Aspects of stewardship

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Perspectives for this presentation

- Not representing employer
- Personal views only
- Not representing Institute and Faculty of Actuaries
- Some of the more radical ideas in this presentation were first set out in a talk for the UK Transparency Task Force: google "savers take control"
- I am a director of the UK Shareholders Association, www.uksa.org.uk
- I volunteer for UKSA as a "wider fields" way of using my actuarial knowledge and interest in investment.

Aspects of stewardship - agenda

- A ramble around the subject... A discussion followed by some “so what” proposals
- Stewardship is behind the origins of the actuarial profession
- But some aspects do not get the attention they deserve, including employees’ working lives.
- The actuarial profession may have in the past contributed to the “short termism” seen in financial management and financial markets today
- The profession’s current research is constructive and helpful for the stewardship agenda
- Fresh ways of thinking about investment (useful, non-mathematical ways)
- Radical ideas for putting individuals first and changing the balance of power in the ownership chain, increasing welfare in work and retirement. Will touch on these briefly and ask your reactions.

Preliminary activity: on removing the political mask, from Inside Out Image

- 10-question worksheet**: wait for instructions before completing
- Then we can share – Chatham House rules: no notes will be taken of who said what
- Purpose of this activity: remind us of the importance of culture where we all work, and how it affects our lives.

- *** reproduced with permission from Inside Out Image: www.insideoutimage.co.uk*

I describe a general picture only: no criticism of individuals intended

- In this presentation I describe many unsatisfactory situations, in order to think about ways to tackle them.
- It is important to emphasise that this does not imply criticism of individuals. Circumstances, business environments, corporate cultures, what is deemed acceptable practice at the time – these all govern behaviour, and we have to start by recognising the current pressures that everyone faces.
- Similar points apply to individual companies; not all companies are run greedily or with a short term focus, and many operators within the financial sector genuinely have their clients interests to heart.

Broad structure of discussion

1. A selection of challenges around investment thinking, aiming today at actuaries
   – Are there some potentially useful research themes here?
2. A non rose-tinted view of capitalism now, identifying ways it could work better
3. A proposition for change, to test your reactions and hear your ideas – and perhaps identify some volunteers?

Regarding the amount of detail in this session: slides will be published after the session. See ARTC conference web pages, also www.uksa.org.uk

Importance of academic contribution

- Often independent, i.e. not beholden to commercial interests. Ideally questioning, curious, challenging.
- New ideas often developed and tested in academia before being absorbed into “accepted wisdom”
- But it can go wrong – love of elegant maths can sometimes blind us to important but complicating/inconvenient ideas. Risk as volatility is an example. Dismissing the concept of “intrinsic value” is another.
- Ideas which academics know to be true can be wilfully ignored or even suppressed by those whose interests are served by doing so: the term “information asymmetry” applies here.

Investment – our personal perspectives

(more audience participation)

- Note IFoA ongoing research on investment decision making
- Today's is a largely actuarial audience, mostly academics: we are not going to be typical!

- Your thoughts please – what two ideas / key words does "investment" most trigger for you?
  - Technical? Mathematical? Financial Economics? Essential part of actuarial problem solving? Elegant? Out of reach for ordinary mortals? Interesting? Exciting? Responsible? Fundamental? Complicated? Simple? Information asymmetry? Important? Stewardship? … and what else can we suggest?

Investment returns – where do they come from, and do we think the future will be like the past?

- In a hypothetical no-growth world, there is no scope for no net new investment, so investment returns depend on price of existing income-yielding assets; which would likely be bid up to high prices with consequent low returns.
- How much of past investment returns have existed because of economic and population growth?
- What might this mean in a future world? We can't keep growing population and using up the world's resources in the way we have, and use of fossil fuels has to grind to a halt
- This was one of the questions implicit in Dr Iain Clacher's paper "On actuarial thought and economic practice"

The concept of stewardship

- Bible: the parable of the talents; make the best use of what you have, develop what you have
- Looking after your assets, the assets of your family, and the assets of those who rely on you – the origin of the actuarial profession in friendly societies and mutual life insurance
- Assets aren't just physical or financial – our skills, our capabilities, our relationships.
- Part of the employment deal should be helping your employees to grow, develop, feel worthwhile, just as the ESG movement emphasises impact on those outside the company
- Stewardship implies trust; putting your own interests second.
- This applies to boards of companies as well as financial advisers and investment managers
- However, many financial arrangements are contractual, not fiduciary. Which is what enables the wealth extraction process
- Much of the above thinking is very difficult to implement if you focus on the short term

Ownership chain – 3 hurdles

- Pensions perspective – that part which is not pay as you go, and which is not an explicit debt on the next generation relies on the accumulation of rights to future profits, and then, in retirement, on a mix of consumption of those profits and selling future profits to the next generation of pensioners. But there are three hurdles within the ownership chain:-
  1. Creation of wealth within companies
  2. Appropriation by management
  3. Extraction by the financial sector

We will now consider each of these

Hurdle one - wealth creation within companies

More audience participation..

- What makes a company good to invest in (as a long term owner, obviously)?
- Will a focus on share price help or hinder?
- What makes a company good to work in?
- What are the ways companies can contribute to, or detract from, society?
- What should we ask from the leadership of companies?
  - Do we get it?
  - What do we get?
  - How is the leadership of companies determined in practice?
  - Can we learn from the leadership structure in the armed forces; how do their operating principles differ from those of companies?

Hurdle two – appropriation by management

- "Ownerless corporations" – term used by Paul Myners.
- Who is there to ensure that boards operate companies in the long term interests of the owners, but with proper regard to other relevant interests? (which is what UK company law requires)
  - Private investors largely off company registers these days, having lost ownership rights when they hold shares through nominees
  - Active investment managers, with a short term trading focus, and massive pay themselves?
  - Passive investment managers? With a holding in everything.
  - There are a few large long term investors left, e.g. academic endowments, local authority pension funds
  - Life insurers and private sector DB schemes do much less equity investment than they used to.
- So companies are largely run in the managers' interests, and executive pay trends illustrate this, as well as damaging the public perception of capitalism. Share-based pay and LTIPS…….

Hurdle three - wealth extraction by the financial sector

- There are a number of honourable operators within the financial sector, but the sector's overall reputation is not good
- Eye-watering amounts are extracted by the financial sector
- It is possible to avoid them, but only if you are self-directed and prepared to put at least some effort in, and only if you know where and how to look. But the "helpers" you can hire typically don't help in this.
- Retail funds – total annual costs, both explicit and implicit, of owning "active" funds likely to be in the region of 2%, or more
- If you use an IFA, if you are wealthy enough for them to be interested, they may want to make an annual percentage charge as well
- Root of the problem – why does the financial sector charge so much?
  - Because they can
  - Because they operate in their interest rather than their customers
  - Which leads us to ask: how could we change this? Hence the idea for "savers take control"

To repeat: stewardship is lacking in

- How companies are run
- How individuals are treated by the financial sector
- The winners
  - Some financial sector participants
  - Company boards and senior executives
  - Perhaps the revolving door between regulation and industry
- The losers - everyone else
  - Employment prospects and international competitiveness damaged by short term corporate focus / under-investment
  - Employee experience may suffer from corporate culture
  - And much worse outcomes from a lifetime of saving for retirement
- But nobody with power has an interest in changing things
  - Again, hence the idea for Savers Take Control (STC)

Today's structure of conflicts and vested interests

- Much too deep and strong to tackle directly
- But unless tackled, a political backlash is a real possibility – well meaning, ill-thought out "solutions" to a "failure of capitalism" – with unintended consequences.
- Public discussion of the challenges can be helpful, indeed vital, but it can take years for new accepted wisdom to replace old
- Financial sector regarded by politicians as source of good jobs and taxes. The damaging consequences of wealth extraction from the rest of the population and poor stewardship are not uppermost in their minds.
- The "establishment" as a whole has no incentive to rock the boat.
- There is no effective force today to counter-balance the power of the financial sector, or its ability to extract wealth and depress long term pension prospects of the bulk of society.
- Similarly, the "corporate governance" movement tackles everything bar excessive pay - but the culture and thinking around pay is precisely what drives the behaviour of the corporate world

Investment stupidities that support status quo

- These are matters the actuarial profession could definitely help with, especially from an academic perspective
- Focusing on asset prices rather than what lies behind, which is the income earning power now and in the future: concept of intrinsic value. Popular journalism focus on capital gains.
- Jane Austen understood this: “Mr Bingley has 5,000 a year!”
- Regarding market values as an objective truth, and thinking that their fluctuation is important. Any academic research that uses market value movements as evidence for a given thesis.
- Focus on capital gains, and “outperforming” other investors – but we know active management in aggregate massively underperforms.
- A popular marketing lie hiding within a half-truth:
  - “charges matter less than performance”
- Lack of thinking about companies’ relative competitive advantage, how sustainable this is, and how to steward it. Instead of: “how easily could I sell”, should ask “would I be happy to own this if the market were to close for 10 years?”

Selection of references / suggested reading

- John Kay: bookshops and www.johnkay.com Two books:
  - *the long and the short of it, a guide to finance and investment to normally intelligent people who are not in the business*
  - *Other people's money*

- Berkshire Hathaway letters to shareholders at www.berkshirehathaway.com. More valuable commercial insights than an entire actuarial education, they also arm you against simplistic economic theories and mathematics. Good to read before studying economics or actuarial science. Note in particular the story about the "Gotrocks" and the "Helpers". See next slides for some specific links

- The booklet *Responsible Investing*, by the UK Shareholders Association https://www.uksa.org.uk/sites/default/files/2019-02/Responsible_investing_2019.pdf

- The misguided beliefs of financial advisers https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3101426

references etc. - continued

- IFoA Autumn Lecture by Paul Myners: In investment, how do we define long term. Video on IFoA Youtube Channel: https://www.youtube.com/watch?v=9nYJExU9Tn4&t=2936s

- UK Shareholders Association 2017 response to FCA's Asset Management Study http://www.uksa.org.uk/sites/default/files/2017FebUKSA_AssetManagementStudyResponsePDF.pdf

- Berkshire Hathaway links:
  - The chairman's letters: http://www.berkshirehathaway.com/letters/letters.html
  - For the gotrocks and the helpers, search for the word "gotrock" in each of: http://berkshirehathaway.com/letters/2005ltr.pdf   and http://berkshirehathaway.com/letters/2006ltr.pdf

Savers Take Control (STC)

Q1: STC - what is it?

- It is a movement primarily to improve the investment outcomes for individuals, by changing the balance of power between the individual and the financial sector. But run by individuals, not a regulatory initiative.
- The secondary aim is to influence the behaviour of the corporate sector generally – towards a longer-term focus, without the large executive rewards that distort behaviour and bring opprobrium on the system.

Q2: STC – what's special about it?

- Uniquely independent and free of conflict – core team all knowledgeable volunteers who are independent of financial sector and of the executive remuneration world
- Motivation is to help savers generally, led for free by people who do not need help themselves. This is a powerful message.
- There is no other not-for profit body aiming to help people get much better financial outcomes from investing.
- But we do need publicity to attract volunteers

Savers Take Control (STC)

Q3: STC – how fast are you going to help people?

- Got to be realistic. Currently, the majority of people have limited financial capability. To start with, we can only likely to influence those who are already able, or who are close to being able, to make decisions for themselves.
- The main message will be aimed at those who are able to save, or who have already saved, at least moderate amounts – in other words, those who will have the largest amount to gain by minimising the charges they pay to the financial sector.
- We will draw public attention to the levels of expense typically suffered, and how to avoid these. This will mean that the better value providers will benefit from increased business, and that we can indirectly influence large flows of money.
- The big secret for most: use self-select services, passive investment, and if you feel you have the necessary knowledge and interest, you can buy individual shares. But it is vital not to trade lots, as the total dealing costs are not trivial, even with execution-only services.

Savers Take Control (STC)

Q4: STC – where are we today?

- At the point of public launch. Aim of public launch is to attract enough attention to reach new volunteers. We don't need many to start with, but we have too few so far. Interest from the media will be essential.

Q5: STC – volunteers: who will they be?

- Anyone is welcome to register an interest.
- Typical response: "I've always been worried about these issues – yes please!"
- Our core team will need to join UKSA. As well as sharing our passion about the need for change in the public interest, and having sufficient financial knowledge, they must be suitably independent and free of conflict. In particular, independent of the investment chain which includes fund management, financial sector and of the executive remuneration world. Our ideas are directly contrary to accepted practice on remuneration.
- But we regard those who have worked in any of these sectors, but are retired from them as very likely candidates – poachers turning gamekeeper.
- And our networking has identified interest within the academic community.

Savers Take Control (STC)

Q6: STC – what are the initial activities?

- Build the core team, at the same time as seeking increasing publicity.
  - Core team needs a diverse set of skills between them, we need the team to be as diverse as possible, providing they pass the independence test. Communicators, organisers, and more analytical types too.
- Typical "think tank" activities – discussions within the team, developing material in the form of papers for public exposure, ad-hoc articles for publication, and organising small and inexpensive conference events for the team, and for non-team bodies to whom we wish to reach out.
- This style of research activity is very similar to how member-led research works within the actuarial profession. Enjoyable sharing of ideas in an environment of mutual respect.
- But all this has to be on a voluntary basis. We may seek donations, but will not expect support from the commercial world.
- The early volunteers will have a major impact on how the movement develops

Savers Take Control (STC)

Q7: STC – what are the areas for research/thinking?

- This follows from Q1 earlier and aims set out
- First, what do people really need to know about investment in order to take control for themselves. Aiming initially at the financially more capable. The ultimate vision is that more general public awareness and confidence will grow.
- Second, what principles for the operation of companies should we be putting forwards, and campaigning for in the public domain. These principles need to tackle the bonus culture for executive pay that leads to short-termism. They will not be developed effectively through regulatory / political means because of the extent of the vested interests.

Q8: STC – what do you think?

Discussion

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