What do they do with our money?

Ask your friends or colleagues the simple question, what is the purpose of finance? - and you may be surprised how long they pause before replying. One reason for hesitation is that this fundamental question is all too rarely asked. So says David Pitt-Watson, Executive Fellow at the London Business School and leading thinker and practitioner in responsible investment.

He himself makes a point of asking the question regularly because he believes that unless we are clear about what finance is for, it will do more harm than good. This was the theme of his lecture in the Murray Edward's series of talks exploring *Capitalism on the Edge.*

Do no harm: a poor *raison d'être*

Pitt-Watson has a specific message for three audiences: those who teach and study economics and finance; those embarking on a career in finance, and those who simply want to understand how finance works, perhaps to influence it.

However, his definition of the role of finance is consistent to all three. Pitt-Watson remembers a gathering of senior young politicians from around the world, who fell silent when asked: "what would be your agenda for the financial services industry?" Eventually, the first to speak said they would like finance "not to collapse the world economy".

Not doing any harm is a pretty poor *raison d'être*. But as Pitt-Watson points out: "Part of the reason the financial services industry is capable of so much harm is because its services are of central importance to our welfare." In essence, these services are:

- the safe keeping of assets
- to provide an effective payment system, without which commerce could not survive
- to share risk, which allows us to buy life insurance and have a pension
- Intermediation, which transfers money from where it exists, to where it is needed.

The last of these is perhaps the most important, argues Pitt-Watson. "That is a process of enormous value. At its most simple it can be combining savings deposits and helping individuals buy homes, businesses to buy assets. It allows economies to grow. It allows social mobility."

Collectively, these services are so important to society that finance pioneers were thought of as philanthropists. It was a minister who set up the first "people's bank" - the Trustee Savings Bank - to serve his congregation; and two clergymen set up the first funded pension scheme.

Theory and practice

Clearly, doing finance well is valuable for society. The flip side of the coin is that doing it badly can have devastating consequences. Mohammed Yunus, an economics professor and financier in Bangladesh, won the Nobel Peace Prize for pioneering micro finance for poor people, transforming their lives. Laudable, says Pitt-Watson, and yet: "What Yunus was doing was, in theory, little different from a loan shark or from Wonga. In theory the same; in practice totally different."

When we consider now how we are doing in practice, the picture is far from encouraging. The financial crisis of 2008 nearly brought the world's economy to its knees. In November that year, Pitt-Watson recalls a much-publicised visit by the Queen to the London School of Economics, when leading economists seemed incapable of answering her simple question: what had happened?

Nobody, it seemed, saw it coming. Even the IMF believed that financial innovation was removing risk from banks' balance sheets; that large financial institutions were in a strong position, and that financial markets in developed countries were "fundamentally sound."

Slow progress

The 2008 crisis was not the first and it won't be the last. Pitt-Watson argues that setbacks can be instructive if lessons are learnt. But, in his view, the finance industry is *not* making progress over time; it is simply not delivering productivity improvements to the real economy.

He cites American academic Thomas Philippon, who compared the costs of the US finance industry with the amount of saving and borrowing it had managed in the past 120 years. His sobering conclusion? The tenfold US productivity increase in that period owed nothing to financial services.

Pitt-Watson spells out the irony: "We have made huge advances in our understanding of economics. We have employed some of our smartest people. But in terms of its productivity, of its critical contribution to the outside world, in aggregate we have achieved nothing at all. No efficiency gain; no avoidance of crises."

The idiocy of tunnel vision teaching

Where, then, is the rigour that we associate with economics and with finance? This is where Pitt-Watson turns to his first audience. He suggests that the masters of these subjects have become so absorbed by them that they spend no time thinking about their contribution to society. And that, says Pitt-Watson "destroys the value of the very discipline they study".

For the ancient Greeks, the word "idiot" described someone with this kind of tunnel vision, and the Greek remedy was education. Adam Smith, the 18th century economist and philosopher, understood this well. The purpose of his work was "to provide a plentiful revenue or subsistence to the people… and to supply the state with a revenue sufficient for the public services."

The trouble is, says Pitt-Watson, that financial economics on the whole has done pretty badly by this metric. He urges a new, less narrow, curriculum for our universities and business schools. "It's not that what we teach is wrong; it is just one dimensional. Like suggesting to a biochemist that they have all the disciplines necessary to practice medicine." He says.

What's more, we need a change in behaviour. Referring to research from Cornell University in the US, Pitt-Watson cites the worrying evidence that when we teach economics students a model of the world based on self-interest, they become less cooperative and more selfish. "Are these the kind of people we want to run our economy in the future?"

Careers for people who care

Pitt-Watson acknowledges that he paints a bleak picture of a dysfunctional industry, and yet his challenge to his second audience - those embarking on a career in the sector - is that finance, well-practiced, lies at the heart of the key challenges we face in the 21st century.

"How we can fund the investment needed for economic development? How we can we take a billion people out of poverty? How can we develop the infrastructure and technology which will make human life on earth sustainable? How can we provide for incomes to older people? How can we share the risks of health, or ageing or other human and natural disasters?" He asks.

"At the heart of the answers to all these questions lies finance. For those of you who want a career in finance, I hope you have the opportunity to help in addressing all these issues."

He distils his advice:

- Never lose sight of the purpose of finance; it is a vital and vibrant part of modern economy

- Beware of “the fallacy of composition”; that if one transaction has certain characteristics, you can’t assume that multiple transactions will also have the same characteristic.
- Remember that finance is a human system, both for whom it serves and how it operates, and therefore dependent on trust.

We are all capitalists now

What about Pitt-Watson’s third audience; those not working in finance, but who might want to influence the system?

He urges them to re-think their own role in the system; to recognise that they, along with huge numbers of ordinary working people, are themselves capitalists and therefore have a legitimate voice in corporate governance.

We tend to feel far removed from the decision making powers that govern our economic institutions. After all, the overwhelming majority of shares in the giant companies are held by mighty so-called investment institutions; the likes of BlackRock, L&G, Aviva, Vanguard and Sarasin.

But, says Pitt-Watson, the money these institutions invest is not theirs. It belongs to the ordinary people who set money aside to pay for their pensions and other contingencies. Therefore, the ultimate shareholders - those on whose behalf the shares are purchased - are all of us.

Opportunities and challenges

This has implications for every chief executive who claims that his aim is to generate value for his shareholders. There are also implications for beneficiaries of the system to influence where the money is invested.

“If we could ever get capitalist companies to behave as though their owners were hundreds of millions of ‘citizen investors’, that would create some profound opportunities, but also challenges.” says Pitt-Watson.

Opportunities arise because shares confer power. In the UK, the re-election of directors of quoted companies, their remuneration package and the appointment of the company auditor are all decided by shareholders in general on a one-share-one-vote basis.

Why then, when we are so serious about political participation, do we ignore our opportunity to influence a maligned capitalist system?

Pitt-Watson acknowledges there are practical difficulties: the sheer numbers of beneficiaries associated with any single pension fund or university endowment, and the equally daunting number of companies in which a fund can be invested.

However, he points to a host of agencies and campaign groups set up in recent years to make voting systems more practical, to increase collaboration for responsible investment and to lobby fund managers.

Yet, such initiatives are tiny in comparison to the opportunity. “That is because most people don’t feel like ‘citizen owners’, so they don’t behave like them.” Says Pitt-Watson.

A little activism goes a long way

When they do, they *can* make an impact. Pitt-Watson cites a successful shareholder campaign to stop a drug company from suing the Indian government, for fear of undermining a deal to license low-cost drugs to developing countries. One fund manager who held shares in the drug company remembers it as “one hell of a campaign” - and yet he received just six emails on the subject.

Raising the citizen voice, says Pitt-Watson, would offer huge opportunity to steer our capitalist institutions in a socially responsible direction. Therein lies a challenge, because our pensions are invested in companies on the basis that they will make a profit.

“We need to take seriously the question of what responsible capitalism might mean.” Says Pitt-Watson. “If we are the capitalists, what do we want from the system?”

That is for each of us to decide. His own view is that companies should be profitable, and that a level of self-interest is inevitable. “But if capitalism is based on the savings of the many, not the few, then it should be run in their interest”.

As to the role of the individual in influencing change? Pitt-Watson urges participation in finance as we participate in politics. “Politics works because we listen to the news, because we have a free media, we protest, we campaign, we join with others, we support parties, we argue and we respect one another. So it could be in finance.”

By way of example, he congratulated Positive Investment Cambridge - a movement of dons and students that is lobbying the University to develop a responsible investment policy for its £2.5 billion endowment.

“Responsible capitalism will not invent itself. Ultimately it is down to us to create it.”

Reflections and discussion

David Pitt-Watson’s talk was followed by reflections from Natasha Landell-Mills, Head of Stewardship at Sarasin and Partners, where she also steers their policy work, and then by questions from the floor.

Landell-Mills stands in broad agreement with Pitt-Watson’s views. In the aftermath of the 2008 crisis, she makes a point of highlighting positive news, notably, the “significant efforts” made by regulators to increase the capital held by banks, and via structural reforms, such as ring fencing.

Yet, she says, “deep fault lines remain”, particularly in her own area - the investment chain. For Landell-Mills these are due to a lack of transparency and ultimately, accountability. Without these, vested interests become a problem.

Problems, however, create opportunities, and Landell-Mills presents food for thought on two fronts.

How to be a smart asset manager

Firstly, she describes her vision of a sustainable and socially beneficial asset manager, whose fundamental role is stewarding clients’ capital to create lasting value for beneficiaries. Initially, this so-called “smart asset manager” focuses on due diligence and dialogue to identify which companies to invest in. Then, once clients have become shareholders, priority shifts to monitoring company performance. “The smart asset manager engages and acts as a long term owner.” She says. Transparency with beneficiaries is key, as is regular reporting - but *not* on performance relative to a market benchmark. “Indeed, they wouldn’t be measuring their risk in terms of a tracking error against that benchmark; they would be reporting back on how they have been delivering earnings on consistent basis.”

Landell-Mills is critical of asset managers who subscribe to what she calls modern portfolio theory: diversifying to invest in lots of companies they don’t know. Smart managers, she says, “will look to manage risk by investing only in companies that they know and monitoring them carefully.”

Finally, smart asset managers keep an eye on the overall market and are willing to engage at a policy level. This leads Landell-MIlls to discuss another opportunity; working in partnership.

Teamwork

Her company, Sarasin, is part of a coalition of investors who are engaging in policy discussion to change the current accounting regime, which she says is failing with “very serious implications.”

At macro-economic level and at company level, decisions are made on the basis of numbers. “For companies, if those numbers are wrong there will be a big problem with accountability, and also asset allocation.” This happens all too often says Landell-Mills.

“With our current accounting regime, and the IFRS (International Financial Reporting Standards), it is our (coalition) view that banks were able to overstate profits in the run up to the crisis and also overstate their capital; so when markets turned, the banks which seemed to be very well capitalised and profitable turned out not to be.”

If changes to accounting standards can make a difference, so too can changes to how companies report on climate change. It is a good thing that many institutional investors are now calling for robust action to combat climate change, but Landell-Mills insists they can do more. “If companies were forced to report more transparently and more prudently, that would drive completely different behaviours by companies and investors.” She says.

A last word for those thinking of a career in finance: “Don’t go in thinking it is static or fixed; it is always evolving and the input of those who are thoughtful and care can massively influence the direction of travel.”

The input of the citizen was a common thread running through the questions that followed: How can individual citizen investors feel empowered when their own stake - such as a pension - is such a tiny fraction of total capital? How far should we trust “expert” investors to make the best decisions on behalf of beneficiaries? If the problems of capitalism are systemic and highly complex, what hope for individuals to make a difference? Why is there so much resistance from government to beef up regulation?

In response, the recurrent theme was that individuals *can* make a difference. They do so most effectively when they are thoughtful and work together. The complexity of the system is no excuse for passing on responsibility to others, and that is why transparency is so important. And a pertinent message for a university: How we teach economics and finance affects the system, and that is where academics have a role.