Speech by Mark Goyder

Launch of Tomorrow's Capital Markets: Investing in what we value
St Paul's Institute, 27 October 2015

Thank you Barbara and warm thanks to the St Paul's Institute for hosting this event and to Robert Gordon and colleagues as well to Yolanda Villafuerte and the Tomorrow's Company team. I have some more thank yous. Let me thank our sponsors, especially Generation Investment Management, and the Generation Foundation, Russell Investments, and Alliance Trust.

Thank you to our Inquiry Team, Damian Carnell of Towers Watson, Mike Clark of Russell Investments, Donald Fleming of Gazelle Corporate Finance, Ingrid Holmes of E3G, Tim Wright of PWC, and you, Barbara.

And let me acknowledge the team that produced and/or were signatories to the report, especially our Director of Research, Strategy and Policy, Pat Cleverly. Pat has done a remarkable job – convenor, editor, ringmaster, and best of all custodian and steward of this project through its moments of difficulty. Pat was ably supported by our Senior Researcher, Aneta Dyakova. Both are in the audience tonight and both will, I hope come to my rescue when I am asked one of those difficult questions about the complexities of EU regulation or the proper use of brokers commission!

The full list of thank yous is in the report and covers two pages. That's typical of a piece of Tomorrow's Company thought leadership. We like to involve the practical people in scanning the changing environment. It is their insights which can help us understand the system well enough to set a new agenda and it is their commitment which enables us to be a catalyst for changing it.

That's what we have been doing, working with leaders of business and investment, for twenty years. We exist to inspire and enable companies to be a force for good. Tomorrow's Capital Markets represents an important advance in that agenda, and it is one we intend to follow up, especially focusing on the improvement in the quality of the stewardship that investors exercise over the companies in which they invest.

I was always taught that good reports didn't need reading in full because of the quality of their executive summary. And that even better reports don't even need an executive summary because the title says it all. Well here we have a title that pretty much says it all: Tomorrow's Capital Markets – investing in what we value. So my talk is divided into four parts. First the challenges of TOMORROW; secondly CAPITAL MARKETS - their role and their potential to be a force for good and stimulate companies and others to be a force for good; thirdly INVESTING; and fourthly INVESTING IN WHAT WE VALUE.

TOMORROW

The report starts with the challenges and opportunities of tomorrow.
Population – by 2050 there will be 9.1 bn people and more 60 year olds than under 15s in the world.
The pressure on **natural resources** – we are already using around 1.5 planets worth of natural resources. By 2030 it will be two and by 2050 somewhere between two and three planets.
Food – we need to be investing $83bn a year in the agricultural sector of developing nations, just to feed the world population at current nutrition levels.
Water – more than 1 billion people still lack access to fresh water and 2 billion to sanitation . In Brazil Sao Paolo's water supply was in crisis and economists estimated the impact at around 1 % of GDP.
Carbon and Energy - We need to mitigate and adapt to climate change. As Ingrid Holmes and others have been arguing, for the EU to become a low carbon economy there needs to be a doubling of current investment levels and a very different approach to the proposed Capital Markets Union to favour new technologies.

Technology - No time here to say more than that technology is disrupting and reshaping our world. And that we can use it for good or ill – as the Talk Talk episode reminds us. Advanced robots for industrial and service tasks could take on work that could be equivalent to the output of 40 million to 75 million full-time equivalents (FTEs). On the other hand, we can and must mobilise disruptive technology to support the human purposes described in this report, and, especially, to open up the real choices for clients of the investment process. .

CAPITAL MARKETS

Directly or indirectly the capital in our capital markets comes from our savings or those of people like us around the world. So it is logical for us as human beings to want to see that capital used and mobilised to tackle the huge problems of tomorrow that I have just listed.

In the report, we describe our capital markets as a hydra. An ugly beast maybe. But one that has proven successful over the generations at fuelling growth and prosperity. Resilient certainly. Capable of adaptation certainly. Good at new solutions.

There is hope. The beast is not out of control. By our actions we can steer it. Provided we give it the right instructions, create the right boundaries and rules and standards of behaviour. And, as Damian Carnell reminds us in his piece, provided we don't imagine we can do it all through financial incentives. Incentives like Long Term Incentive Plans, based on dubious and excessively short-term criteria, or share options that create incentives to manipulate the current share price rather than build a better company.

That's the thing about markets. They are good servants, but they are bad masters. We need to unlearn some of the economics that we have been taught. Too many economists have taught us to believe that markets are perfect. Not true. Markets are imperfect and varied and can be set up to serve very different purposes. And they can be manipulated. Look at LIBOR. Look at insider trading.

It is still often taken for granted that all economic behaviour can simply be explained in terms of people's desire to make money. Not true. People set up companies for all sorts of reasons - rarely, in fact, just to make money.

It is sometimes assumed that shareholders and stakeholders are different people, to be thought of in different compartments. Not true. You and I and many like us, are both shareholders and stakeholders. We need our investments to reflect the totality of what we value, not just the short-term financial side.

What's more, all of us are more accurately thought of not just as consumers, bent on maximising narrow individual self-interest, but as citizens, a critical distinction in language and thought soon to be explored in detail in a fascinating forthcoming report from the New Citizenship Project.

Too many economics classes still teach that if companies concentrate on making money, irrespective of how that money is made, then markets will somehow magically turn that profit into a good outcome. Not true. We know that an exclusive focus on moneymaking without regard to ethics, impacts or reputation often results in anything but good outcomes, where the customer, the employee, the community and the shareholder can end up as the victim. Just look at VW.

So in the week when, unlike VW, that other German car manufacturer Mercedes is celebrating its Grand Prix success with Lewis Hamilton, I would suggest that capital markets are like racing car engines. They will only perform at their best for us if they are set up right, and carefully tuned and retuned.

And, if I can continue the analogy, the effectiveness of capital markets depends very much on the wheels and the steering. If our investments are to be well looked after we need to ensure that the original message sent from the steering wheel by the client is not lost in a confusion of poorly aligned suspension and conflicted and misaligned wheels.

Encouragingly, the report points to many examples where the steering does –self correct through the actions of people in the system as Mike Clark of Russell Investments puts it on p 27 'we can recognise the power of self-organisation, of participants getting together to change things'. One of the examples he quotes is the development by the Pensions and Lifetime Savings Association (formerly the National Association of Pension Funds) of a Stewardship Framework, which helps asset owners to assess and differentiate the stewardship claims of asset managers. I'm proud to say Tomorrow's Company itself was a catalyst in this particular example of self-organisation. So capital markets need tuning.

INVESTING

Let's reflect for a moment on the word 'investing'. The first key point to remember is that there is an investment chain. If we want the right results out of investing we have to understand the chain. Leon Kamhi will be saying more about what we call the stewardship value chain. The second thing to remember is that capital markets are not all about investing. There is a large part of our capital markets that are, necessarily, about trading.

In this report we are saying that we need to see a number of realignments, if we are not to end up with the real economy of wealth and value being overwhelmed by the casino economy of trading. We talk about some fund managers who claim to be acting on long-term mandates but who are actually trading short-term. Then there is High Frequency Trading – where delays and other remedies may be needed to ensure that a few players don't get to rig the casino at the expense of others. In the appendix to the report (on p 34) we offer three good practice examples of better alignment between the rewards to the fund managers and the rewards to the clients.

On page 30 of the report, George Latham of WHEB Asset management makes the case for a focus on climate change risk that doesn't simply screen out the undesirable carbon-heavy investment, but supports investment in a new economy where better solutions are developed.

On page 27 of the report Donald Fleming of Gazelle Corporate Finance talks of a new alignment between the corporate pension fund and the sponsoring company, and the need to 'recalibrate the balance of incentives' for defined benefit pension schemes so that the two are not engaged in a self-destructive downward spiral. You see this coming out in many of the issues raised in the report. Should pension funds be lending a company's shares so that hedge funds can go short on them? Should fund manager remuneration and performance management incentivise the investors who have a stake in SAB Miller, or before them Astra Zeneca or Cadbury, to sell out just because it helps them achieve their performance targets and their bonus for the year?

WHAT WE VALUE

So, having recognised the need for realignments that keep the casino activities of capital markets in balance this brings us finally to the question of 'what we value'.

There was a story in yesterday's Financial Times that crystallised the issue for me. Apparently and I quote: *'Investors are piling pressure on companies to lower their tax rates, despite the growing assertiveness of tax authorities and heightened reputational risks, according to a poll…Some investors were focused on transparency, reputation and the stability of the tax rate. But for many, it was simply a case of minimising costs and maximising returns.' Vanessa Houlder Financial Times Mon 26 October 2015.*

Is that the mandate that most of us as clients would have given to the institutions that are handling our money. I think not. This to me is an example of investors making an assumption about what we, their clients and beneficiaries, want out of our investments.

For too long we have been enslaved by a superficial and inaccurate description of fiduciary duty. We have been told, for example, that pension trustees cannot make investment decisions that reflect that ethical principles if these stand in the way of the anticipated short-term financial returns. I have always found this dogma hard to understand. It implies a spurious certainty about the best ways of making money. It is a doctrine that in the early part of this century might have encouraged pension funds to invest heavily in companies like Marconi just when its new management was destroying 95% of its shareholder value.

As you will be able to read shortly when we publish the report of our Futures project, Tomorrow's Company has collected considerable evidence that the relationship may go the other way, and that, provided they are patient, institutions will make more money for beneficiaries by investing in companies that are connected with the changing expectations of society.

But now the legal position is becoming clearer. In the UK the Law Commission has made it plain that it is permissible for pension trustees to use their judgement. And the report by Tomorrow's Company on Tomorrow's Value also sets out the issues in a much more balance and nuanced way.

It is not only OK for decision makers in capital markets to make investment decisions that put the wellbeing of humanity at their heart. It is arguably a dereliction of fiduciary duty for them not to do so. Our capital markets may be a many-headed monster but they have changed and can change and we need to build on every opportunity for them to change, many of which are catalogued in the report.

As savers and investors we all have choices we can make. The key thing is that we make them with our own wider view of value at the front of our minds, and that those who design, regulate and operate our capital markets set them up so that our wishes as citizens can be respected.

I was inspired, Barbara, by a homily that I say that you gave recently about the harvest and about plenty. Years ago, economic activity was simpler to describe. Sowing, growing, reaping, threshing, winnowing, storing. We can't clearly see the grain in the barn. But that is what needs to change. The key activities of our harvest include:

Saving/investing/stewarding assets/ providing investment advice/managing funds/ starting, growing financing and floating businesses/ putting in place the right boards/ creating the right cultures and the right measurements and incentives/ appointing their leaders/ stewarding those companies for today and tomorrow/ ensuring they are properly accountable.

Connecting all of these activities is part of what we in Tomorrow's Company mean by the golden thread of stewardship. A thread which working with others, we intend to strengthen as we follow up the issues described in this report.

Tomorrow's savers need to be able to understand, and influence, the seeds that are sown in the economy of tomorrow. We need to be offered options that enable us to know and shape the character of the harvest we are funding.

Capital markets exist to serve wealth creation and societal health. Let us take every step we can to ensure that they are attuned to that purpose.