Notes from Milken Institute 6th Annual London Summit, 6 December 2016

Session: The Evolution of Asset Management

Panelists: Rick Lacaille, Executive VP and Global Chief Investment Officer, State Street Global Advisors; Igor Tulchinsky, Founder and CEO, WorldQuant LLC; Gregory Williamson, CIO, American Red Cross; Janet Cowell, Treasurer, N Carolina Public Pensions; Andrew Capon, Columnist, EuroMoney Magazine (Chair).

An interesting dynamic between the current Asset Managers (AM) and their clients. The Asset Managers seemed nervous that big change is ahead but seem to be hanging on to current high profits while they can. The customers emphasized the coming changes, and several times commented that costs need to be driven down and performance improved. They pointed to the trends emerging that spell big change in Asset Management.
Here are some bullet point notes.
- stalled revenues and growth in AM industry.
- though still have good profit margins.
- pension managers are forcing fees downwards in this low return environment.
- need the right products for the future. A feeling that current products have not been so rewarding for customers and that change is needed as investment styles evolve to the new geopolitical environment.
- will need to squeeze a number of layers out of the system to reduce costs
- pensions will not pay for beta. So the question is much they will pay for alpha. It was 20%, but is now up to 30%. Pensions want to move to paying only when promised performance is actually delivered!
- the chair was a bit skeptical stating ‘it’s still one of the most profitable industries’. (Well, I guess Kodak was still profitable at this stage of the game!)
- Janet Cowell, the pensions treasurer stated that the AM industry is typically delivering returns of 5% whereas the customers, the pension funds need 7-8%.
- need to drive down costs and pass the savings on to customers.
- one of the customers stated that actually things will change ‘dramatically’ and a lot more rapidly than many asset managers are accepting. He mentioned blockchain, web-based investing etc, that break the old paradigm and eliminate need for many jobs in AM, which should drive down costs to the benefit of the customer.
- Igor Tulchinsky, Founder and CEO, WorldQuant, a company of several hundred scientists analysing data and building trading algorithms, agreed, and said ‘the ability to extract information with computing power is changing things. Everyone is becoming a quant these days.’ He feels there is great opportunity in AM with new technologies and methods developing. Employment opportunities are growing globally through internet connection and new quantitative methods.
- The emerging countries are a source of new customers. They may be very different from the db fund and have different needs.
- Rick Lacaille repeatedly spoke of alpha and beta and combinations in wonderful jargonese: ‘alpha plus beta get separated, then alpha and beta want to get together again in smart beta’; ‘is it dumb alpha or is alpha undiscovered beta’; 'things will move towards beta which should be low cost or free, and that leaves enormous scope for alpha’. 'Smart

beta is just dumb alpha'.
- Gregory Williamson said in the USA, institutions are shifting money away from public markets into private equity and to support entrepreneurial activities. There has been a large outflow from traditional public market investments. (We are seeing this in the UK with Neil Woodford's fund and James Anderson at Scottish Mortgage Trust going that route. I do wonder if they really understand what they are doing. Biting off more than they can chew?)
- Janet Cowell agreed and said that investment in private equity had done very well for them. Their pension funds do not have liquidity issues so locking money up for longer is no problem.
- Gregory Williamson pointed out that sophisticated investors around the world, instead of using asset-based returns, are now use factor benchmarks. Instead of being identified as an equity or fixed income or hedge fund manager, they would rather be known as growth-value-momentum investors. We will see this transition across the industry and it gives opportunity to provide better portfolio construction.
- because they are retrospective, quant and big data will not help you identify businesses which dramatically change their business.
- pension Defined Benefit sector is declining rapidly. 40% of UK db's are cash flow negative now. Defined Contribution will face the same problem in the future as those cashing in their db plans i.e. How to invest the money to generate income without taking too much risk.
- only 'dumb DC' (defined Contribution pensions) money is propping up the system. This will go the same way as the Defined Benefit asset management.
- Gregory Williamson: retirees will find they haven't had the returns they expected and will litigate. Corporations whose db plans failed to deliver will ask 'why would I delegate investment to those who are clearly the dumbest investors in the world.' They paid the pension AM managers yet it's the corporate that has the liabilities on its book. They start to take in-house control of their db plans. Several corporates in the US have already done this. So a renaissance in defined benefit is beginning.
- Rick Lacaille: Following the financial crisis and the bail-out of asset managers with tax payers money the AM industry needs to regain the confidence of regulators by being transparent, particularly about its costs. The pension manager on the panel agreed this us needed.
- is there systemic risk from the pension industry which manages many trillions? Leverage and herding lead to systemic risk but according to Rick Lacaille neither applies to pension AM. In fact there is increasing range of ways to invest and heterogeneity of clients needs and investments among AM managers and they don't use leverage.
- though herding into higher-yield ETFs and other illiquid investments was raised as a concern.
- all agreed that systemic risk comes from leverage and counter-party risk and synthetic instruments. Though Igor raised the concern that people can pile into the same space even if they don't realise it.
- AMs are moving into direct lending, replacing banks who don't have the balance sheet to do it. How will this evolve? It is healthy to find new sources of capital. Will it require AMs to move from low balance sheet to high balance sheet businesses? There are policy changes ahead as this develops.

- Self-management of wealth: Billionaires set up their own family wealth offices so they had transparency and control. Panelists expect to see this move ‘down the chain’ with more investors self-managing their own assets. Anyone can now obtain instantly data and information which only professionals had access to only a few years ago. A massive change which is beginning to favour self-investment. Democratisation of finance. Barriers to entry for CFAs are being reduced so the previous advantage of Asset Managers is being reduced. Gregory Williamson: Investors finally wake up and say 'I do have assets, I can buy capabilities and skills and create a better solution on my own.'
- Igor the quant: in 2007 we had just over 100 alphas, which is a trading signal derived from a set of data. Now we have over 2 million such signals, and by end of year it will be 4 million and be end of next year we expect close to 10 million.' The pension manager observed that increasingly everyone is using quantitative methods. Not just to improve returns but also a focus on using data to manage risk. Rick Lacaille raised some doubt saying they had tried these quant methods with a computer so bog they had to reinforce the floor without much enlightenment. He asked is all the mass of data and signals simply there in the price momentum anyway. Igor agreed there are diminishing returns to the data.