $8.1bn in late 2014 to Global Logistic Properties, based in Singapore and the second largest logistics owner in the US.

The above LBA Realty deal was its biggest foray into US logistics following its exit by selling IndCor Properties. Previously, it had accumulated 150 million square feet of logistics properties in Europe over recent years, which had been expected to be sold as an initial public offering (IPO). But no such plans have been announced yet.

Other big investors have also been attracted by logistics. Singapore’s GIC and the Abu Dhabi Investment Authority have been recent buyers.

Global Logistic, in which GIC is
Blackstone profits from China’s overseas shopping spree

This private equity giant has found Chinese overseas expansion very lucrative. In the past three years, Blackstone and its portfolio companies have disposed of more than $16bn of property assets to Chinese investors, according to Dealogic and The Wall Street Journal research.

The large number of deals between Blackstone and Chinese buyers came as a result of efforts by Stephen Schwarzman, Blackstone’s CEO, and Jonathan Gray, its Head of Real Estate. Over the years the duo have assiduously cultivated ties with Beijing.

Blackstone set up a Hong Kong outpost in 2007, with former Hong Kong Financial Secretary and well-connected businessman Antony Leung as chairman. Leung engineered the purchase by China’s sovereign wealth fund of £3.1bn of Blackstone stock in advance of its IPO in 2007. This episode led to some criticism, as the shares went down following the financial crisis.

Notwithstanding this setback, Schwarzman continued to build ties with China. In 2013, he funded a scholarship programme to send US students to China, with a $100m donation from his personal assets, buttressed by another $200m from a major shareholder, recently bought $1bn-plus of portfolios from Ross Perot Jr’s Hillwood.

According to Charles Sullivan, President of US Operations for Global Logistic Properties, logistics has moved up in corporate strategy importance, and the sector has proved to be resilient even as other real estate areas have been cooling.


Blackstone, which claims to be the world’s largest private equity real estate group, with $103bn in property assets, has several advantages in Chinese deals

From the perspective of the companies being sold, Chinese owners are attractive for their likely long-term commitment, in comparison with the more limited time horizon of private equity firms.

5.5bn, earlier in 2016, making a profit of about $500m, having reportedly held them for less than one year. It had also guided the sale of Waldorf Astoria, the prestigious New York hotel, to Anbang for nearly $2bn in 2014.

Hotels fit in very well with the Chinese love for travel and have been a major focus of Chinese investment abroad. At least $25bn of the almost $200bn invested abroad in the first ten months of 2016 was in hotels. There is a preference among the Chinese for hotel chains, as they need less hands-on management than industrial firms, are less politically sensitive and stand to gain from a boom in Chinese’s overseas travel.

Blackstone, which claims to be the world’s largest private equity real estate group, with $103bn in property assets, has several advantages in Chinese deals. Its willingness to do business with Chinese companies, such as Anbang with its inexperience of transacting with the West and opaque ownership, has put it in good stead.

Blackstone’s current size of $361bn assets managed by Blackstone reached a record high of $361bn. In moving towards offering longer term buyout investments, it is going to some extent in Warren Buffett’s direction, as is the case with other leading private equity firms. Blackstone’s current size of $361bn assets under management now put it within sight of the higher echelon of global fund houses. In the next decade, it could well reach the ranks of the top ten, though it would defy classification as a conventional fund management group and could perhaps be described then as Berkshire Hathaway number two.

Editor’s comment

Clearly, Blackstone is no longer a pure buyout firm. It has too many other diverse interests that do not fit in. Its property arm makes it a large real estate operator but with a difference in that it does not back the usual type of commercial property investments. As its feats in logistics and hotels demonstrate, it is somewhat savvier than the typical property company.

Some of its deals in hotels and logistics also make it look like an old style Wall Street investment bank, given the brevity of the time frames involved.

After strong third quarter results, assets managed by BlackstoneIColor: Color

FTfm, 31.10.2016


FTfm, 31.10.2016


SURPRISING PARTNERSHIP BETWEEN FUND MANAGER AND HIGH-FREQUENCY FIRM

A surprise trading link between a top fund manager and a high-frequency trader (HFT), unthinkable just a few years ago, has brought into the spotlight the trading relationships between the buy-side and sell-side. The link is signalling undergoing a radical transformation in the investment dealing landscape.

It was revealed that the leading German asset manager Union Investment was discussing the appointment of Virtu, an electronic market maker, as an agency broker in Europe. Christoph Hock, Head of Multi-Asset Trading at Union Investment, said that using electronic traders such as Virtu offers the fund manager additional access to best-in-class technology and highly sophisticated analytics. Doug Cifu, CEO of Virtu, said in early August, when releasing its second quarter earnings, that it had started to provide order routing capabilities and post-trade analysis to institutional investors in the US, and was now moving towards linking up with buy-side firms both in the US and Europe. Its link with Union Investment is considered the first of its kind in Europe, involving the partnership of a high-frequency firm and a fund manager with more than €250bn assets under management.

While this link would have caused a shock in previous years, several important changes have since occurred with more complex markets and investors focusing on better execution quality. Zar Amrolia, Co-chief executive of XTX Markets and a former senior trading executive at Deutsche Bank, points out that two driving forces are under way.

One is the banks having a huge cost base in technology that is cumbersome and lags behind that of the high-frequency firms. The second is that the latter having made a huge investment in dealing infrastructure that is much better than what the banks have, want to capitalise on it through outsourcing agreements with banks. So, Virtu is partnering not just with fund managers but also with banks, and in August entered into a three-year agreement with J.P. Morgan to help it with US treasury trading. The sell-side, for its own part, is struggling with an excessive cost base, weak trading volumes and falling commission income.

The Markets in Financial Instruments Directive (MiFID) II is also contributing to the pressures, with its demands for best execution, forcing managers to take sufficient steps to achieve this. Along with changes in research rules, the pressure is for more links of the above type.

Sell-side firms clearly have much to worry about over HFTs supplanting them with their fund management clients. But Union’s Hock was reassuring on this point. He said that partnerships with investment banks will continue to provide benefits, such as access to their in-house liquidity, block trading, and market structure and regulation know-how. It is suggested, in fact, that the increased competition will act as a spur to the bank-based brokerages set on continuing with the execution business to get their act together.

Investment banks themselves see the high-frequency firms not just as competitors but also as potential partners, along the lines of the J. P. Morgan-Virtu deal. A senior executive at a global bank said that, in order to survive in the business across all asset classes, a low-level infrastructure is essential, and that companies like Virtu can help here.

It is suggested the partnerships between HFTs and banks will draw out what each party is good at. Banks, according to Amrolia, might want to cherry-pick what they do themselves and what is outsourced. In the latter case, they could connect with different firms for pricing, market connectivity and other functions. Amrolia
emphasises that the banks have the credibility, trust, financing, clearing and transaction-processing expertise. They will focus on these core areas of their added value and partner with specialists only in the highly commoditised fields.

Editor’s comment

A few years ago, high-frequency trading was a source of concern on the part of large numbers in fund management. Union's link with the high-frequency firm is a clear indication that many among investment managers see their benefits.

However, this is not to say that accusations of unfairness have disappeared (see box).

Extract from ‘Speed bumps curbing high-frequency traders’, Investment Management Review, October 2016

Share trades have been executed at a large number of venues, including 13 exchanges where orders are public, more than 40 dark pools, where orders are not public, and many broker-dealers. It is feared by leading asset managers that this fragmented system allows high-frequency traders to jump in ahead of them, taking advantage of their order information. IEX claims that its innovation will protect investment firms, including mutual funds, from unfair and abusive HFT strategies.

Editor’s comment

The approval of the speed bump system signifies a departure, in that there is official recognition of the speed bump possibly doing good, thereby implicitly acknowledging the possibility of HFT causing some harm.

Overall, it seems that many HFTs have a positive impact on the dealing process, but some are prone to abusing it. This situation is not unique to high-frequency trading. It is also true of other sectors such as private equity and hedge funds.


FUND MANAGERS GAINING FROM NEW LIBOR TURMOIL

The London interbank offered rate (LIBOR – see box) is bidding to become once again a source of pressure in the banking system, after the upheavals in this rate in the early years of the financial crisis and the rigging scandals that followed it. LIBOR, the rate at which banks lend to each other, has been rising sharply though the official rate remains low, causing much concern.

This time, it is neither a financial crisis nor bank shenanigans that are causing the problem. It is a new Securities and Exchange Commission (SEC) rule affecting money market mutual funds. This rule came into effect on 14 October. From that date, prime money market funds (MMFs) had to let their net asset values (NAVs) vary with the underlying assets, rather than fix them at $1 per share and thus guaranteeing this figure to investors whether coming in or withdrawing.

Overall, the new rule is producing a small tempest in financial markets.

LIBOR

LIBOR is the average interest rate at which a selection of banks on the London money market are prepared to lend to one another. LIBOR is quoted in seven maturities (from overnight to 12 months) and in five different currencies.

For instance, the three-month dollar LIBOR rate is the rate applicable to loans in dollars of three months’ duration.

LIBOR is monitored closely worldwide as it is used as a base rate (benchmark) by banks and other financial institutions. Rises and falls in the LIBOR interest rates can therefore have consequences for the interest rates on all sorts of banking products, such as savings accounts and mortgages.

Prior to the 2008 crisis, investors in MMFs that made very short-term
loans to banks’ corporates and the government had been used to considering their holdings as bank deposits, with the ability to put money in and withdraw it as needed.

The regulation stipulates that MMFs, excepting those that invest only in government securities, will have to float their NAV. Furthermore, they may have to establish rules that prevent investors from pulling out too much money at one go as an alternative to introducing redemption fees. The reform is intended to stop the funds ‘breaking the buck,’ a popular term for failing to meet the obligation allowing investors to get their money back at the fixed amount of $1.

The new rule is causing a small tempest in financial markets …The last time LIBOR was a source of anxiety was during the financial crisis of 2008, when it represented a serious gauge of fear

LIBOR, the traditional benchmark, is used to set interest rates for loans with a value of many trillions of dollars worldwide. Increases in it reflect either stresses in bank funding or Fed policy with regard to rises in interest rates. In 2016, the Fed’s interest rate policy had nothing to do with rising LIBOR. It is the new rule on MMFs that is the problem.

The last time LIBOR was a source of anxiety was during the financial crisis of 2008, when it represented a serious gauge of fear. Though there is no panic this time, it has been climbing steadily, and on 22 August 2016 the three-month dollar LIBOR increased to over 0.82%, a seven-year high and 0.2% higher than in June.

Matters changed when one of the big MMFs, the Reserve Primary Fund, broke the buck.

LIBOR remains very important in the US system. Approximately 20% of household debt and 30% of business loans, comprising $28tn, are linked to LIBOR.

On the face of it, a rise in LIBOR could have been regarded as a boom for banks, whose margins are squeezed by the low-interest-rate regime, and a general rise in interest rates could have been seen as beneficial. But not in this case. A higher LIBOR could, by pushing up banks’ short-term funding costs, cause additional strains. In July and August, in anticipation of the new rule, many of the prime MMFs, those who do not invest solely in government debt and are hence exempt from the new rule, suffered from swift outflows, contributing to the problem.

The SEC has caused prime MMFs to be less attractive and the landscape of the wholesale funds market to change, in the opinion of Steve Kang, a strategist at Citigroup. Between October 2015 and July 2016, prime MMF assets fell by more than $500bn to $1.2tn, and government funds that invest in treasuries expanded to $1.6tn. This situation has pushed up borrowing costs for many types of players who used to rely on prime MMFs as a source of funds.

With hundreds of billions of dollars forced into government securities by the new rule, the supply of short-term funding to other participants such as corporations, local governments and banks has dwindled. According to the Investment Company Institute (ICI), the outflows had accelerated up to early October 2016, reaching $1tn. MMFs dedicated to government bonds had doubled in size in the first nine months of 2016 to about $2tn, whereas the prime MMF industry shrank to nearly about $583bn, compared with $1.5bn at the beginning of 2016.

Brian Reid, Chief Economist at the ICI, expects the higher LIBOR returns to eventually attract some investors back to prime MMFs, but he feels that the sector will remain a shadow of what it was for quite some time as investors prioritise safety and liquidity.

Fund managers are sniffing an opportunity in the changing landscape of short-term finance. For decades, MMFs have been a vital part of the financial global system, channelling private and corporate cash into short-term loans around the world. Bob Browne, CIO at the asset manager Northern Trust, points out that the diminished status of prime MMFs is an opportunity. The rise in short-term corporate borrowing costs, with the average yield on three-month commercial paper having jumped by a multiple of five to 85 basis points, has attracted bond funds and hedge funds. Ultra-short bond funds are among the gainers. They offer more flexibility and, according to Morningstar, there are signs of growing interest in them.

For instance, Morgan Stanley Investment Management’s very short-term fund has assets of about $600m now, having been launched at the end of April. PIMCO’s Enhanced Short Maturity Active Exchange-Traded Fund (MINT) increased its assets by 22% in late 2016 to $5bn. Now that regulation has destroyed a major part of the money market fund industry, a big opportunity is seen for short-term bond funds.

Editor’s comment

Following the damage caused by the rigging scandal early in the last financial crisis, the LIBOR benchmark has not recovered the immense universal prestige it used to enjoy. While it still remains important, it seems not to have the power to impact financial markets as it had previously.

Short-term bond funds are clearly cashing in on the reduced popularity of prime MMFs. But the logic in their popularity on this account is not clear. These short-term funds cannot offer a fixed price guarantee any more than the prime MMFs are allowed to do under the new regime. It seems to be more a matter of sentiment than logic.


‘Rising LIBOR - SECular shift’, The Economist, 27.08.2016

‘When a dollar isn’t quite a dollar’, Bloomberg Businessweek, 29.08.2016


‘Funds sniff openings in US money market industry upheaval’, Robin Wigglesworth and Joe Rennison, ft.com, 04.10.2016

‘The wrong kind of rate rise’ Euromoney, October 2016
SEC SEQUEL TO 2015 ETF FLASH CRASH

The exchange-traded fund (ETF) flash crash of 2015 created shock waves around the world, given that an asset type previously relied upon for safety was affected (see box 1). Even at that time, it was clear that a thorough review of the workings of ETF trading was called for and that the authorities needed time to investigate and consider. It is not surprising, therefore, that the Securities and Exchange Commission (SEC) has not rushed with its verdict. Reportedly, an SEC working group looked into ETFs about a year ago. Now, the regulator is believed to be getting ready for this thorough review.


A date that will probably go down in history as a black day in the exchange-traded fund (ETF) sector is 24 August 2015, when a horror story unfolded, causing retail investors massive losses. These were not for understandable market reasons, but due to weaknesses in ETF trading procedures.

The potential for retail investors’ ETFs losing massively from a future ETF debacle should not be ignored by their advisers.

The flash crash highlighted the interdependence of ETFs with the underlying stocks and futures market

The concerns are that the scale of flows into ETFs may be exacerbating financial market volatility. Currently, they represent nearly a third of all US shares traded by value, according to the investment bank Credit Suisse. The flash crash highlighted the interdependence of ETFs with the underlying stocks and futures market.

Editor’s comment

It is right that the SEC is taking its time and avoiding the plethora of hasty regulation that was the hallmark of the early years of the financial crisis, which has led to many unintended consequences and has still not created confidence in the averting of another crisis.

The mass of the retail public and their advisers have assumed that ETFs offer rock-solid safety. This may not be valid now (see box 2). It is up to the SEC, in consultation with the exchanges and traders, to come up with a solution that justifies investors’ faith.


Exchange-traded funds (ETFs) were supposed to be safe and reliable in terms of delivering what they said on the tin. Not anymore. The date of 24 August 2015 has all the hallmarks of going down as a ‘black day’ in the history of this young, fast-growing sector.

This sector may not be far behind corporate bonds, which are widely recognised as posing a systemic risk because of potential illiquidity. At least for the time being, perhaps ETFs need to carry a health warning, for investors as well as the authorities concerned about financial stability.
THREE NOVEL ETF IDEAS

While a fee-cutting war between leading exchange-traded fund (ETF) providers is underway, Jason Zweig of The Wall Street Journal has identified three innovative ideas designed to help the ordinary investor with filling the gaps in the investment choices available.

On the face of it, lower fees would seem to be attractive to investors, but this price war is not necessarily a boom to existing investors.

The first idea recognises that many members of the public are already exposed in their work to a particular industry. Therefore, it is suggested that a variation of a passive portfolio be made available that comprises the entire market except for the particular sector the individual works in. This particularly makes sense in the case of high risk sectors such as energy, technology and financials. For instance, many employees at Enron, Bear Stearns and Lehman Brothers were ruined in the financial crisis. Under these circumstances, overexposure to the industry that they work in was best avoided.

ProShares, the ETF manager launched four such funds in 2015, but these have yet to catch on with investors.

The second idea is the Whole Planet Portfolio, which would package every publicly traded stock and bond worldwide into a single fund for holding by a youngster for a lifetime. This concept could be tweaked to consist of, say, 60% stocks and 40% bonds.

The third idea is a bond instrument. Currently, a holder of a bond fund could lose money if interest rates rise, because the fund will always have bonds that are yet to mature and therefore subject to interest rate fluctuations. Elisabeth Kashner, Director of ETF Research at the investment information firm FactSet, proposes ETFs that would hold all their bonds to maturity. Investors would be assured of getting their money back, whatever happens to interest rates.

The fast-developing price war among the top ETF groups is in full swing. In late 2015, BlackRock began the battle by sharply reducing its fees on more than two dozen of its ETFs. The next in line was Fidelity, which cut average fees in June 2016 for 27 of its index mutual funds and ETFs. BlackRock produced the second round of the reductions in early October and once again Charles Schwab reported new low prices on its ETFs.

Modernisation of operations may therefore not be huge. Should the price cutting go on for very long, however, then the profitability of the companies could be slashed.

Vanguard is probably better placed than most, given that it is a mutual company without having to worry about shareholders. What is very clear is that, while the passive sector is causing massive destruction in the active industry, it is not itself immune from the downward pressure on profit margins that is a black cloud over the industry as a whole.


‘Race to the bottom: how low can fees go?’ Sarah Max, Barron’s, 17.10.2016
BLACKROCK SUES VOLKSWAGEN

BlackRock, the biggest global fund manager and the eighth largest holder of Volkswagen’s (VW’s) ordinary shares, has entered the ranks of investors suing the automotive giant (see box 1).

Top investors and fund managers are in the process of going ahead with legal action against the leading car maker Volkswagen, following the scandal that emerged in 2015 over its cheating on emission standards. The US’s Environmental Protection Agency (EPA) announced in September that the company had violated US emission tests by fitting vehicles with devices that enabled the bypassing of environmental rules.

Following the revelations, the share price of the auto company has fallen by about 40%, leading to many top investors collectively nursing billions of dollars in losses. Norway’s Oil Fund, the world’s largest sovereign wealth fund, had a 1.2% stake in the firm at the end of 2014 and was one of the worst affected.

The group is joining other investors in legal action in Lower Saxony, the home state of the German car giant. The law firm Quinn Emanuel is in the process of pursuing the case against the car maker. The other top ranking investment organisations include State Street, Norway’s Oil Fund (one of the largest sovereign wealth fund in the world), the California State Teachers’ Retirement System and the Greater Manchester Pension Fund.

Quinn Emanuel has been financed by Bentham Europe, a litigation management firm supported by the activist Elliott Management. During the summer, VW agreed to pay over $16bn in settlement against civil claims by car owners, state authorities and franchise dealers in the US for compensation. The auto group is disputing civil claims outside the US much more strenuously, asserting that the US law was unique and not applicable to other countries. For instance, it said there was no US style class action framework outside the US.

But a German court has sanctioned the lawsuits, using other legal mechanisms.

Colin McLean, the Managing Director of the UK investment boutique SVM Asset Management, pointed out that the company’s voting structure, giving some investors more votes than others, was a particular problem.

Regulators are also reviewing the situation, and criminal investigations are believed to be ongoing in both the US and Germany. The European Commission is not currently involved in potential prosecution. Nevertheless, it is working on securing compensation for car owners across the EU. But it is not finding it easy to co-ordinate action among the different countries, particularly because many individual EU states are worried about jobs and investment should VW suffer too much. For the same reason, US attorneys are trying to work out how much they can fine the auto company without putting it out of business.

By mid-September, there was a flurry of investors joining lawsuits, in the fear that a one-year statute of limitations might prevent later action, given that the original scandal broke on 18 September 2015.
Environmental, social and governance (ESG) specialists have highlighted that the VW scandal demonstrates the need for ESG precautions. Numerous organisations had warned about corporate governance issues at the group. Colin McLean, the Managing Director of the UK investment boutique SVM Asset Management, pointed out that the company’s voting structure, giving some investors more votes than others, was a particular problem. According to him, disproportionate voting rights can lead to long-term relationships that undermine governance credibility. He also noted that, while a company might claim to be compliant with ESG guidelines, in truth it may not be so, and that much better verification is needed.

The saga constitutes a landmark for asset management in several important aspects

Editor’s comment
The attitude of the US and EU authorities in trying not to put VW out of business is an interesting slant on the ‘too big to fail’ criterion adopted by regulators for very large financial institutions. Perhaps this concept needs application to all industries.

In several other respects, the VW’s situation is not just about a few investors, albeit very large ones, suing one company in an isolated case. The saga constitutes a landmark for asset management in several important aspects. BlackRock’s participation in particular suggests that legal action by asset managers might become much more standard (see box 2).

The fact that ESG warnings had been made about VW before the scandal erupted could lead to asset managers taking ESG much more seriously than they have done before, particularly in view of the saga following in the wake of the BP oil spill disaster.

'German court clears the way for investors to sue VW', Patrick McGee, Financial Times, 09.08.2016


'Movers - downs', Kyle Stock, Bloomberg Businessweek, 03.10.2016

'Lessons to learn from VW scandal', Attracta Mooney, Financial Times, 10.10.2016


Editor’s comment
The mechanisms for top investment management firms and institutional investors are well in place for pursuing legal claims against companies that breach environmental duties, particularly when cover-ups or dishonesty are involved. With climate issues set to receive increasing prominence in the years to come, such legal action might become much more frequent.
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REGULATORY SPOTLIGHT:

REMUNERATION RULES WILL NOT HAVE A STRONG IMPACT

Dr Wolfgang Mansfeld

How can regulation ensure that the fund industry offers suitable and understandable products, working for the benefit of the investor at reasonable prices?

The obvious solution seems to be to impose rules on product design and transparency. This is exactly what has happened on an extensive scale over the past decade. Regarding product design, one could point to the restrictions on the use of derivatives by retail funds. In the EU, such rules were imposed soon after the financial crisis. The US is likely to follow a similar path.

Regarding product disclosure, there have been waves of new regulatory requirements. More than a decade ago we had the ‘simplified prospectus’, which was replaced five years ago by the Key Investor Document (KID). The KID, in turn, will soon become part of an even more ambitious Packaged Retail and Insurance-based Investment Products (PRIIPs) regulation.

Despite all the rules already imposed, product regulation will remain on the agenda. Some lawmakers dream of defining suitable products by legislation. Most recently, against the background of the Capital Markets Union project, the ECON committee of the European Parliament called on the European Commission “to introduce a simple, standardised, portable and safe financial products framework.”

Doubts remain, however, about whether product-related rules are sufficient to align the fund manager’s interests with consumers’ needs. Product restrictions must not go too far, as ‘one-size-fits-all’ products hardly accommodate the different needs of investors. Regarding transparency, there is little evidence that ever more disclosure requirements would improve the quality of consumer choice or product costs and quality.

Meanwhile, regulators soon concluded that it is not enough to regulate at the product level. Therefore, the focus of regulation has shifted to rules regarding the conduct of fund managers.

Since the financial crisis, the focus has shifted to rules regarding the conduct of providers, in order to strengthen the fiduciary standards applied by the industry. Satisfactory fiduciary standards require that fund managers act in the best interests of the client when they have discretion in handling client money.

A number of detailed conduct standards and procedures have been introduced...
in recent years. These cover areas like
the composition of boards, risk and
liquidity management, the valuation
of financial instruments and best
execution. Some regulators seem to go
even further. The UK FCA, for example,
has started a comprehensive review
into value, competition and efficiency
in the asset management sector.1

Some lawmakers dream of defining suitable
products by legislation

The latest set of conduct standards
targets the remuneration of fund
managers. In the EU, the Undertakings
for Collective Investment in Transferable
Securities (UCITS) and alternative
investment funds (AIFs) have both
introduced a legislation framework
for such standards. The legislation has
recently been completed by guidelines
released by the European Securities
and Markets Authority (ESMA), the
European financial markets regulator.2

The key elements of these
regulations are the following:

• The remuneration provisions apply
  in particular to senior management, portfolio
  managers, and control
  functions. They also have to
  be applied to sub-advisors.

• A defined governance structure has
to be in place to adopt and review the
remuneration policy. The structure
includes the top management
body, a remuneration committee
and the compliance function.

• The remuneration policy must
  not encourage risk taking that is
  inconsistent with the UCITS’ risk
  profiles or rules; performance-related
  remuneration must be based on a
  multi-year framework (appropriate
to investors’ recommended holding
  period in the fund), so that the
  assessment is based on the longer-
term performance of the fund.

• Fixed and variable remuneration
  components must be balanced
  appropriately; pay-out of between

40–60% of variable remuneration
must be deferred over a period
of three to five years, provided
that the deferral period is (1)
appropriate in the view of investors’
holding period, and (2) correctly
aligned with the nature of the
risk of the fund in question.

• It has to be possible to reduce or even
  claw back variable remuneration if either the
  manager or the fund
  concerned performs badly.

• Finally, there are a number of
  requirements for internal and
  external disclosure of remuneration.

All in all, the guidelines look reasonable,
although rather complex in some
aspects. They set a framework for
remuneration policy which has to
be detailed by the management
company. It will be good news for
the industry that the guidelines are
subject to the proportionality principle.
According to ESMA, proportionality
may lead on an exceptional basis to the
disapplication of some requirements.

To some extent, the guidelines may
have a positive impact too. More
delayed payments may better align
the managers’ time horizon with
investor interests. Perhaps more
focus will be put on non-financial
incentives due to cost pressures and
rising standards of transparency.

But I do not believe that there will be
a measurable impact on investment
results. Fund managers have always
made every effort to achieve the best
possible investment performance.
Academic studies have found that
bonuses do not improve performance.
Neither will restrictions on bonus
payments improve performance.

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will restrictions on bonus
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Engagement for executive pay

Since the financial crisis, pay has been
falling at investment banks but rising
at asset management firms. There are
signs that asset managers have started
to benefit from the culture of excessive
pay that can be observed in investment
banks and many other companies.
According to research by the Financial
Times, in 2015 the CEOs of the 20 largest
listed asset managers received variable
pay 15 times larger than base salaries.
(However, the share prices of the same
companies fell by 10% on average.)

The unrestricted level of pay should
not hamper the pursuit of good
investment performance. But a serious
concern is that asset management
executives enjoying comfortable
pay packages will hardly be active
shareholders who control pay levels
and structures in investee companies.
They will hesitate to act as stewards
of responsible pay practices.

In a number of countries, shareholders
have been given extended powers on
’say-on-pay’. Asset managers have so far
been cautious in making use of these
powers. If this changes over time, both
the investee companies and the fund
managers themselves could benefit.

Dr Wolfgang Mansfeld, from 2002 to
2005, was the President of EFAMA.
Until June 2011, he was on the
Executive Board of Union Asset
Management Holding, the holding
company of Union Investment
Group, Frankfurt am Main. From
2007 to 2010, Dr Mansfeld was the
President of BVI (German Investment
Funds Association). From 2004 to
2011, he was a member of ESMA
(European Securities and Markets
Authority) Consultative Working
Group on Investment Management.

1. Asset management market study Terms of Reference, the FCA, November 2015
2. AIFMD Remuneration Guidelines, March 2016, and UCITS Remuneration Guidelines, October 2016, ESMA
THE TRUMP CARD FOR SUSTAINABLE INVESTMENTS AND ESG
Jag Alexeyev

How will the outcome of the US election influence investments that focus on sustainability and the integration of environmental, social, and governance (ESG) factors?

The environmental part of the ESG equation may be affected most. After all, the new administration considers climate change a hoax and intends to pull out of the Paris Agreement. It plans to cut back on the US Clean Power Plan, and will support the coal and oil industries instead of renewable energy.

Immediately this suggests that the goals set by the Paris Agreement – to transition towards cleaner energy, to reduce carbon emissions and limit climate change – will become much harder to achieve. Preventing global temperatures from rising more than 2 degrees Celsius, the threshold above which climate change would trigger serious repercussions, may now be impossible.

Asset managers thus need to assess the potential investment consequences of temperatures rising 4–6 degrees Celsius before the end of this century.

ESG is about identifying and reducing risks. With the election, these risks were suddenly amplified. Concerns about climate risk will only grow as the US administration ignores carbon emissions, reducing chances of limiting global warming.

Climate change brings not just environmental risks, but also – as highlighted by the US Department of Defense – threats to national security, social impacts of refugee migration, and conflicts over resources such as food and water.

Investment consultant Mercer had estimated the potential financial impact of climate change on returns for portfolios, asset classes and industry sectors between 2015 and 2050, based on various climate change pathways. In a four degrees-Celsius high-damage scenario, chronic weather patterns pose risks to the performance of asset classes such as agriculture, timberland, real estate, and emerging market equities.

Hedging and adjusting sector weights represent possible ways to reduce climate risk exposure. For passive mandates, investors may consider low-carbon and sustainable versions of broad market indices. Within active mandates, firms have opportunities to manage portfolio exposure to climate change risks.

Choices by the Trump administration will also influence how ‘stranded assets’ materialise. Stranded assets are those that lose value or turn into liabilities before the end of their expected economic life. The term refers to fossil fuel reserves that cannot be extracted and used as a result of regulation, carbon pricing, market forces, or disruptive innovation.

The stranded asset hypothesis was put forward by the Carbon Tracker Initiative, which argued that if global warming were limited to two degrees Celsius, the resulting ‘carbon budget’ would render much of the reserves of fossil fuel companies unburnable. One-third of oil reserves, one-half of gas reserves, and over 80% of coal reserves would remain unused.

This would have profound financial repercussions on the equity and debt of energy companies and their investors. The potential implications are so great that the Governor of the Bank of England is investigating stranded assets as a potential risk to financial stability.

Does a Trump administration, by abandoning the goals of the Paris Agreement, suggest that stranded asset risks are now lower? Coal and oil companies in the US will be able to extract and commercialise more of their reserves than thought.

The market dynamics and investment impacts however may prove more complex. Coal has become uncompetitive compared to
renewable energies. The long-term decline of coal, therefore, may not be averted by short-term subsidies or policies of the US Government.

Meanwhile, excess oil production and a renewed glut may exacerbate oil price volatility, resulting in another crash as seen by the sector in 2014 and in 2015. Sources of oil with higher production costs and breakeven prices, such as shale, tar sands, and unconventional offshore assets, may be prone to further stranding.

Regardless of what the US Government does, an increasing number of US and global corporations across industries view the carbon efficiency of their operations and supply chains as enhancing their bottom line. ESG investors will continue to allocate capital to such firms.

In addition, a lax approach to carbon in the US may result in an increasingly divergent path in the transition to cleaner energy. Some US companies may become less carbon efficient over time, which could have financial implications for those firms in a post-Trump era.

The growing pools of capital in search of environmental impact may also shift away from the US towards newer energy technology opportunities in Europe, Asia, and selected emerging markets. China and other nations will become leaders in green finance, leaving the US behind.

A recent study by carbon disclosure research group CDP found that European oil companies are already ahead of their US peers in the shift to low-carbon technologies, alternative energy, and on climate governance issues. This divergence will widen under the Trump administration, with implications for shareholder engagement and investment allocations within ESG strategies.

Institutional asset owners will expand their shareholder engagement efforts with companies to improve carbon disclosure, reduce emissions, and address climate-related risks in their business and supply chains.

In the end, a Trump administration that denies climate change may galvanize the private sector to invest even more in renewable energies and carbon efficient technologies. This may prove to be the big ‘Trump card’ for sustainable investments in the long run, despite near term challenges.

Already, more than $8.7tn in the US is invested with managers who incorporate ESG, a number that has grown 33% since 2014, according to the Forum for Sustainable and Responsible Investment (US SIF). Globally, sustainably managed assets exceeded $21tn at the start of 2014, growing dramatically from $13tn in 2012. Sustainably managed assets by now are likely to have reached, perhaps even surpassed $25tn around the world.

Sustainable investing remains one of the fastest growing themes in asset management, driven by client demand and market forces. That is unlikely to change. Yet it will become even bigger as fund managers embed sustainability in today’s leading product categories and vehicles – the magnets that attract fund flows. These magnets include multi-asset allocation strategies, index funds, exchange-traded funds, smart beta, liquid alternatives, and outcome-oriented solutions.

Jag Alexeyev is Founder of Impactvesting, a research and consulting firm that helps asset managers create climate resilient and sustainable investment solutions. He advised more than 100 asset managers as Head of Global Research at Strategic Insight, a leading provider of fund intelligence. He established Strategic Insight’s international operations in 2001 and led the group until 2014.

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Global managed assets

In isolation, it is difficult to interpret what amounts and growth rates mean. Figures in billions and trillions are bandied around and it is useful to assess how the numbers for each sector relate to the whole.

Estimated global managed assets at end 2015 reached $105.5tn, representing an increase of 0.8%, compared with the corresponding end-2014 figure.

Although hedge funds, exchange-traded funds (ETFs) and private equity are much talked about and receive prolific coverage in the media, it is interesting that they are all (still) small in total relative to mutual funds. The other big asset pools include pension funds, insurance and sovereign wealth funds.

Two new categories appear in the table above and elsewhere in this section: Regulated open-end funds and private capital. The first category includes mutual funds and ETFs. The second is a broader category of private closed-end funds with the actual figures very close to private equity (please see Notes 2 for details of these changes).

Regulated open-end funds

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>497</td>
<td>561</td>
<td>16.1</td>
<td>15.9</td>
</tr>
<tr>
<td>Bond</td>
<td>547</td>
<td>319</td>
<td>8.2</td>
<td>7.8</td>
</tr>
<tr>
<td>Money market</td>
<td>193</td>
<td>404</td>
<td>4.6</td>
<td>5.1</td>
</tr>
<tr>
<td>Balanced</td>
<td>456</td>
<td>546</td>
<td>4.9</td>
<td>5.1</td>
</tr>
</tbody>
</table>

Regulated open-end funds achieved inflows of almost $2tn globally in 2015. Regulated open-end fund assets were $37.2tn at the end of 2015, slightly above the end-2014 level.

Exchange-traded products

In 2015, the growth of the exchange-traded product (ETP) industry remained strong, with net inflows into ETPs of $351bn. Total assets increased to $2.96tn.

Pension and insurance assets

<table>
<thead>
<tr>
<th>Assets ($tn) 2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension funds</td>
<td>26.0</td>
</tr>
<tr>
<td>Insurance</td>
<td>28.0</td>
</tr>
</tbody>
</table>
Assets of pension funds decreased by 0.9% in 2015, according to Towers Watson estimates. Assets of insurance undertakings exceeded those of pensions funds, with $28.1tn in total.

**Alternative funds**

<table>
<thead>
<tr>
<th></th>
<th>Net flows ($bn)</th>
<th>Assets ($tn)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2015</td>
</tr>
<tr>
<td>Hedge funds</td>
<td>76.4</td>
<td>43.8</td>
</tr>
<tr>
<td>Private equity*</td>
<td>590</td>
<td>550</td>
</tr>
</tbody>
</table>

* AUM figures as at end June 2015

Growth of the global hedge fund industry amounted to 3.6% in 2015 due to moderate inflows and performance. Fund assets increased to $2.9tn at the end of 2015, according to Hedge Fund Research (HFR).

Private capital fundraising was again strong in 2015, although below the 2014 level, with more than $550bn of capital raised and assets reaching $4.2tn mid-2015, according to Preqin research.

**Top ten asset managers**

<table>
<thead>
<tr>
<th>Rank</th>
<th>Manager</th>
<th>Total assets ($tn) end 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>BlackRock</td>
<td>4.8</td>
</tr>
<tr>
<td>2</td>
<td>Vanguard</td>
<td>3.4</td>
</tr>
<tr>
<td>3</td>
<td>State Street Global Advisors</td>
<td>2.3</td>
</tr>
<tr>
<td>4</td>
<td>Fidelity</td>
<td>2.0</td>
</tr>
<tr>
<td>5</td>
<td>BNY Mellon</td>
<td>1.6</td>
</tr>
<tr>
<td>6</td>
<td>J.P. Morgan</td>
<td>1.5</td>
</tr>
<tr>
<td>7</td>
<td>PIMCO</td>
<td>1.4</td>
</tr>
<tr>
<td>8</td>
<td>Capital Goup</td>
<td>1.4</td>
</tr>
<tr>
<td>9</td>
<td>Prudential</td>
<td>1.2</td>
</tr>
<tr>
<td>10</td>
<td>Legal &amp; General</td>
<td>1.1</td>
</tr>
</tbody>
</table>

**Notes 1**


Regular, systematic and authoritative statistics across all sectors are hard to come by in the fund management industry. Given that the statistics are from different sources, there may be some incompatibility in the definitions and assumptions underlying the figures. Hence, the figures reported should be treated as approximate and designed only to give a feel for relative orders of magnitude.

**Notes 2**

The ‘Perspectives’ column for *IMR* January 2017 contains some changes in the categories, figures and sources for the statistics.

**Mutual funds**

The mutual fund statistics are based on the statistics of ICI, EFAMA and the International Investment Funds Association (which among them are consistent).

Since 2015, these statistics have been broadened. They include now all substantively regulated open-end investment funds. The broadened coverage has been applied backdated, starting with the first quarter of 2014.

The figures in *IMR* January 2017 reflect the new format, also for the 2014 figures. Therefore, the 2014 figures in IMR January 2017 are not the same as the 2014 figures in the previous IMR issues.

Furthermore, the category has been renamed from ‘Mutual funds’ to ‘Regulated open-end investment funds’. The new category comprises the total of ETFs (which was not the case before).

A detailed description of the new collection can be found in EFAMA’s *International Statistical Release 2015*, Q1, p.8.

The first table in this section titled ‘Global managed assets’ is an estimation.

**Hedge funds**

So far the hedge fund statistics had been based on monthly public press releases by Eurekahedge. In the course of 2015, Eurekahedge has stopped the press releases in the usual format.

Therefore, *IMR* has switched to HFR as a source. HFR is the leading provider of hedge fund analysis worldwide.

HFR issued press releases on 20 January 2015 and 20 January 2016, which contain figures both for investor net inflows of the year before, and the assets under management year end.

**Private equity**

Private equity (PE) figures have been based on Preqin press releases or free publications for years.

Preqin has now announced an ‘updated terminology’ for the fund categories covered. From now on:

- PE will be narrowed and refer to buyout and venture capital only.
- A new broader category, ‘private capital’, will refer to a broader spectrum of private closed-end funds, including PE, private real estate, infrastructure and natural resources.

Figures are also published for 2014, according to the updated classification.

The new category ‘private capital’ is, with reference to the figures, very close to the former PE category. Therefore, *IMR* decided not to stick with the PE category – which would have meant working with much lower figures from now on – but to apply the new ‘private capital’ category. Figures for this new category are available for 2014 and 2015, and there is little change regarding the 2014 figures used up to now.
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