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A precondition for sustainability

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The asset management industry is horribly conflicted. On the one hand it is supporting the grassroots drive to encourage big business to adopt sustainable policies. On the other, the majority of investors and asset managers are simultaneously adopting strategies that destabilise asset prices and promote short-termism.

Unfortunately, the latter effect not only undermines the former, but does untold damage to the macroeconomy.

Over the last decade public opinion, urged on by the millennial generation, has sought to instil in businesses an awareness of the need for sustainable strategies. Asset managers have taken up the cause by steering customer funds towards companies whose policies are environmentally friendly, socially aware and observe good governance. The movement has brought about a definite change in ethos and some improvement in practice.

The conflict for the fund management industry arises from the difference in policy horizons between companies trying to make their operations sustainable and those of the average asset manager. Sustainable companies must take the long view in planning decisions and be prepared to sacrifice short-term profits in the interests of future private and social returns. In utter contrast, competitive pressures ensure that most portfolio investment is conducted with an eye to the next quarterly or annual return.

It is necessary to understand why most asset managers adopt short horizons and what that implies for the way markets behave. Despite the scale and complexity of the industry, asset management really has only two ways of managing money:

1. **Cashflow investors** focus on the fundamental worth of companies represented by the future stream of cashflows expected from securities. This approach calls for patience while waiting for prices to adjust or earnings to come through and is the essence of long-termism.

2. **Price-only investors** exploit the trending caused by tidal surges of funds constantly sluicing through security markets. Momentum and trend-following strategies are the most obvious examples of a price-only approach. In simple terms, such strategies buy (or overweight) recent winners and sell (or underweight) recent losers. This is a short-term strategy in which investors pay no regard to fundamental value, simply hoping to sell around the peak.

In practice, most active funds are run using a combination of these approaches due to the pressures of the performance reporting cycle. By convention, fund performance is measured against the returns on a market cap index or by peer group comparison. Asset managers are either instructed to keep performance within a close range of the benchmark (via tracking error constraints) or do so unasked for fear of falling behind the pack and being thought incompetent. To reduce the risk of extended underperformance, managers chase stocks and sectors that have gone against them regardless of valuation, which amounts to a momentum strategy.

Add momentum-only funds and high-frequency

traders, together with hedge funds looking for quick wins, and the full scale of assets being actively managed with short horizons and without reference to fundamentals becomes apparent. Bearing in mind the high turnover needed for any momentum strategy, estimates that around 90% of stock market trades bear no relation to fundamentals[1] don't look unreasonable.

> *"If a company's share price does not come close to estimates of fundamental value, company CEOs and their boards face a dilemma. Do they seek to seek to maximise long-term cashflows or short-term share price?"*

The impact on the corporate sector and its hoped-for drive to sustainability is clearly negative. If a company's share price does not come close to estimates of fundamental value, company CEOs and their boards face a dilemma. Do they seek to seek to maximise long-term cashflows or short-term share price? The policies needed in each case are mostly mutually exclusive.

Just as asset managers need to keep short-term performance flying high, CEOs are expected to keep their stock prices and profits in line with competitor firms or face the sack or takeover. Chuck Prince's "as long as the music is playing, you've got to get up and dance" is every bit a momentum strategy. Short-termism is then reinforced by a reward system of early-exercise stock options. Long-term objectives are abandoned. Capital expenditure and R&D may be cut, leverage increased which may haunt the business in a downturn, and accruals used to flatter the current profits and balance sheet. This is not fertile ground for firms seeking to take on long-term sustainability programmes.

This is the sad situation in which capitalism finds itself today. The first step towards reform is that this scenario should be accepted as reality by all players: trustees of funds, investment advisors, policymakers and the asset managers and business leaders themselves.

Sustainability programmes will always take second place so long as asset managers invest without reference to long-run cashflows. Millennials should extend their target beyond sustainability to the much broader objective of reforming the whole approach to asset management where the social gains would be immense.

If you would like to discuss any of the ideas raised in this paper please contact us at:
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[1] Kolanovic and Kaplan, JPMorgan, Market and volatility commentary (June 2017)

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