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THE FUTURE OF FINANCE

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BEYOND THE WHY QUESTION

Global capital markets separate from the real world

Challenging convention

The Why Question

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Views expressed here are those of the author, who is solely responsible for any errors and omissions.

In a lecture I heard some years ago, a philosopher asserted that science tries to answer the question 'how', while philosophy tries to answer the question 'why'. In looking at the corpus of work produced by academics and practitioners on finance, it seems to me that most, if not all, are trying to answer the 'how' question, but almost none attempt to answer the 'why' question. My view is that this is because finance as a discipline sees itself as an extension of economics; and economics, since the nineteenth century work of French economists such as Walras[1] and later of Marshall[2] have seen economics in essence as a science, and therefore this preoccupation with the 'how' question is a result of a spillover of that assumption.

Scientists, of course, would find the idea of a science that relies on the concept of 'externalities' and an attempted aggregation of individuals' often disparate behaviours and mood shifts to explain why the laws postulated by this science do not seem to work dynamically, or universally somewhat baffling. In his book

Common sense, therefore, tells us the laws of physics are constant observable and universal and observation tells us the 'laws' of economics are not. To my mind this argues that we should stop treating economics, and indeed financial theory, as a science and go back to treating it as part of political philosophy, and perhaps

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The "Why" Question in Investment Theory

Posted by Saker Nusseibeh, Hermes Investment Management, on Tuesday, March 28, 2017

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Tags: Accountability, Capital allocation, Capital markets, Corporate Social Responsibility, ESG, Institutional Investors, International governance, Market efficiency, Shareholder rights, Shareholder value, Stewardship, Sustainability, UK
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Editor's Note: Saker Nusseibeh is Chief Executive of Hermes Investment Management, chair of its Executive Committee, and an Executive Board Director. This post is based on a Hermes publication.

Economics has developed as a science, conveniently forgetting its roots in political philosophy. Unfortunately that "science" is severely dated, and the functioning of the global capital markets has become separated from the real world. A simple thought experiment throws light on the theoretically correct strategies for a rational saver, but leaves us with unsatisfactory answers. Neglecting the societal context of our saving activity only serves to further isolate the capital markets. Instead, a self-perpetuating system requires investors to evolve from simple allocators of capital to its steward, with far broader responsibilities. Maximising holistic returns represents practical action of the responsibility by investors, and stretches far beyond creating wealth simply for its own sake.

Introduction

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- ► **The Why Question,** by Saker Nusseibeh, published by The 300 Club in March 2017
- ► **The "Why" question in Investment Theory,** by Saker Nusseibeh, published by the Harvard Law School on 28 March 2017

An appeal to the heart

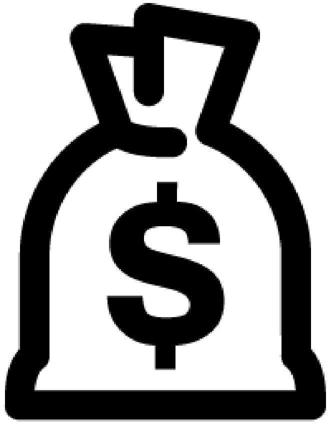
- ►In the ‘Why’ paper I appealed philosophically and morally from a society perspective

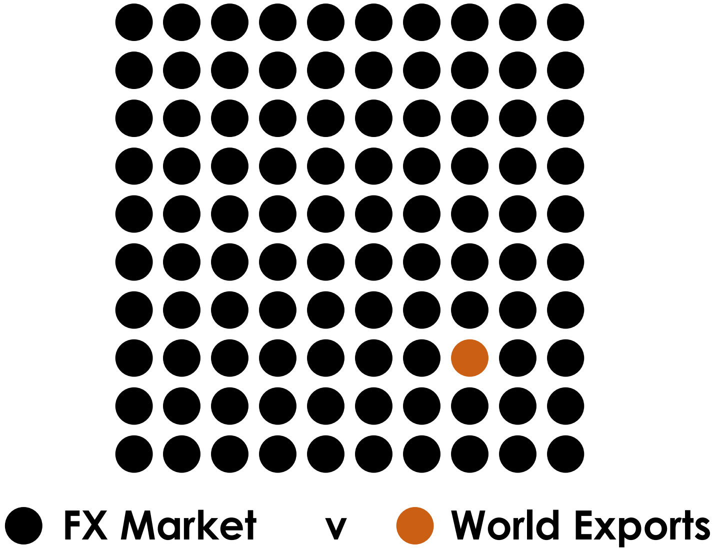
- ►…as well as to investors

Today

► I would like to appeal to hard-nosed financiers

Do we invest purely to accumulate wealth?





- Investors are simple allocators of capital, thinking only about ***how*** to put capital to use rather than ***why***
- Global capital markets are separate from the real world

Poker player v portfolio manager: who wins?

Gambling has better odds of success

55% > 51%

Odds of profiting through a poker ‘bot’
or top-seeded poker player

Hit ratio of skilled alpha managers
(it’s even worse for financial strategists)

Do we invest to control companies?

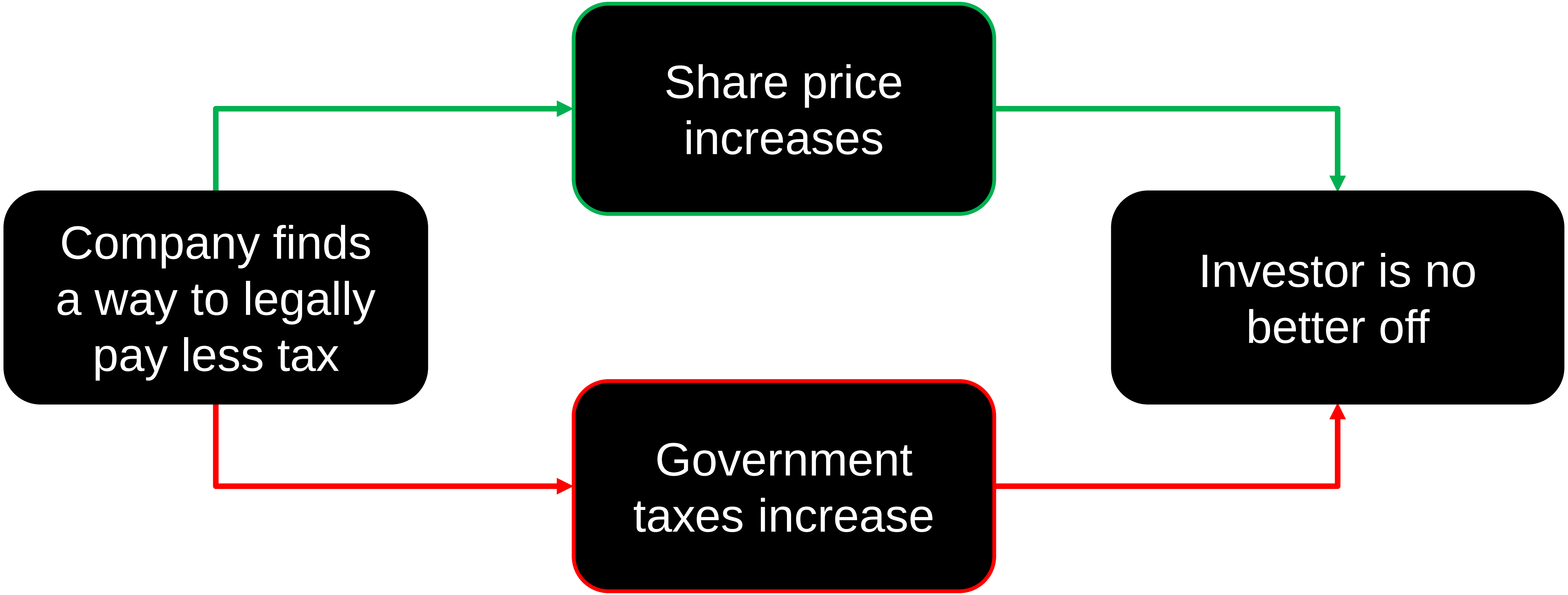
- ►Listed companies have an enormous influence on our lives: we live where they operate and are their employees, suppliers and customers
- ►Investing should be a tool for savers to exercise their democratic will
- ►This justifies holding stocks in times of economic contraction
- ►Is this a third dimension of the ‘nationalisation’ debate…

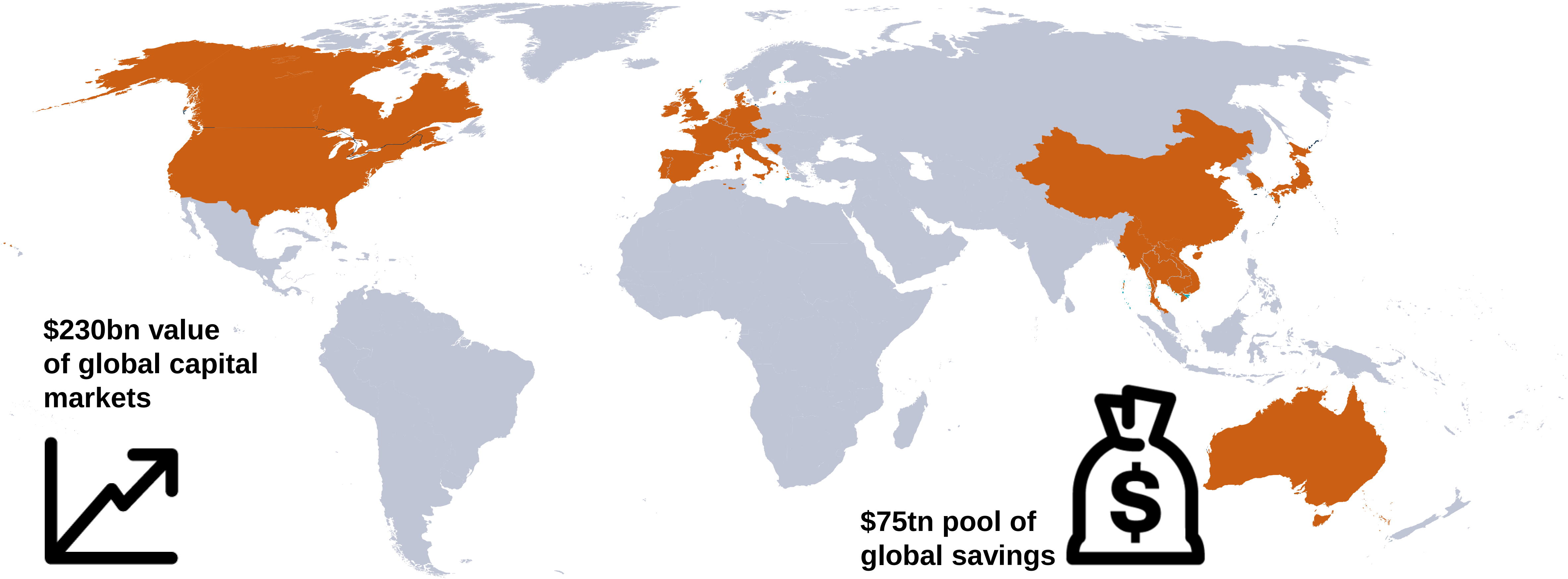
Success is often measured by direct benefit

- Sell – Buy = Profit

- In isolation

But secondary and tertiary effects matter





Source: Lay, K. "Financing Global Public Goods at Scale", published 2014 and Hoogvelt, A. "Globalisation, Risk and Regulation", published 2012.

Fiduciary duty

►What is it?

►How do we fulfil it?

The lawyers

- ►Fiduciary duty is the highest standard of care

- ►Fiduciary duty exists to encourage specialisation and induce people to enter into a fiduciary relationship

Shakespeare

► "The first thing we do, let's kill all the lawyers"[1]

[1] Taken from William Shakespeare's Henry VI, Part 2.

Fiduciary duty

► The spirit of fiduciary duty should be “the highest standard of care” which should imply total or holistic returns

► It is also the trend, because not only is it ***good***, but it is also ***good business***

The mainstream

- ► ESG investing is moving into the mainstream
- ► Governments, regulators and clients now demand both companies and their owners consider the wider ESG implications of their business activities

Political / regulatory

- Government focus on corporate behaviours
- New stewardship codes
- Regulatory requirements
- Changing fiduciary obligations

Environmental

- COP21 Carbon reduction commitments
- Stranded assets
- Water scarcity
- The VW scandal

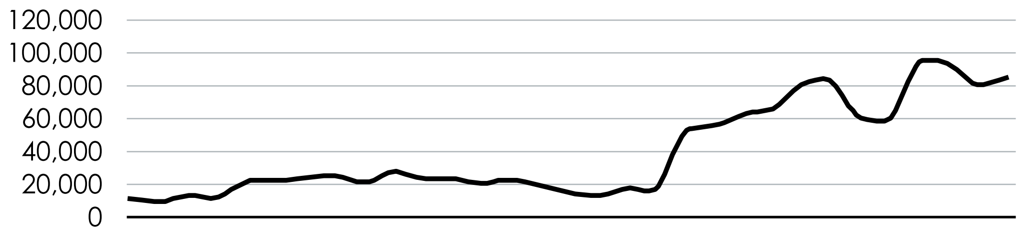
Social

- The expectations of "millennials"
- Nationalism and protectionism
- The shareholder spring
- Population growth & migration

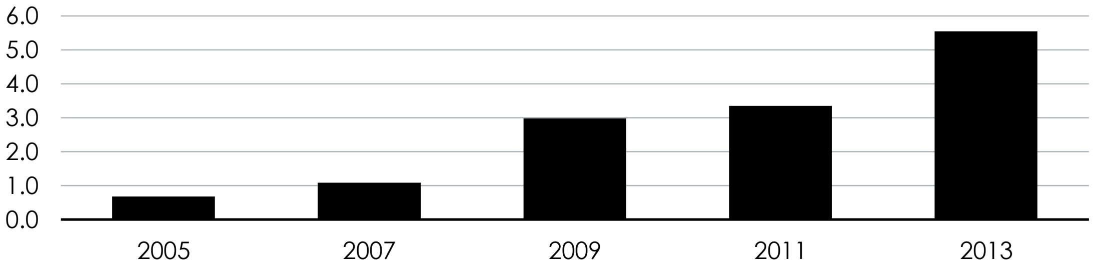
Technological

- ESG data availability
- Activism through social media
- Affordable renewables
- Efficient buildings

ESG related searches on eVestment



Growth of ESG integration in European pensions and savings, $tn



Source: EUROSIF, European SRI Study 2014, exchange rate $/€ 1.06.
Note: Graphs demonstrate positive trend in integrated ESG demand and search activity. However definitions of truly 'integrated' ESG are inconsistent and so absolute numbers should be taken in this context.

The body of research

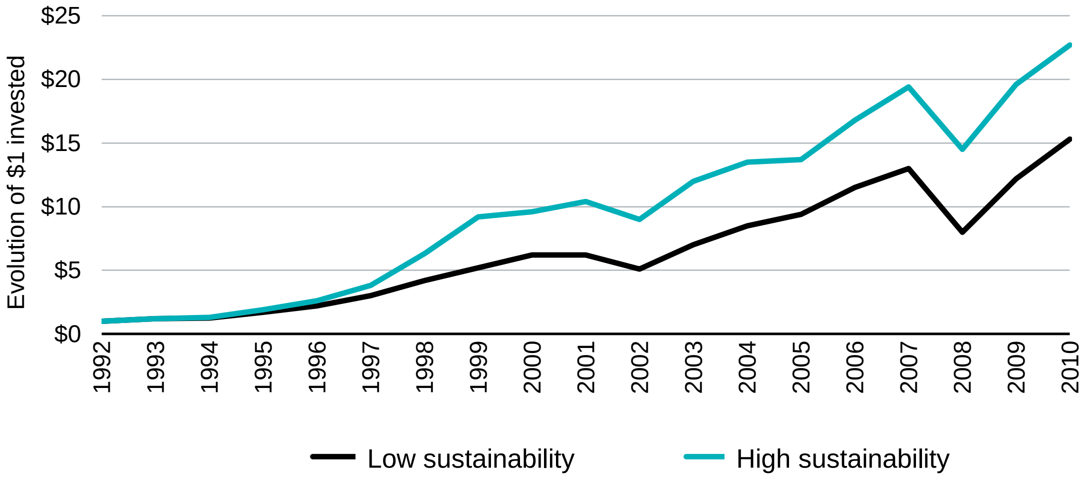
- ►The body of research continues to grow supporting ESG as a driver of performance
- ►A 2015 meta-study compared the output of over 200 academic studies, industry reports and books

Corporate cost of capital	90% of the cost of capital studies show that sound ESG standards lower the cost of capital
Operational performance	88% of the reviewed studies show that solid ESG practices result in better operational performance
Stock market performance	80% of the studies show that stock price performance is positively influenced by good CSR practices

Integration and engagement

- ► The investment case is compelling on both counts
- ► Extensive research shows that both drive enhanced returns

‘High Sustainability’ firms generate higher returns over the long term

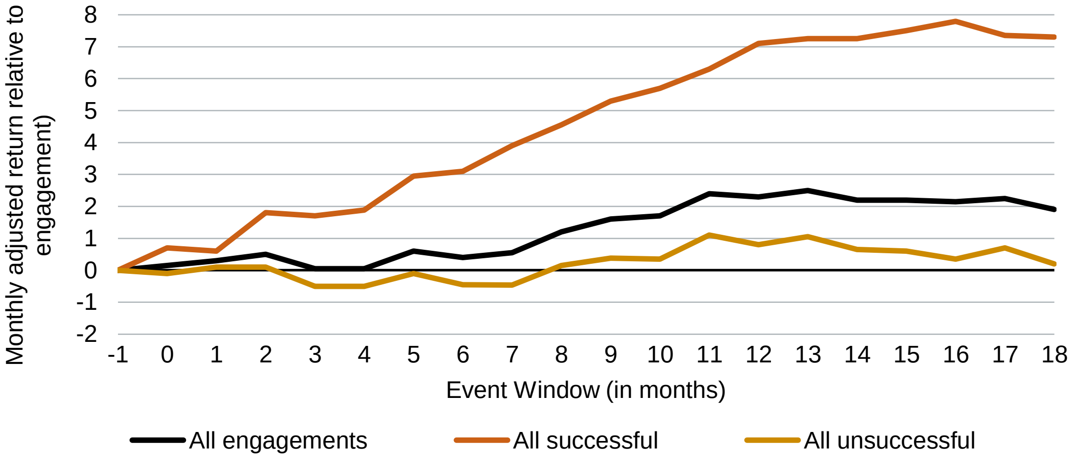


2014 study by Eccles, Ioannou, and Serafeim investigated the effect of corporate sustainability on organizational processes and performance using a matched sample of 180 US companies.

High sustainability companies = those that voluntarily adopted sustainability policies by 1993. Low sustainability companies = those that adopted almost none of these policies.

Past performance is not an indication of future results.

Engagement drives enhanced financial performance



2012 study by Elroy Dimsona, Oğuzhan Karakaşb, and Xi Lic analyses an extensive database of corporate social responsibility engagements with US public companies over 1999–2009 addressing environmental, social, and governance concerns.

Engagements are followed by a one-year abnormal return that averages +1.8%, comprising +4.4% for successful and zero for unsuccessful engagements.

Past performance is not an indication of future results.