Stewart Investors

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Does Fund Management have a social purpose?

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'The fund management industry has done very well – but mainly for itself.'[1]

A little history

The stock market and bond market have their origins in the financial revolution of the late 17th century. The stock market developed to provide funds for overseas trading companies, like the English East India Company, while the bond market funded the state, mostly raising funds for waging of war.

Professional investment, or a fund management industry, began to develop in 19th century legal offices. Lawyers managed client money and launched vehicles, such as investment trusts, to pool savings and provide diversification. Fund management was viewed as conservative, even 'boring', and reflected the values of thrift associated with the Victorian middle class.

The principal aim was to deliver a financial return, usually not specified in absolute terms, but expected to be higher than the current interest rate. The rise of stock market indices from 1896, when Charles H. Dow created the Dow Jones Industrial Average, introduced the concept of 'underperforming a benchmark index' and 'relative performance' which could be used to sanction the loss of client capital and altered the notion of risk.

A social dimension developed alongside the growth of the stock market. Until the rise of the welfare state, most government spending, funded via the bond market, was concerned with defence of the realm and waging war. However, the stock market had a wider economic purpose - funding the nation's economic development by channelling capital from savers to the corporate sector and so creating employment and wealth.

What is a Social Licence to Operate (SLO)?

Recent years have seen the rise of 'ethical' or sustainable investment strategies which regard investment as having a broader purpose, one which takes account of all stakeholders, not just shareholders, and considers the influence of investment on the environment and society.

The term 'Social Licence to Operate' was originally used in the mining industry to examine the impact of mining projects on local communities and the environment. As a result, mining companies were encouraged to recognise the wider costs of their projects and invest in the local community by funding charities and education projects. By doing so they would gain, or sustain, an SLO from the local community.

A company will face significant difficulties if it alienates stakeholders and loses its SLO. It could come under severe criticism, negatively impacting its operations and ultimately threatening its existence.

1 Phillip Coggan quoted in the Economist, 28 February 2008.

When a company mistreats one particular stakeholder it often mistreats others. We can think of a retailer with a reputation for treating suppliers unfairly which was later found to be manipulating earnings, and an electronics company with a reputation for taking advantage of minority shareholders which had a poor health & safety record.

What is fund management's SLO?

Does the fund management industry have an SLO? Parts of the industry have clearly lost sight of their fiduciary role as guardians of clients' capital. Some investment businesses focus purely on short-term financial returns and earning large fees, a form of 'casino finance' which takes little or no account of other stakeholders. Such funds seek to buy and sell entirely based on price. As a result, they will often invest in poor quality companies on a short-term basis, taking no stewardship responsibilities over the businesses in which they invest.

A related concern is the rise of passive investing, including Exchange Traded Funds (ETFs) and Index Funds which shadow a benchmark. These products, which have expanded significantly in recent years, do not differentiate between companies, and so provide capital to both good and bad ones, including those that might be damaging the environment or mistreating their workforces.

Another worrying trend is that intermediaries such as banks, insurance companies and platforms, are taking more and more fees to sell investment products. This is clearly not in the long-term interests of savers.

The SLO of the fund management industry is undermined by short-term speculative investors and the index huggers. However, there is a growing part of the industry which does consider the wider impact of investment, alongside financial returns.

A broader purpose

We believe that fund management has a broader 'social' purpose. Fund management should play a role in pooling society's savings by encouraging a savings culture around long-term investment. Fund managers should argue for the benefits of regular savings for the long-term benefit of society. It is important that they play an active role in communicating the importance of a savings culture.

Fund management should play a part in the capital allocation process, making capital available to well-managed, quality businesses and allowing them to thrive to the benefit of all stakeholders, not just shareholders. A philosophy of careful stewardship is in the best interests of clients and should protect capital over the long-term.

Integrating Sustainability

Environmental, Social and Governance (ESG) factors have long been central to our investment process. Sustainability analysis and financial analysis are the same thing. For example, we are unable to form a view about a company's cashflow growth without assessing how it manages relationships with communities, customers and suppliers. What regulatory scrutiny will the company be under as a result of the products it sells, or how it sells them, or how it pays taxes? How efficient are its operations in terms of energy and water use?

In our view, a long-term investment mindset and a focus on quality are helpful preconditions for integrating sustainability fully into any investment philosophy and process, although our interpretation of quality is based on management, franchise and financials rather than narrower definitions (such as return on capital employed, cashflow and gearing).

A greater focus on long-term sustainability positioning and analysis of ESG issues should enhance the risk-return profile of any investment strategy. All our strategies incorporate ESG into the investment process, but the Sustainable Funds Group carry analysis a stage further by only investing in companies which contribute to and benefit from sustainable development.

We are committed to our role as fiduciaries and putting clients first. Fund management should be a conservative, even dull, pursuit, focused on the growth of client capital over the long-term.

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