Sunday 21 September 2008

" … once we stabilize the markets, we then have to take actions to make sure this doesn't happen again.

… we have a regulatory system that is **broken**. It's **outdated**. It's **outmoded**. It doesn't fit the world we live in."

Hank Paulson, *US Treasury Secretary*
Former CEO of Goldman Sachs

1. We live in very interesting times! This quote, from Fox News on Sunday night, summarises what many of us I'd guess feel

2. The fact that you are bothered enough to come to this event means its not news to you that the global financial markets need fundamental reform.

3. But what I'm not sure we fully realise is that the dramatic and traumatic events of the past week present us with an unprecedented opportunity to bring about change that goes way beyond merely tinkering at the edges.

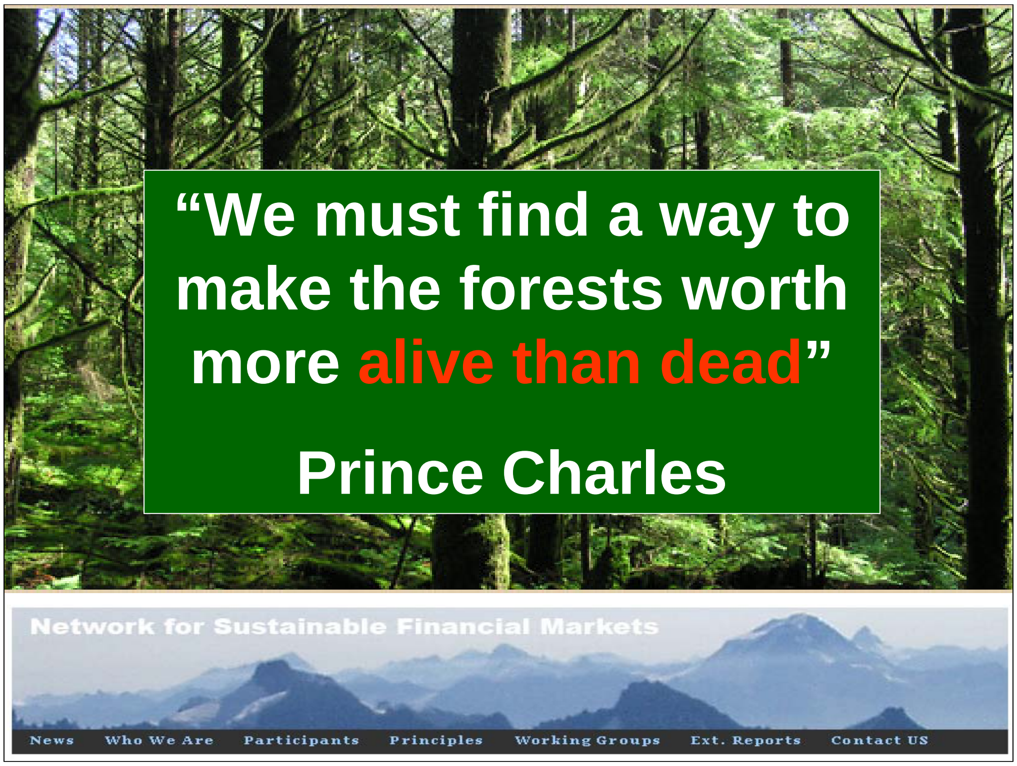
4. There is no better evidence of this window of opportunity than the name of the man who made this comment:

HIT ENTER

1. Up until only a very short time ago Hank Paulson, the former chairman of Goldman Sachs, was not known for being an advocate of government interventions in the markets! But look at what Paulson and the Fed and the SEC have done in recent days: Wall St bail out, restrictions on short selling etc

2. As Naomi Klein documents in her book The Shock Doctrine, times of shock are when big changes – good and bad – are often pushed through. We know what Mr Paulson wants to do***. <u>But where's the regulatory reform agenda that the international RI community is ready to push forward today?</u>***

3. Whilst media attention is focused on the financial markets, there's another crisis unfolding which is just as worrying but different kind – more akin to crisis a frog faces when put in cold water and then that water is raised to boiling but so slowly that the frog just doesn't sense the need to jump out.



1. Who knows what this slide shows? It's a picture of one part of the Amazon in 1975. ***HIT ENTER.*** And this is the same area today.
2. And this is happening globally: ***HIT ENTER.*** Forests are disappearing at rate of an area the size of greater London every day. This deforestation accounts for 1/5th of world's annual GHG emissions.
3. Why is it happening? When cleared for agricultural use, forests are worth $200-400 per hectare. When standing, they have no value! Despite the fact that the environmental services they provide have been estimated at $15,000 per hectare!
4. Talk about market mis-pricing!.
5. The problem elicits piecemeal solutions, rather than a systemic response. Eg well meaning individuals and organisations buy up a bit, but loggers move elsewhere. Investors move in, prices go up, they sell.
6. National regulation by itself doesn't work – why should less developed countries make the economic sacrifice when the developed world didn't protect its forests?
7. For forests to be preserved there must be sustainable predictable income for those countries. And for this to work carbon has to have a serious price. That means key parts of world to be in a cap and trade system: ie regulation mobilising and directing market forces.
8. **So is creating this systemic change a major focus for the RI community? Specifically, given we aren't going to get a clear enough carbon pricing signal soon enough, is the RI community mobilising its collective resources to find a good-enough interim holding solution?**
9. The good news is Prince Charles has convened a group of powerful financial sector individuals under in his Rainforest project – individuals acting in their private capacity – to see how to create the system change that's needed

Building Sustainable Financial Markets

RIAA's International Responsible Investment Conference, Melbourne 24 September 2008

What is Different About NSFM

- Individuals: less constrained thinking
- Investment practitioners & academics
- Wisdom of crowds: global and cross-disciplinary
- Change oriented & systemic view: empirical and learning by doing

•The network is a meeting place for individual acting in a **wholly private capacity** – **more free to explore ideas unconstrained** by institutional agendas or interests.

•**Why practitioners and academics?** When working in mono-cultures, things get sterile and folks start to behave like their labels! Academics start to become “ivory tower”, practitioners start to become complacent (happy clappy) and consultants start to sell! Mixing folk makes things much more creative.

•The network is able to **draw on the wisdom of crowds** - and we can boast a very well informed crowd amongst our members. The network is **global** (whilst we in the West worry about the liquidity crisis, the rest of the world has been concerned with commodity crisis/food riots. To succeed, we need to look for how these issues are **interconnected**. And that also explains why the Network is intentionally **interdisciplinary** (too complex for just investment professional, just economist or just lawyers)

•Finally, it is **actively change focused** and takes a **systemic view of issues**, i.e. looking at the way financial markets are built and how they operate, and whether financial markets mechanisms are doing a good job at providing incentives that will ensure that market participants are delivering against the fundamental purpose of the financial markets. And to achieve this change, the Network is firmly committed to **being empirical and not ideological** and adopting **a learning by doing** approach.

•We arent saying the network today is perfect. Indeed, its only recently started – these are intentions. Its just that collectively, we have lost sight of what the “fundamental purpose” of the markets is for amid all the excitment of the bull market and all the financial innovation – and on our RI side, all the excitement about thematic funds, asset growth and promise of integration.

•But when you binge, you get a headache and now is the time to revisit the financial markets’ “raison d’être” ...

So let's go back to basics and remind ourselves of the primary function of the markets. This is taken out of a current textbook used by students doing Masters in Finance at prestigious universities.

"Finance is the study of how people allocate scare resources over time…

It goes on to say: **A basic tenet of finance is that the ultimate function of the system is to satisfy people's consumption preferences, including all the basic necessities of life, such as food, clothing and shelter.**

Economic organisations, such as firms and governments <u>exist</u> in order to facilitate the achievement of that ultimate function."

So the ultimate objectives of the financial markets is to enable much better, <u>more much efficient</u>, allocation of capital… it always was but now, there is an extra challenge.

We are operating in a world that is increasingly "resources-constrained" (be it in terms of "financial capital" or other types of resources such as talent or environmental resources)

But what does this mean in practice?

Efficient Resource Allocation

We can all agree that markets are about efficient allocation of resources, but what should "efficiency" mean today?

Albert Einstein in his Nobel Prize acceptance speech observed that **"Not everything that counts can be counted …. and that not everything that can be counted counts."**

By focusing only on simple (some would say simplistic) economic and financial measures, we make it inevitable that we fail to efficiently allocate scare resources

Sometimes, progress depends on remembering things we may have forgotten or ignored…

Beyond Economic Measures

- “Gross national [or domestic] product measures neither the **health of our children**, the **quality of their education**, nor the **joy of their play** **…**
- It is indifferent to the **decency of our factories** and the **safety of our streets** …
- It measures everything in short, except that which makes **life worth living** …”

Robert Kennedy 1968

We show this quote from Robert Kennedy not because its doable in its pure form today.

But rather because it captures a fundamental truth which crosses party political lines. It really challenges us to find better ways to take into account the resource productivity of the underlying assets.

For example, how well a company is utilising limited resources such as human capital or water to generate sustainable value creation - i.e. future cash flows - in an increasingly resources-constrained world.

That’s the only way we can move beyond what Peter Senge, in his new great book the *Necessary Revolution*, calls the Industrial Age Bubble.

Its the only way to lead to a more Regenerative Economy.

And it’s also the way to find more stable, most sustainable investment results, more connected to the real, productive economy and less vulnerable to booms and busts. Yes, what’s good for the world is also good for our investment returns! We’ll return to this point shortly.

But first, let me tell you what NSFM stands for:

The NSFM Principles

- Sustainable long term value creation
- Identify hidden risks and opportunities
- Balance short-term vs. long-term interest
- Improve market participants accountability for acting responsibly
- Improve governance at financial institutions
- Promote a coordinated global approach

I said NSFM is firmly on the side that there's a systemic problem. Here are 7 guiding principles that we felt characterized what needs to change and this is what NSFM participants have pledged allegiance to join!

Whilst the 1st focuses on the desired output, the other 6 are looking at the mechanisms that are needed to deliver this.

1. **The purpose of markets is to create long-term, sustainable value:** Too much financial market activity over recent years has had too little real economic, let alone wider benefit. Greater attention needs to be paid to how sustainable, long-term value is created, and market and regulatory reforms directed towards creating such value.

2. **Sustainable, long-term value creation requires greater effort be put into valuing "hidden" risks and rewards that are today ignored:** All too often, companies offload costs onto society, while capturing benefits for their private gain. Similarly, companies that invest in the creation of long-term value for society are often inadequately rewarded. Correcting this (ie internalising positive and negative externalities) is critical to ensuring capital allocation is truly efficient and requires coordinated action by regulators and investors.

3. **A better balance between short-term and long-term thinking is needed:** Given the numerous tax, legal, accounting, regulatory and compensation incentives for financial sector participants to prioritise short-term gains at the expense of greater future value creation, concerted action is needed to re-balance the system.

4. **Market participants must be held more accountable for their actions:** The widespread shifting of financial risks away from those who create them, while compensation systems reward through-put, creates moral hazard. Originators of risk should be made, through micro and macro actions, to 'eat some of their own cooking'. This applies to all market participants, including asset owners who are accountable for understanding the risks they accept in the search for alpha.

5. **Governance at all financial institutions should be improved**: Better governance and risk management practices are needed throughout the industry and this requires upgrading of board oversight, risk models and reporting.

6. **Better alignment of financial interests** is needed to reduce agency costs: Measures to better align the short-term activities of financial companies with the longer-term interests of their customers are necessary to correct the incentives for intermediaries to profit at the expense of end beneficiaries.

7. **A coordinated global approach** is needed to better protect the financial markets: In an increasingly global marketplace, individuals and organisations tasked with oversight should put much greater emphasis on coordinating with others so that financial institutions cannot play regulatory arbitrage.

These Principles guide the activity of NSFM's working groups which are focused on different aspects of this systemic crisis. Acting as "solution incubators", these working groups commission and undertake research and policy work to influence organisations that have the power to change the system.

Current NSFM Participants

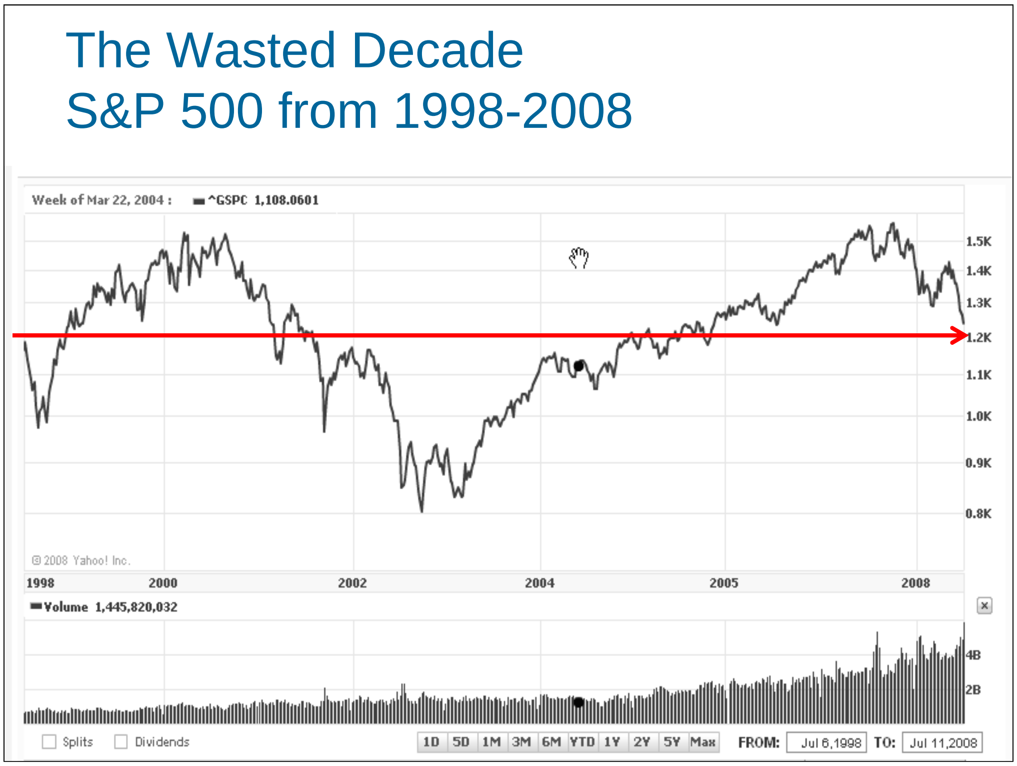
Robert Adamson	Hand Dijkstra	Janelle Knox-Hayes	Vasudec Palladam	Michael Siebecker
Keith Ambachtsheer	Ralf Frank	Floris Lambrechtsen	Frank Partnoy	Ken Stewart
Rob Bauer	Murray Gold	Jinyan Li	Avinash Persaud	Nicholas Taylor
Adrian Berendt	Jack Gray	Steve Lydenberg	Poonam Puri	Raj Thamotheram
Ann Byrne	Danyelle Guyatt	Michael Mainelli	Amin Rajan	Jeroen Tielman
Mark Campanale	Frank Jan de Graaf	Franz Maritsch	Benjamin Richardson	Mark van Clieaf
Greg Chipman	Stirling Habbitts	Heleen Mees	Nick Robins	Ed Waitzer
Cecile Churet	Matthew Haigh	Paul Moxey	William Russell-Smith	Steve Waygood
Gordon L. Clark	Jonathan Hayward	Mike Musuraca	Janis Sarra	Helen Wildsmith
Ronald B. Davis	Keith L. Johnson	Robert A. G. Monks	Howard Sherman	Cynthia Williams
Stephen Davis	Sean Kidney	Louise O'Halloran	Penny Sheperd	Peer Zumbansen
Paul Dickinson	Eric Knight	James O'Loughlin	Dan Siddy	… and more

That doesn't mean all NSFM members think the same thing! God forbid! Just as we don't have the same expertises, we don't always have the same diagnosis about what's wrong.

But that's ok because this is a complex system and there are no single causes. In our more reflective moments, each of us know we don't have the full answer!

But what we all agree on is that today's financial markets mechanisms are failing in a big way to fulfill its primary purpose: that of allocating capital efficiently to productive uses. All of us are involved in our day job – be it as practitioners or academics in this. And so we can very clearly see that progress is far too slow. Far too incremental. And we can all see the limitations of the existing organizations that are pushing for change – trade associations inevitably tend towards lowest common denominator positions. Not that they aren't needed or even that they aren't doing the best they can. Just need more pressure.

NSFM includes leading academics and financial market professionals from Australia, Britain, Canada, France, Germany, the Netherlands, New Zealand, Switzerland and the United States - and is growing! There are already several Australian members – definitely punching above your weight – but my hope is that after today, there will be many more!



Talk of the wider, fundamental purpose of markets always brings concerns about negative impact on members, fiduciary duty concerns etc. So lets just look at what business as usual is delivering

Let's take a hard nosed look at the financial results of the narrow shareholder value only approach. This chart shows the real return on the S&P 500 since 1998, after subtracting consumer price inflation, was just ***HIT ENTER*** about zero!

In just the last 10 years, we have witnessed two major bubbles with financial, economic and this time round especially, social consequences on a massive scale. The last one affected people at the bottom – the very bottom – of the ladder. The only real beneficiaries were the intermediaries in the financial system. It's quite sickening when you stop and think about it.

Some things have gone up, however….

Growing Concerns About Short-Termism

Data from Jack Bogle, founder, Vanguard

Portfolio Turnover vs. Annual Returns
942 Equity Funds
(Morningstar Data for 10 Years Ended 2/2005)

	Turnover	Trans. Costs	Exp. Ratio	Net Pre-Tax Return	Risk (SD)	Risk-Adj PT Ret.	Risk-Adj AT Ret.
1Q	13%	0.1%	1.0%	11.5%	16%	11.6%	10.1%
2Q	40	0.4	1.1	11.1	17	10.9	9.0
3Q	75	0.7	1.3	10.1	19	9.5	7.5
4Q	165	1.5	1.3	9.8	21	8.9	6.5
Avg	73%	0.7%	1.2%	10.6%	18%	10.3%	8.3%

".. we see considerable fault-lines with the investment management value proposition as it stands, in that the vast majority of investment products carry too much cost for the value they deliver..there is little long-termism ... we are crisis prone because of poorly structured incentives and other excesses".

Defining Moments:
The Pensions & Investment Industry of the Future, ***Watson Wyatt****, 2008*

Jack Bogle in his forthcoming book "Enough" shows fund turnover has gone from 40% in 1970s to over 100% today.

And turnover doesn't help the vast majority of end beneficiares as Watson Wyatt recently noted

Growing Concerns About Macro-Economic Impact

Fiscal Year	Median Total Compensation
1999	$1,032,665
2000	$1,108,950
2001	$1,602,470
2002	$1,641,733
2003	$1,853,923
2004	$2,436,190
2005	$2,896,433
5006	$3,496,595
2007	$3,195,824

Data from the Corporate Library

"… it is shocking that the majority of firms are willing to sacrifice long-run economic value in order to deliver short-run earnings. Companies do this in response to intense pressure from the market to meet expectations…. we assert that the amount of value destroyed by firms striving to hit earnings targets exceeds the value lost in these high profile fraud cases… What is worse is that these actions are not even considered to be a 'problem' by many CFOs".

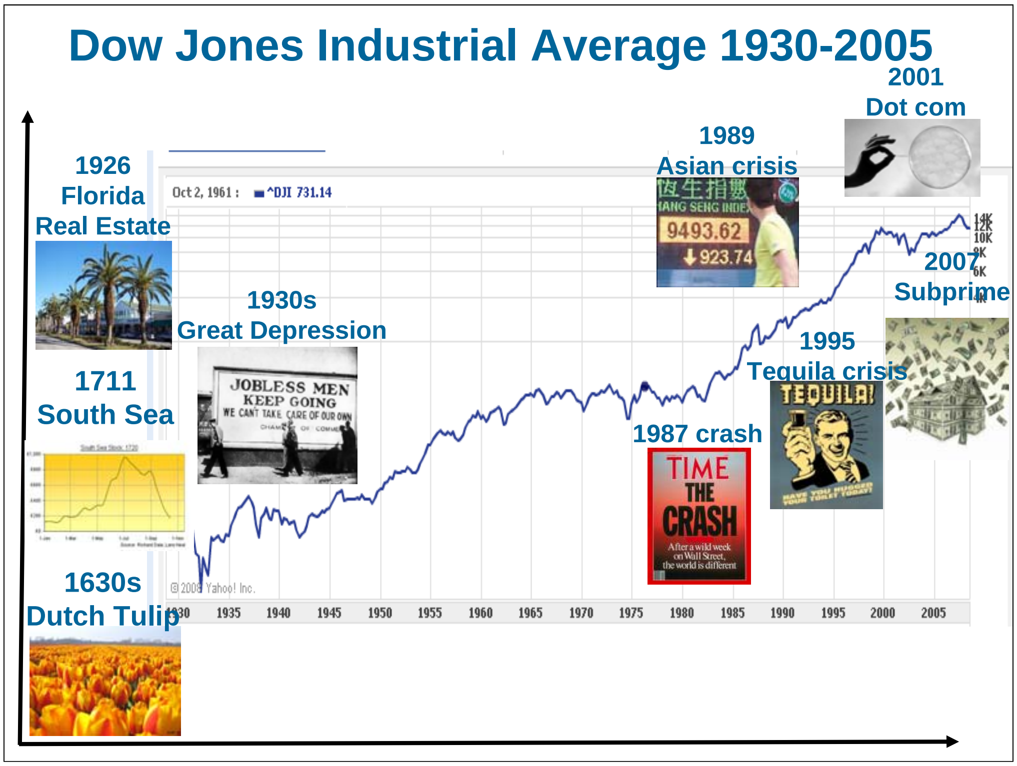
Value Destruction and Financial Reporting Decisions, John Graham et al,
***Duke University**, Sept 2006*

And another thing that's gone up is pay for "super rich" CEOs – the title reflects the need for a new category. As is happening across the world, Andrew Leigh at Australian National University reveals an explosion of pay rises at the tops of corporations. In the early 1990s, a CEO in one of this country's top 50 companies earned 27 times the wage of an average worker. By 2002 this had risen to 98 times. OR LOCAL EXAMPLE

What we are slowly beginning to recognise is there are big financial costs to this kind of "winner takes all" incentives.

Duke University academics have shown that most CFOs will rather trade off investment in activity they know will bring greater profitability (eg R&D, advertising, staff training) if this means they can meet "the number" – ie manage earnings

And another very damaging consequence of our approach is a greater propensity to bubbles and more damaging bubbles when they do occur.



Bubbles are a symptom/product of misallocation of capital. Of course, they arent new.

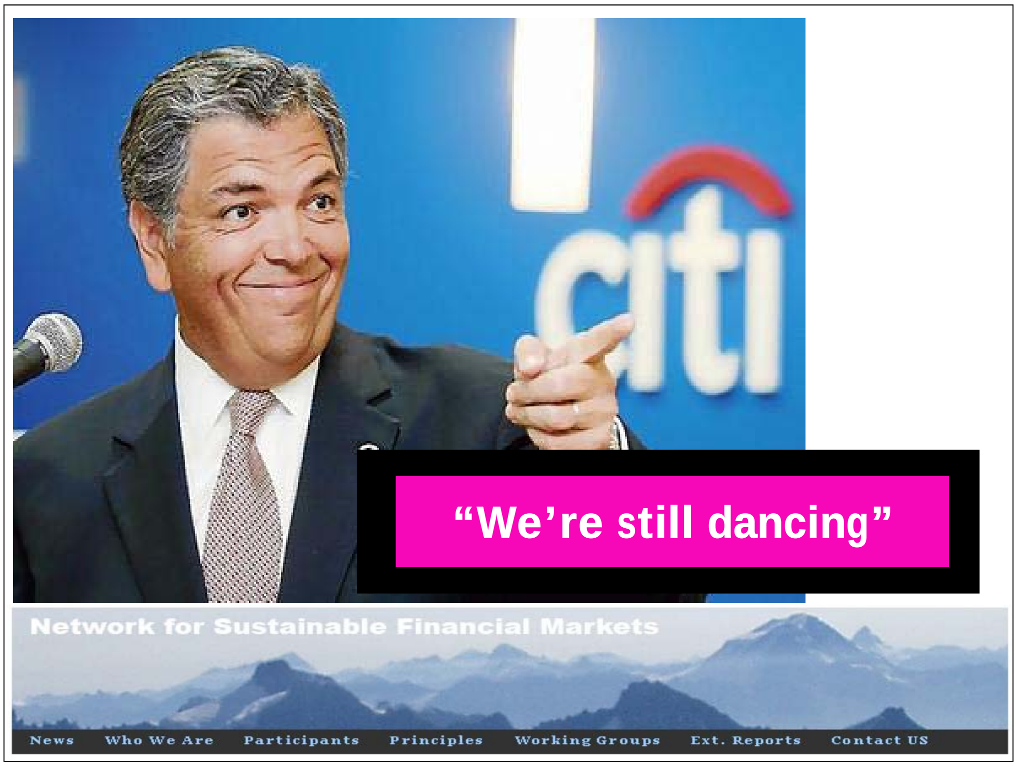
HIT ENTER.

Going back to the 1630s, Dutch investors traded tulips for prices equivalent to entire estates! Stocks in the British South Sea Company traded for 1,000 pounds (unadjusted for inflation) in 1711 and then were reduced to nothing by the later half of 1720. The 1st half of the 20th century witnessed the Florida Real Estate bubble and the 1929 crash in the US...

As the DJIA Index (the oldest ongoing index) shows, a period of relative calm followed the Great Depression. Maybe investors who experienced that were wiser. Maybe this was partly linked to the Glass-Steagall Act, enforced in 1933 to prevent banks from owning other financial companies…

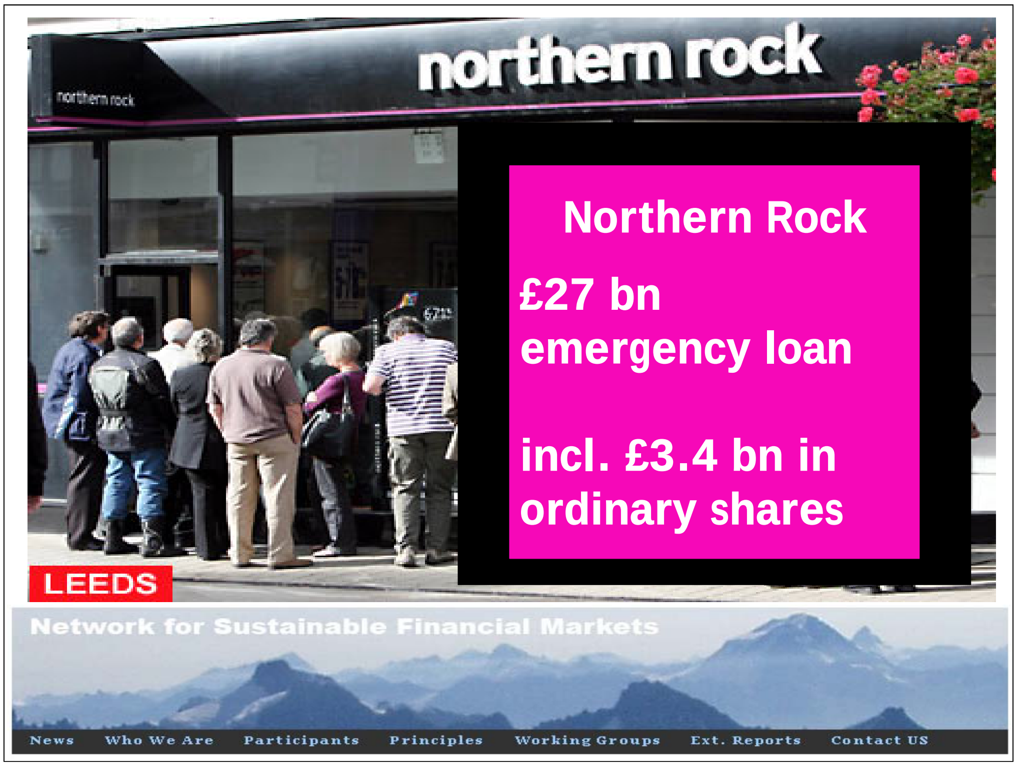
What we can say is that since the 1980s bubbles keep happening and they are getting more frequent and the consequences are getting worse.

I'll come back to the issue of what connects these bubbles but for now, I just want to remind us of the very real impact they have on the underlying economy... starting with the financial industry itself.

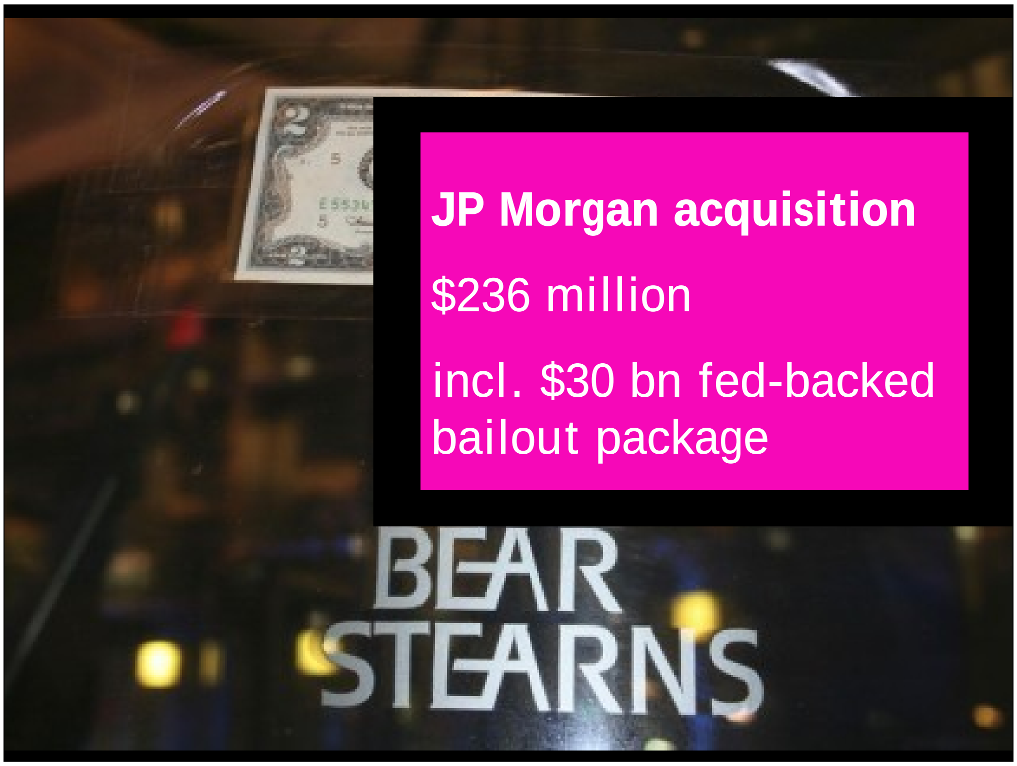


When asked by the FT about Citigroup’s CDO exposure at the beginning of July 2007, CEO Chuck Prince famously said that ““When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing,”.

But Chuck Prince was really only saying what everyone was more or less doing as we have slowly been finding out….

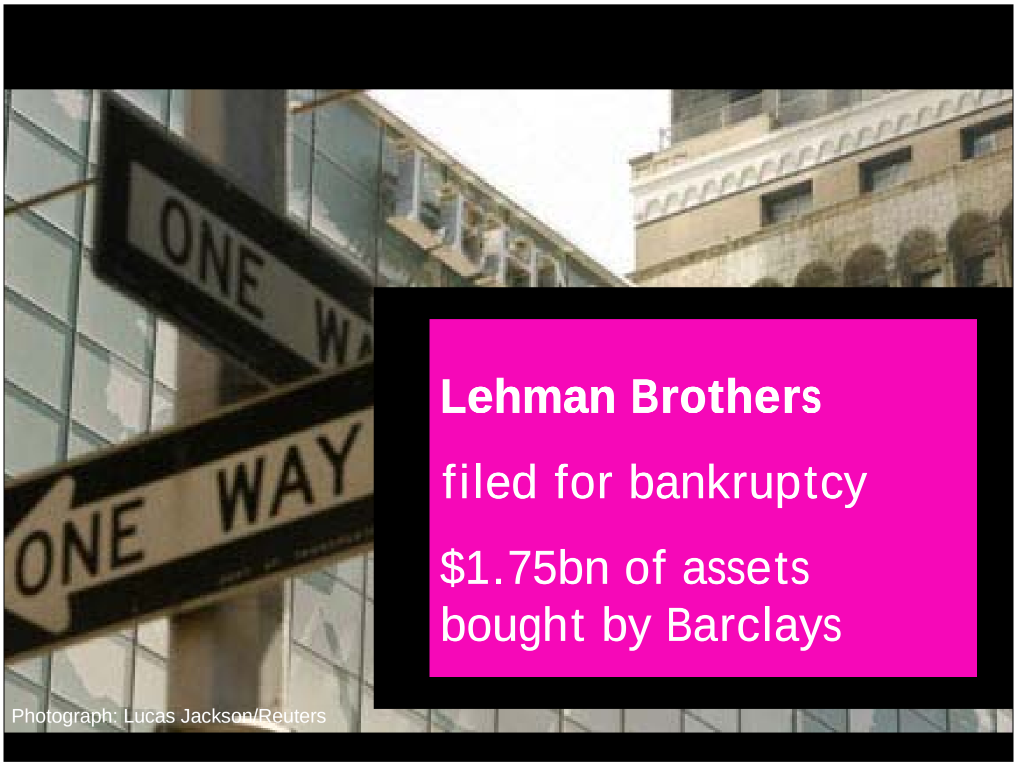


In the UK there was Northern Rock



In the US, the collapse of Bear Stearns was narrowly avoided when JP Morgan announced on Monday 17 March 2008 that it would acquire Bear Stearn for $2 a share -- a massive discount to the firm's closing price of $30 on the previous Friday. A week before, the stock was trading above $60 and a year ago it was at more than $150. Following the announcement, the shares lost 89% of their value in 1 day.

Merrill Lynch was acquired by Bank of America for $50bn



Lehman filed for bankruptcy on 15 September , triggering panic in the financial markets and a sell-off of equities.

Key Lessons From the Sub-Prime / Credit / Liquidity Crunch

- Excessive leverage / debt
- Flawed and excessive incentive structures pushes all market participants … even asset owners!
- Oversized financial sector
- Vicious circle of short-termism, disintermediation of product sellers (“pushers”) from people who end up holding the risk

The system is as prone to periodic crises and misallocation of capital as it was before sub-prime.

Increasingly acknowledged that these bubbles are not acts of god or fate

They have common denominators

Some are now so obvious that there is no doubt – eg illusion of liquidity until there isn't any!

But others are more ‘political’ since to accept something as a cause is to acknowledge it needs action.

Excessive leverage – wasn’t considered to be a factor a few months ago, and now it is. Woody Brock and a few others to thank.

Remuneration systems… big rewards (financial and social) for CEOs who succeed, shareholder punishment if performance less good than peers and pretty good personal outcome for even if complete failure Latest scandal is guaranteed bonuses for Lehman staff there is a long history in many countries. LOCAL EXAMPLE: The CEO of National Bank got $14 million whilst the scandalous trading mistake that happened during his watch which cost $360. Former James Hardie CEO Peter Macdonald left with $9 million for a public relations disaster. Basically all upside potential and no real downside risk

The failure of credit rating agencies, partly because of conflicts of interest.

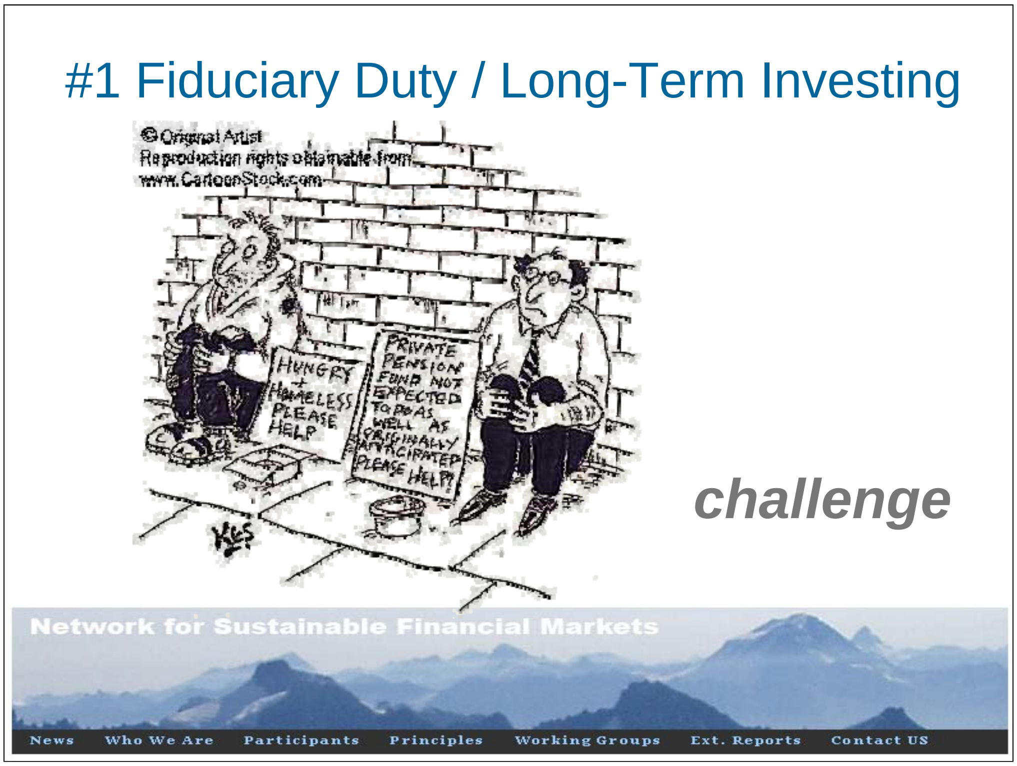
The lack of understanding (and oversight) for complex financial instruments such as derivatives

<u>So what do long-term responsible investors have to say about both these issues?</u>

Current Active Working Groups

- Fiduciary duty and long term investing
- Executive remuneration
- Climate change
- Regulatory reform

Well to help fill this gap…which really is quite worrying when you think about the fact that investors are the real losers….here are the specific issues that the NSFM Working Groups are examining.



OECD is promoting (good) process guidelines for asset owners/trustees. Quite influential in shaping national action plans.

But with no real focus of what these process guidelines are designed to achieve!

Important to remember OECD is also the body that believes in corporate governaqce, corporate responsibilty, action on bribery, etc

NSFM working group made a written submission to OECD and is pushing a wider debate though a bulletin board discussion in partnership with AQ Reserach and media work

•Pension fund governance and investment behaviour need to be considered together

•Funds should explain how they deal with the risk of herding behaviour (preference for adopting the same strategies and tactics as similar institutional investors

•Funds should explain how, in practice, they deal with conflicts of interest at investment managers

•Funds should explain there position on theoretical concepts which dominate practice (eg efficient market theory, modern portfolio theory) and how these align with the interests of their beneficiaries

These are questions most funds will never have discussed formally and developed management strategies for. High time it happened!

#1 Fiduciary Duty / Long-Term Investing

intervention

How does this fiduciary duty project fit with NSMF principles and rationale?

Lets take each of principles in turn

The submission seeks to make real the general idea of sustainable value creation and efficient allocation of capital– by changing how asset owners think about this

It highlights that current investment beliefs - which have a big if unconscious effect on how asset owners operate - don't address today's hidden risks/opportunities

It argues for a rebalancing with greater emphasis on longer term but with safeguards

It focus on the responsibility of asset owners – not just about blaming the supply chain

Of course, it takes as read the connection with good governance of the funds – but elaborates what this governance is for

Its very explicit that changing remuneration agreements is critical for making progress

And its very clearly pushing for global coordination by targeting OECD

Plus it exemplifies what NSFM can do– fill a vacuum in thought leadership – but then hand it on to an agency that can do something (OECD)

What's interesting is the working group consisted of member from many countries, including lawyers, academics, former and current pension fund management. The email discussion over several weeks, healthy debate!

#2 Executive Remuneration

Source: The Economist, May 2008

challenge

This graph says it all!

And now many of these are beneficiaries of state aid!

#2 Executive Remuneration

HSBC chief backs bank pay reform

intervention

Network for Sustainable Financial Markets

Source: BBC website, 13 September 2008

News Who We Are Participants Principles Working Groups Ext. Reports Contact US

A growing number of senior figures – Nout Willink (the Dutch banking regulator), Sir Mervyn King (his UK equivalent), and even industry insiders now accept we need big changes to remuneration design.

HSBC Chairman Stephen Green told the BBC that the banking industry was too focused on short-term profits. He said that current pay schemes did not reflect long-term performance.   He said compensation should be consistent with the long-term interests of the market as a whole and the shareholders of a given institution.

But how to get to this? And as an aside, why have institutional investors – especially those with the least conflict of interests and the most connection with ordinary people, the pension funds – been so passive and silent?

The intervention NSFM is exploring is how to marshall the combined power of the specialist corporate governance research agencies like GMI and the Corporate Library, the proxy voting agencies like RiskMetrics, GlassLewis and Manifest and credit rating agencies like Moodys and S&P to better evaluate these alignments so its much clearer who is a laggard and who is a leader.

#3 Climate Change

This is a slide from a campaigning group but it does raise some uncomfortable questions for us in the RI world. Yes, we may be investing in clean tech niche products but what about the mainstream investments? How have we changed how we are allocating capital to traditional carbon dirty energy companies? And how are we incentivising companies in all sectors to invest significantly in energy efficiency?

There's a challenge here which is profound. As the Stern report (2007) says, **"Climate change is the greatest and widest-ranging market failure ever seen".**

To avoid the worst impacts of climate change, greenhouse gases need to be reduced to 20% of today's levels by the end of the century..

The cost of making this cut is in the order of 1% of world GDP if we act now, versus a reduction in Global GDP of between 5-20% by mid century if we continue with business as usual

So the economic case should be clear… but the markets can't act today to allocate capital away from carbon-intensive activities to low-carbon processes and technologies because we don't have the right pricing framework. Carbon doesn't have the right price, energy efficiency isn't a big enough priority.

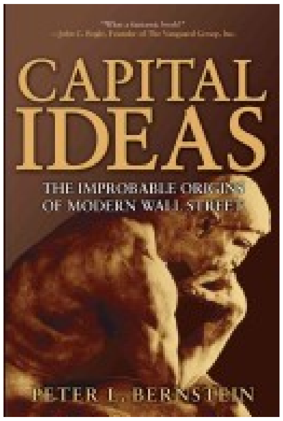
There are many investor initiatives in this space – INCR, IIGCC, IGCC, CDP, P8 – but can't help but conclude there is more talk than fundamental action. Ultimately the answer is a stable and realistic price for carbon. What the climate change working group is looking at is how can it help focus these other institutions on this task – what evidence can it find and what case can it make that it's what they should be focusing on. Again this is work in progress – no answers yet but it's the right question so watch this space.

#4 Regulatory Reform

1. NSFM is a group of individuals who have different expertises and views on the regulation and other key questions.
2. That said, all are of the opinion that in order to regain and maintain the health of the financial systems, there needs to be a better, a different approach to both the micro / bottom up - this is very important - and also macro / top down aspects of assessing and managing risk.
3. There is historical fact that after cycles of deregulation come cycles of deregulation – in the *Triumph of the Optimists,* Dimson, Marsh and Staunton show that investors go through alternating cycles of pessimism and optimism, a kind of financial manic depression, down we went with the WW1 Decade, then up with the Roaring Twenties, down again with Scary 30s/fateful 40s, up again with Pax Americana 1, back to the scary 70s, then Pax Americana II. And now the bubble of Wall Street exceptionalism has well and truly burst.
4. So why don't we move on, recognise that re-regulation is inevitable but try to avoid the problems we have seen with SOX and other emergency regulatory projects?
5. It's good to see constructive thinking from across the political spectrum: "Now is not the time for ideology…pragmatism is a conservative virtue. It is time everyone to start practicing it" Lawrence Lindsay, American Enterprise Institute
6. What we need to be focusing on – in a hard noses and pragmatic way – is how to get the right balance between macro and micro
7. And especially where there are well proven and persistent market failure, what novel government led action could help – firm "nudges" to quote the very popular book of the moment.
8. All this means the financial sector – and investors in particular need to put away our knee jerk reaction to regulation and start thinking creatively.

1. What market players – including the $15 trillion strong members of PRI – are missing is we must actively engage in the reform process without delay
2. Otherwise we will be victims of politicians responding in knee jerk fashion to the fury of the tabloid press and voters
3. Investment professionals need to understand this is no longer just a finance story - now regularly Page 1 news in the popular press with a big emphasis on calls for revenge on "Greedy Pigs" in the City.
4. In response to the ill-informed but highly emotive pressure from the tabloids, the politicians and, to a lesser extent, the regulators are already responding in a fashion that is not entirely helpful.
5. The appetite for revenge is huge – and as market players, we need to take responsibility for this
6. It means being more humble and being more real world – remembering the purpose of a pension product, not just the technical and legal aspects
7. Means thinking beyond the narrow boxes we all find it easy to occupy and to accept markets serve a greater good.
8. If financial sector organisations don't get on board the reform wagon in a constructive manner, they will only have ourselves to blame if they get run over by it. If we do, we can do everyone – ourselves included – a favour
9. But this involvement has to be principled (there is no point getting involved as wreckers) and we need to be creative (after all, we probably know best how to address persistent market failures).
10. One challenge for us is that we make money from these failures so it will mean engaging new people – RI specialists, public affairs professionals - who can go beyond this narrow approach to the problem.

Turning a Crisis into an Opportunity?



"Many of these innovations lay hidden in academic journals for years, unnoticed by Wall Street until the financial turbulences of the 1970s forced practitioners to accept the harsh truth that investment is a risky business."

Peter Bernstein, 1992

1. Want to end on a hopeful note. Progress comes from remembering what we have known before and doing the sort of thing that what has worked before
2. Peter Bernstein highlighted the disconnect between what needs to happen and what does happen in his 1992 book entitled "Capital Ideas".
3. Speaking about risk management, he wrote that "many of these innovations (he was talking about Markowitz, Sharpe, Scholes etc) lay hidden in academic journals for years, unnoticed by Wall Street until the financial turbulences of the 1970s forced practitioners to accept the harsh truth that investment is a risky business."
4. The question today is what is known but hidden that we need to dig for, dust off and implement?
5. That's one of the things NSFM and others urgently need to do. Some options include: Articulate and implement a better theory about how market work – the adaptive market hypothesis as articulate by Andrew Lo and in different words, Woody Brock (who focuses on endogenous risks) and Keith Ambachtsheer (who calls it "integrative investment theory") is a good candidate for this. Another change is to require that the now considerable evidence that human capital is worth taking routinely into account in investment decisions actually happens in practice – there really is no excuse aside from weak professionalism and blind ideology for ignoring this social factor. Another need is new definitions of risk which move beyond the alluring sophistication of financial numbers – models which have time and time again been precisely wrong - to consider the soft factors so we can be approximately right more of the time.
6. The reality is that the financial system is powerful and paradigm change comes slowly. Remember Galileo was only pardoned by the Vatican in the 19TH Century for questioning what rotated around what!
7. But we don't have this kind of time this time.
8. Making paradigm change practical – bite sized chunks - is the important and urgent work for that NSFM and other groups need to do…so please think of how you can help.
9. We could use funding for core resources (everything is being done on a voluntary basis). But fundamentally we need good minds who want to see change happen and are willing to do what it takes to get this change.

Looking Ahead

- Version 1.0 – ethical / SRI investing
- Version 2.0 – responsible investing
- Version 3.0 – sustainable financial markets

To conclude, let's take a helicopter view of what's been happening in this field of work known as RI.

First (Version 1.0), there was ethical/SRI investments. The focus was on products/boutiques. But despite huge growth of awareness its still about 1% of EU AUM - static. The industry is focused on positive / negative screens and the key debate is about different brands, different versions of the screens. Key organising groups were/are the national Social Investment Forums and the key clients were retail – well-meaning people who want to feel good about at least a part of their investment savings.

Then came along Version 2.0: responsible/sustainable investing. The focus here is on mainstreaming/integration. Key organising groups are PRI/EAI but see national SIFs evolving. In Australia it is now called the Responsible Investment Association. The UKSIF is also changing its name to focus on sustainable investing. And thematic groups (CDP/INCR/IIGCC). Service industry is about ESG analysis, engagement overlay providers, and perhaps most interestingly, units within sell side research firms.

What's coming next (Version 3.0) is yet to be named – so lets call it sustainable financial markets for now. Note, this is broader than "just" investing.
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3.0 is about system change. But the world isn't ready for this – we aren't even really doing version 2.0 yet - so its at the ideas and tentative experimentation stage. We have the PRI academic network, Keith Ambachtsheer International Central for Pensions Management, The Yale CG group, the Marathon Club has passed the baton about long-term investing to Paris and Caisse des Depots and of course, NSFM. But interestingly, the group is also much broader than it used to be. There is new regulatory intent and new kinds of regulators (Adair Turner at the FSA for example, gets climate change. Even the much criticised SEC Chairman Christopher Cox gets the need for wider disclosure than just financials. Sell side analysts are now starting to look at sensitive CG and pay questions, the credit rating agencies that helped cause the mess are now starting to do ESG assessments, investment consultants have put their blue sky strategy teams on the case. And there is much stronger interest from NGOs/union interest. This could be very significant - the same way corporate sector came under scrutiny in 90s, now its turn of the investment community.

Like evolution, each stage doesn't negate the validity or importance of the previous, indeed learning from 1.0 is what drove 2.0. Similarly the learning from 2.0 will be what drives 3.0.

For Financial Markets to Change, We Need to Change Together

- Mainstream investment and RI professionals both need to think creatively!
- Both face same challenges – going beyond their current products, competencies & business models
- Both face organisational/group think constraints
- Projects like NSFM could help break log-jam

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1. **For financial markets to change, we need to change together** and **practitioners are a key player**. Its said that all the major changes in the Catholic Church have come from within – its just too powerful to force to change – and perhaps the same is also true, even now, of the financial sector.
2. Interestingly, today**, NSFM doesn't have so many practitioners** and this is something those practitioners who see the need and opportunity could help address!
3. It's a **challenge to both mainstream investment and RI professionals - they have more in common than they may like to acknowledge!**
4. Both face **same challenges** – going beyond their current products, competencies & business models to what customers really need.
5. Both face **same organisational/group think constraints** – i.e. both have to learn to think creatively and outside their comfort zones.
6. Projects like **NSFM could help break log-jam**
7. Final webpage of NSFM site is the famous quote from Margaret Mead : ***Do not doubt that a small group of committed individuals can change the world. Indeed it is the only thing that ever has!***

A Challenge For You

Find an issue you know the RI / mainstream investment community doesn't really have a good enough answer to, which you are really concerned about and think is important and join / start a working group!

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1. A challenge to audience!

For RI audience: Find an issue you know, in your heart of hearts, the RI community doesn't really have a good enough answer to. Something you are really concerned about and think important and know you cant really address in your day job. And join/start a working group! To give you one example, water funds are doing very well as products but do they really help the world adapt to the coming water crunch and could the financial system do more to be a part of the solution?

For mainstream audiences: Your tribe as pooh-poohed change (at least in practice) for a long-time – either paid lip service to ESG issues but not been part of your day job. This is understandable given context, incentives, performance metrics, training. But can't be allowed to continue and cant be solved one firm, one analysts at a time. Where can you see the opportunity for change and how can you help realise that opportunity?

1. So thank you for listening so attentively and look forward to the questions, challenges and ideas for moving forwards.