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REQUIEM FOR AN INDUSTRY

A plea for innovation in asset management

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The good folks from Occupy Wall Street/St. Paul's/the City *et al* are *definitely* onto something. Any grass roots movement capable of garnering kudos from the Vatican, central bankers, senior U.S. military officials, anti-globalization activists, and PIMCO bond king Bill Gross simultaneously must really have touched an important nerve in the *zeitgeist*. And, while the Occupiers have rightly drawn the world's attention to many of the worst ills of contemporary capitalism, they have not yet mentioned one which we consider to be equally pernicious and arguably posing an ever greater long-term threat: the financial system's almost pathological abhorrence of innovation.

By "innovation", we are *not* referring here to the profusion of arcane, opaque financial engineering and pyrotechnics which are invariably trotted out as proof positive that Wall Street, the City, and their peers are the apotheosis of ingenuity, dynamism, and even, in extreme cases, social utility. No, instead we mean real, *fundamental* innovation that challenges the basic assumptions which underpin the financial system in its current form, *and* which acknowledge both past failings and the fact that today's and tomorrow's investment environment is quite literally unprecedented, and will therefore absolutely require unprecedented approaches in response.

In brief, we believe that both asset owners and their investment managers all over the world are failing woefully to demonstrate the level of innovative thinking – and *action* – remotely commensurate with the gravity of the global economic, environmental, and social conditions in which we currently find ourselves. The supreme irony in all of this, of course, is that the resistance to innovative approaches is at an historic peak at precisely the point in time where the *existing* approaches have, for the most part, failed in the most spectacular fashion imaginable!

At its most superficial level, the strongest manifestation of this systematic abhorrence of innovation can be seen in asset owners' nearly universal insistence on a substantial historical track record from asset managers. It apparently matters little whether or not that track record is consistently egregious; what matters is that it simply exists, and the longer the better. Asset owners increasingly pay lip service to wanting innovation and creative thinking, but that innovation had better come equipped with a 3-year

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It's the MEGATRENDS, stupid!

The systematic lack of innovation that we are talking about is perhaps most apparent when it comes to the lack of understanding and responding to one simple fact: that the world confronting investors today and for the foreseeable future is radically different from that which obtained even 10 years ago. The world's center of economic gravity is shifting inexorably from west to east, from north to south, and from rural to urban. Natural resource degradation and scarcity are increasingly constraining both economic activity and the quality of life for hundreds of millions. Growing population and consumption are putting an unprecedented strain on both natural and social systems. Income inequality is not only increasing, but it is now far more likely to catalyze radical political change and even violence. Sustainability considerations are becoming increasingly critical to companies' competitiveness and profitability. The world has become an increasingly transparent, 24/7 place where companies have nowhere to hide, and the expectations of their stakeholders are at an all-time high. One could go on... Yet despite all this, ask yourself (or, better still, ask your investment committee and/or money managers): "Can you demonstrate to us precisely how you've responded to these tectonic changes? What new investment assumptions and models do you use now? What different sources of information, research and analysis? How are these being integrated with traditional investment factors?" The sad, sad truth is that *at least* 95% of them, were they to respond honestly, would have to admit that nothing fundamental has changed in their investment processes since 1980, if their firms had been around that long.

Well, O.K.: we'll grant that there are a lot more computers and Bloomberg terminals around these days. But *fundamental* changes? Nada. And remember what Einstein said about the practical definition of insanity: doing the same thing over and over again, but expecting different results and outcomes...

In the particular case of the sustainable investment space, we'd argue that this pervasive resistance to change and innovation is precisely why the *true* figure for the level of meaningful integration of sustainability and financial considerations among the \$30 trillion worth of UN Principles for Responsible Investment signatories is much closer to one percent than the ludicrous figure of eighty

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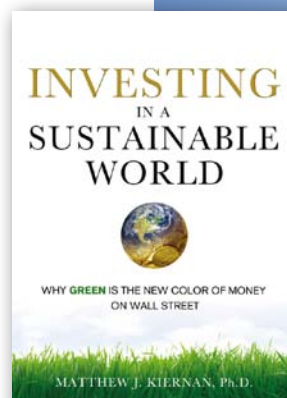
track record, at a minimum. And woe-betide the asset owner who breaks ranks and tries a new and “untested” investment strategy, no matter how compelling it might appear.

One could readily be forgiven for thinking that the risk that investment committees and CIO’s are *really* trying to manage is an entirely different kind of risk altogether, and one far more feared: career and/or personal reputational risk. That is, it’s the risk involved in doing something substantially different from one’s peers. As John Maynard Keynes famously said, it appears that it is much preferable to fail conventionally... So, even in the face of results from conventional strategies which often range from the consistently sub-par to the catastrophic, it is the brave institutional investor indeed who is prepared to break ranks and attempt to break new ground. Even where institutional investors do actually seek the frisson of being first, they still insist on being first *second*. And so no one moves, and the global minuet of “after you, Alphonse” continues. Hardly a recipe for the innovation and new approaches which current conditions so evidently demand!

Now, this might be remotely acceptable if the “tried and true” approaches of the past were delivering terrific results. But they aren’t. As the world looks to find a way out of the economic hole in which we currently find ourselves, we need to accept that it has been the investment decisions of institutional investors that have played a significant role in digging that hole in the first place. One could draw up a list as long as your arm of the mistakes that investors have made, and while Governments can be justly criticized for their unsustainable debt levels, it is the *investors* who must accept responsibility for investing without questioning the long-term ability of a country to actually pay off its debts, or of companies to deliver financial *and* social/environmental sustainability.

percent suggested by the signatories’ self-assessment. Do you doubt that? Well, can you point to \$26 trillion in “sustainable” investment strategies implied by the 80% figure? We know that we certainly can’t. And, while we’re at it, why did the UN’s very own Staff Pension Fund come within a whisker of not even signing the PRI principles which the UN itself had developed and promulgated in the first place? Perhaps even more to the point, why, after more than a decade of discussion and consideration, is *none* of the \$40+ billion in the Fund managed with even a cursory glance at the environmental or social track records and impacts of the companies in which it invests? For that matter, why on earth would a \$10 billion foundation give away over \$400 million each year in grants to support environmental causes and initiatives (roughly 5% of its assets), while simultaneously steadfastly refusing to even inform itself about what level of environmental risks and impacts are being generated by the other 95% of its assets in its investment portfolio?

The answers are many and varied; indeed, I’ve written an entire book (*Investing in a Sustainable World*) attempting to provide a cogent answer. But the bottom line is this: an unholy concatenation of cognitive blinders, institutional inertia, and a dogged unwillingness to break ranks with one’s peers has created an entire investment ecosystem where true innovation is consistently stifled to the point of near-extinction. We can – and must – do better. And time is running out... Persisting with the same old tired approaches will not only fulfill Einstein’s classic definition of insanity (trying the same thing over and over again and expecting a different result), but poses a serious risk to the financial integrity of the pensions on which many millions depend.



ABOUT US

Inflection Point Capital Management is a new, sustainability-driven asset management boutique. A research-driven organization, IPCM builds on the knowledge base and networks of its predecessor company, Innovest Strategic Value Advisors. Innovest was ranked by the Thomson Extel survey of institutional investors as the #1 research firm in the world in the sustainability space. IPCM has offices in London, New York, Toronto, and Melbourne.
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