HISTORY RESUMES

Last November, thousands of US families suddenly started feuding across their breakfast tables, and people were startled to discover they had been "unfriended" on Facebook. Before that, in June, a similar phenomenon was seen in the UK. French families and friends may be about to undergo the same experience.

The election of Donald Trump to the US Presidency, the UK's vote to leave the EU and the upcoming French presidential elections are all remarkable in that politics suddenly matter to people again.

As populism grows across the developed world, other geopolitical phenomena can be observed too: the growing assertiveness of China, India and Russia; the destabilisation of the Middle East; the multiplicity of terror events; a large and growing migrant crisis.

It's not just families and friends who are waking up to new realities. The response of the Western liberal media is little short of frenzied, alarm bells are ringing in boardrooms and investors' noses are twitching. Geopolitical risk is back.

Return of a familiar foe

Geopolitical risk virtually disappeared from the investment lexicon in the late 1980s/early 1990s, when the Berlin Wall came down and the Soviet Union self-destructed. The "End of History" was proclaimed by American author Francis Fukuyama, and the phrase stuck.

Many professional investors in the 1970s and 1980s could never quite accept the End of History narrative. After all, for us, geopolitics had been the key risk. As custodians of other people's money, we could hardly shrug our shoulders at the collapse of Bretton Woods, oil price shocks and rocketing interest rates.

And, of course, geopolitics was regarded as a key risk long before my cohort started investing. Investors throughout the 20th century contended with momentous events ranging from world wars, to the Russian revolution and the Great Depression. In fact, apart from the 20 years following 1989 and the fall of the Berlin Wall, geopolitical risk has been a near-constant feature of markets. In other words, the relative geopolitical calm of the 1990s and 2000s was an anomaly, not the norm.

In some regions, there has never been an End of History moment. When I speak to CFA Institute charterholders in China, I hear that their main focus is political. Monetary policy, government edicts and changes in taxation drive markets in China. Not just in China either, but in many other countries and regions besides.

We have forgotten in the West that politics is important. We are only starting to remember that big corporations do not run the world after all.

How do investors view geopolitical risks?

Let's consider what The Resumption of History might mean for the investment community. We called on the views of CFA Institute charterholders, thousands of whom manage traditional or alternative investment portfolios in firms worldwide. In February this year, we surveyed our members on the impact on asset management of political uncertainty and received more than 1,400 responses worldwide. This survey was a follow-up to polling we carried out in July 2016, just after Brexit.

Responses to the polls indicate a high degree of fear. UK investment professionals, in particular, are very worried about the potential impact of Brexit on the domestic economy: some 70% believe Brexit will cause the competitiveness of the UK to deteriorate.

Investment professionals in other parts of the world agree. Nearly three-quarters of respondents from continental EU said they expected firms in their market to reduce their presence in the UK as a result of Brexit. While Frankfurt, Dublin, New York, and Paris are seen as the biggest winners from Brexit in economic terms, London is overwhelmingly regarded as the biggest loser.

The wider concern about Brexit is that the European Union may not withstand the shock, coming so soon after the European sovereign debt crisis of 2009-2010 when bond yields spiked alarmingly. More than half of respondents think more "exits" from the EU by 2026 are likely. This is an increase on the 49% polled in July 2016. And compared with July 2016, a higher proportion of respondents think EU wholesale disintegration is likely (36% vs. 21% in July 2016).

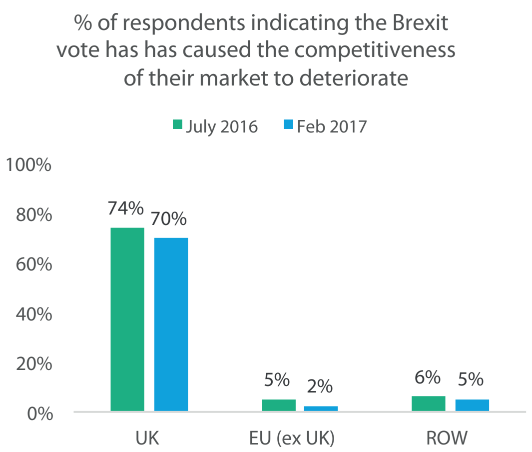
It's not clear from the survey why investment professionals are more concerned now than they were in the immediate aftermath of Brexit. But it's likely that reality has sunk in and it is accepted that the referendum result is being treated as binding and that the UK will de facto leave the European Union.

Digging deeper into the thoughts of our members revealed that most expect Brexit to lead to an increase in market volatility. Some 75% believe that market uncertainty will persist for another six to 24 months, while a fifth expect Brexit-related uncertainty to persist for more than two years.

Brexit aside, some 70% of respondents said investment returns over the next three to five years would be impaired by geopolitics.

Incidentally, while we're on the subject, I'll remark, without further comment, that the political risk viewed as having the single biggest impact on investment strategies is…Donald Trump.

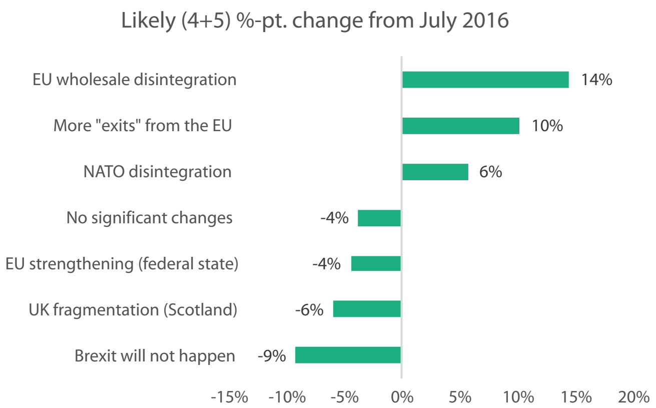
Figure 1: The impact of the Brexit vote on competitiveness, by geography



Source: CFA Institute

- 70% of respondents in the UK said Brexit has caused the competitiveness of their market to deteriorate, down slightly from 74% in July 2016.
- Very few respondents from elsewhere in the EU and the rest of the world (ROW) indicated the vote has caused the competitiveness of their market to deteriorate.

Figure 2: Possible consequences of Brexit by 2026: change from July 2016



Source: CFA Institute

Compared to July 2016:

- a higher proportion of respondents think EU wholesale disintegration is likely (36% vs. 21%)
- A higher proportion think more exits from the EU are likely (59% vs. 49%)
- A lower proportion think it is likely that Brexit will not happen (5% vs. 15%)

Time for asset management to step up

In short, CFA Institute polls point to increased concern and an increased focus by the investment community on geopolitics.

And geopolitics is just one headwind facing asset managers and their clients. It is just one of many challenges that, combined, represent an inflection point for investment firms. Perhaps the greatest of these challenges is the trust by investors in the industry, combined with the perception that we are overpaid and overcharging for the value we deliver. From the trust issue cascades a whole load of other challenges, not least of which is the proliferation of regulation, which has created a raft of risks and costs which we simply didn't face even 10 years ago. Then there is the lack of engagement by long-term investors with the investment industry. Pension scheme members, for instance, routinely choose the default option for their investments, either unable or unwilling to select options that might better meet their long-term needs. Meanwhile, millennials' apathy is being cleverly exploited by fintech providers, who threaten to turn fund distribution upside down. Add to all this a lack of financial inclusion, low savings rates and low returns, and you have the perfect recipe for an industry ripe for disruption.

I don't think talk of wholesale disruption is any exaggeration. At a time of changing risks in the world in general and at this inflection point for asset management in particular, our profession needs to radically rethink its value proposition. It needs to offer investors clear value through skilled asset management at the appropriate price, and it needs to earn the trust of investors and potential investors through actions rather than words.

The importance of skilled asset management

Let's take a moment to consider skilled asset management and what it means for the value proposition.

The geopolitical risks I have outlined will likely produce greater volatility and more uncertainty of outcome. Now, more than ever, investors need high-quality active management to enhance and protect their wealth.

But what, in fact, is active management? It is widely viewed as stock selection but it can, and should be, much more than that. Active management at its best is comprised of a number of client-focused elements which, combined, deliver outcomes that investors seek. These elements include:

➤ Advising on risk and investment preferences
➤ Establishing income needs
➤ Assessing time horizons
➤ Analysing tax impacts
➤ Finding a mix of investments that address the above needs, and managing that mix over time.

Even deciding to invest in a passive fund is an active decision. To invest or not to invest is an active decision. It takes skill and experience to make decisions. That's where investment professionals come in, and that's where we can show a sceptical investor universe that we are willing and able to add value to their portfolios and to their well-being.

Seizing the moment to regain trust

No value can be created for investors, however, unless the investment industry regains the trust of older investors and captures the imagination and trust of younger ones. We must seize this moment to do so. Inflection points are rare – the industry needs to grab the current opportunity with bond hands and institute reforms which will benefit its clients for generations to come.

In a nutshell, it needs to move away from being an industry and towards being a profession. That is, move away from something that is inward-looking, self-serving and geared to profit and become something that is geared towards customer needs first and itself second.

CFA Institute has thought long and hard about how it can be an agent of cultural change and has organised itself with this goal in mind. As well as setting global standards for investment firms and professionals, we encourage diversity, educate customers and encourage investment businesses to think in terms of customer needs. We advocate for transparency, appropriate fees and appropriate structures. We also think it is important to help businesses to think about ethics in their own companies and how they set standards, and we encourage them to think about hiring practices based on all the above criteria.

Our efforts and the efforts of other likeminded organisations will take time to bear fruit, but we would like to think we are making a difference already. Our standards are widely used by investment firms and we are gradually seeing other improvements such as greater diversity within workforces, a focus on fees and value for money, and greater transparency as regards potential conflicts of interest.

Action, not words

Moving from an "industry" to a "profession" will help rekindle investor confidence. This in turn will drive greater participation in capital markets, and help create new value for asset managers and their clients.

I would like to set out four concrete aims which every asset management firm could take on board. Each of these aims moves asset management a little further away from being an industry which purveys products and closer to being a (trusted) profession.

1. Revise business models. High fees are less defensible at a time of low returns. We must create more value, for more clients, on thinner margins.

2. Fix our problem with young people. They don't trust financial services. We must show leadership by building and endorsing business models geared to long-term investor outcomes, not our own financial targets.

3. Recruit more of the right kind of people. We want investment firms to make themselves attractive to people who are motivated by more than money. The extra factor is an intangible element we call phi, which is derived from deep motivational forces: Purpose, Habits and Incentives. It is the hidden variable that drives great performance. And it is high-impact – our research shows that a one-point increase in phi is associated with a 55% better chance of client satisfaction.[1]

4. Adapt new technologies before they disrupt us. We become trusted purveyors of technology, not opponents of technology on the basis it is a threat to our traditional business models.

Making finance socially useful again

These aims are part of the overall mission of CFA Institute to lead the investment profession for the benefit of society – what we call "Inclusive Capitalism". Through Inclusive Capitalism the industry can reconnect with its purpose to serve society and capital can flow to the most productive uses.

Finance is about both the long and the short term, but today there are huge long-term issues – climate, financial inclusion – that are not widely addressed. This needs to change. It is an open question whether asset management is geared towards providing the capital to meet these challenges. Short-run profit motivation, tax incentives and so on argue against this.

Meeting longer-term goals is not the only thing we do that is socially useful, but it could be the most dramatic.

Seizing the opportunities

I make no apology for wrapping up by returning to Brexit. Although I live in Hong Kong and I'm the chief executive of a US-headquartered organisation, I am a Londoner and proud of it.

Worries about Brexit's impact on London are reasonable. It is almost certain that some – mainly euro-denominated – deals will move to Frankfurt and Paris. But does this sound the death knell for London? Not at all. London has three natural advantages that aren't going anywhere: law, language and the Greenwich meridian.

The City of London has always adapted fast and the global role for London will be better structured outside the EU regulatory net so, all else being equal, London will continue to grow. Global capital will continue to course through London's financial arteries, the city's real estate will still be sought after and migrant workers will still seek to work there.

It is possible that some of the capital will flow from new sources, that new buyers of property will emerge and migrants will arrive from different shores compared with today. And this is the point about geopolitical risk – it's not all negative, it throws up new and exciting opportunities too. These opportunities allow all countries, not just the UK, to redefine and optimise their role in the changing geopolitical mix.

Inflection points can be the start of new prosperity – or existential agony. The outcome depends on vision, wisdom and courageous action. It is incumbent on all investment professionals to help shape that outcome by eschewing the status quo and becoming visionaries, and acting with wisdom and courage.

Source: 1 S&P/LSTA Leveraged Loan Index

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