

# the review

CISI.ORG/REVIEW

PROVIDING INSIGHT AND ANALYSIS FOR FINANCIAL SERVICES PROFESSIONALS

FEBRUARY 2020



WELCOME TO FINANCIAL SERVICES

## Access all areas?

WHY FINANCIAL SERVICES  
FIRMS NEED TO RECRUIT  
FROM EVERY WALK OF LIFE

### RESTRICTED ACCESS

- CAREER
- WORK EXPERIENCE
- PROFESSIONAL QUALIFICATIONS
- INTERNSHIP
- FOLLOW PARENTS' FOOTSTEPS

# welcome

“41% of employees in the financial services sector are following in their parents’ footsteps – more than three times the national average for other sectors”



According to widely reported research by KPMG in 2019, 41% of employees in the financial services sector are following in their parents’ footsteps – more than three times the national average for other sectors. This limited level of social mobility, defined by the UK government as “the link between a person’s occupation or income and the occupation or income of their parents”, prompted us to commission research into five different groups – parents, teachers, firms, our members, and the financial services community – to gather data on and better understand the barriers and access to our sector.

Our special report on social mobility (pp.17–24) includes the survey results from the first three groups – 513 teachers, 1,013 parents, and around 40 firms – on the value of work experience and how it can provide access to a career in financial services. It reveals that 77% of parents with children at independent/private schools say their children are aware of financial services as a career path, compared to 50% with children at local authority schools. It also reveals that “parents and teachers think professional qualifications in financial services are more important than university qualifications in financial services”.

Mark Yallop, chair of the Fixed Income, Currencies and Commodities Markets Standards Board, may have graduated from Oxford University in 1982 with a degree in natural sciences, but he decided to “do something different” and proceeded to build a successful career in financial services off the back of a graduate traineeship with Barings Bank in the City. Read his profile interview on pages 32–34.

Other highlights include an ethical dilemma about workplace ‘banter’ (pp.44–45), a look at new rules on defined benefit pension transfers and their impact on the advice process (pp.35–37), and insight into the origins and implications of Gresham’s Law (pp.64–65), by Alderman Michael Mainelli, Chartered FCSI(Hon).

As ever, please get in touch with any comments or suggestions.

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# CISI.ORG

CHECK OUT THE ONLINE EDITION OF *THE REVIEW* AND THE WIDER CISI WEBSITE FOR EXCLUSIVE WEB-ONLY CONTENT

100110  
011001

## Watch



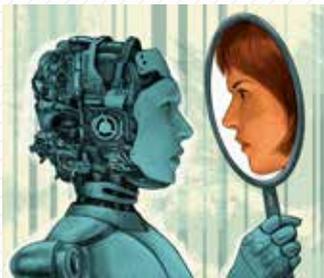
We launched our mental health portal on World Mental Health Day, 10 October 2019. As part of this, Miles Kean, executive director at Coutts, talks about his own struggles with mental health and shares his advice on how you can cope with mental illness.

For help and more information visit the CISI's mental health portal at [cisi.org/startaconversation](https://cisi.org/startaconversation)

View the full mental health playlist at [cisi.org/mhplaylist](https://cisi.org/mhplaylist)

## MOST COMMENTED ON

Grey matters ethical dilemma: Jane Doe  
[cisi.org/janedoe](https://cisi.org/janedoe)



## Learn



SENIOR MANAGERS AND CERTIFICATION REGIME Q&A  
CPD GAINED: 1.5 hours  
Distinct pass numbers: 40

## MOST READ

Spirit or letter?  
[cisi.org/spirit-or-letter](https://cisi.org/spirit-or-letter)

Ask the experts: Capital gains tax on UK property  
[cisi.org/cgt](https://cisi.org/cgt)

How to work from home efficiently  
[cisi.org/wfh](https://cisi.org/wfh)

How to deliver a killer presentation  
[cisi.org/presentation](https://cisi.org/presentation)

To read more, visit  
[cisi.org/review](https://cisi.org/review)



## Read



FIFTY SHADES OF GREEN  
Disparate investment and regulatory approaches towards environmental, social and governance investing are ramping up complexity for investment managers and advisers. What progress has been made in establishing a taxonomy for sustainable activities?  
[cisi.org/50shades](https://cisi.org/50shades)

## EVENTS

THE PARAPLANNER CONFERENCE 2020 - 12 May, America Square Conference Centre, London, EC3N 2LB

Preceded by

THE BIG PARAPLANNER SOCIAL  
11 May, London

For more information and to book your free member place, visit  
[cisi.org/paraconf20](https://cisi.org/paraconf20)

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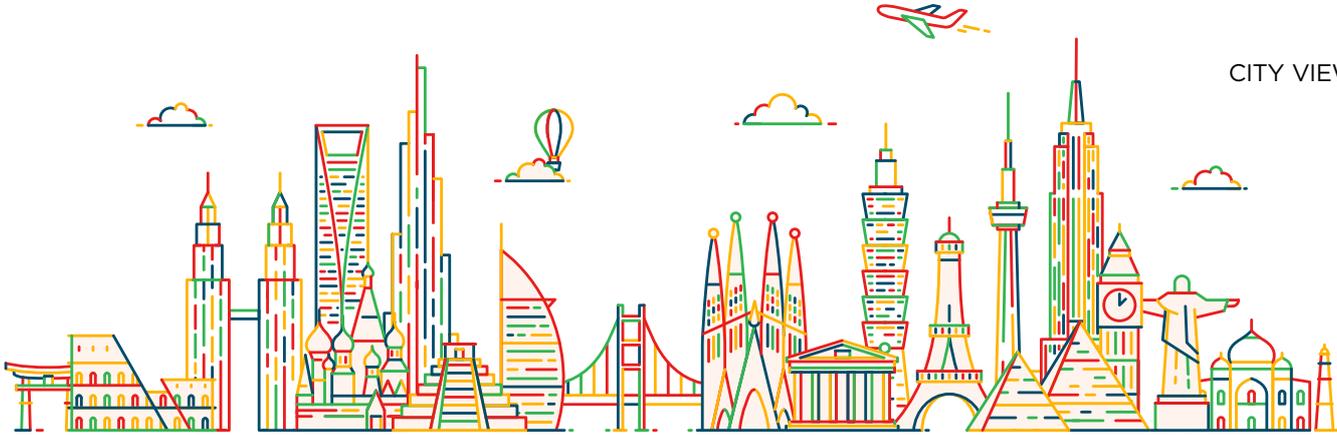
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# Purpose and profit

FIRMS NEED CLARITY OF PURPOSE TO PROVIDE VALUE FOR ALL STAKEHOLDERS, BUT WITHOUT PROFIT, THEY CANNOT MEET THEIR WIDER OBJECTIVES

Why are we here? A question that might once have been heard most frequently in sixth form philosophy classes is now being discussed at the most senior levels in boardrooms of financial services firms globally. One only has to review the Financial Reporting Council's latest UK Corporate Governance Code to see that the topic of purpose is now front and centre for regulators and firms alike.

But many organisations today are concluding that a broader social purpose is not just 'the right thing to do', but also a requirement to ensure their firm's long-term success. In August 2019, the US Business Roundtable – an association representing some of the largest firms in the United States – released a 'Statement on the purpose of a corporation'. The Statement, signed by nearly 200 chief executives of major companies including Amazon, American Express and J.P. Morgan, is striking for its shift away from a doctrine of shareholder primacy towards an emphasis on delivering value for all stakeholders, including customers, employees, suppliers and communities, and shareholders. By contrast, the US Business Roundtable's 1997 'Statement on corporate governance' declares that "the paramount duty of ... boards of directors is to the corporation's stockholders; the interests of other stakeholders are relevant as a derivative of the duty to stockholders". What a difference 22 years makes.

In the UK, the FCA is conducting a review of purpose in financial services, having identified this as one of four key drivers of behaviour in its *Approach to supervision*, published in April 2019. The CISI has contributed to the FCA initiative, facilitating roundtables for the retail investment sector to discuss the role of a broader purpose. Outcomes of these discussions have been varied, encompassing a range of views on what this means in practice and the roles of different actors in its implementation. One theme, however, has come through consistently: firms ignore purpose at their peril.

ILLUSTRATION: GETTY IMAGES

## The purpose of the CISI

This has prompted us to look more closely at our purpose as an Institute. As a charity with a royal charter, we have clear listed objectives on our website:

1. To promote, for the public benefit, the advancement and dissemination of knowledge in the field of securities and investments.
  2. To develop high ethical standards for practitioners in securities and investments and to promote such standards in the UK and overseas.
  3. To act as an authoritative body for the purpose of consultation and research in matters of education or public interest concerning investment in securities.
- While these objectives largely answer the 'what' and the 'how', they are perhaps less clear on the 'why'. Of course, as a charity, profit is not our prime goal; our priority is to maximise our objectives rather than just our surplus. However, we recognise that without profit, we cannot meet our wider objectives.

A sustainable future for the CISI requires us to be equipped with a clear statement of purpose that considers the changing face of financial services globally, including developments in areas such as fintech and environmental, social and governance, and increasingly rapid innovation across businesses. Are we clear about how our international activity aligns with our current purpose and how we should develop in the future?

To help answer these questions and more, we are conducting a review of our ultimate purpose. To do so we will be consulting widely with key stakeholders, including CISI staff and Board members, our forums and regional committees, our national advisory councils and, of course, members of all levels in both the UK and internationally. The consultation will take the form of roadshows, giving all stakeholders the opportunity to discuss their thoughts as to what our purpose is, as well as, equally importantly, what it is not.

We want to define a clear ethos and driver for our activities, which will shape our future endeavours and support a sustainable and flourishing future for all of our stakeholders. ●

# AROUND THE GLOBE

The CISI's international network of offices looks after 45,000 members worldwide

# 33%

growth in Gibraltar exam registrations

## GLOBAL MENTAL HEALTH PORTAL LAUNCHED

In October 2019, we launched a mental health portal aimed at encouraging the conversation around mental health in financial services and to help end the stigma around discussing mental health issues.

The portal is in response to a question we asked of our members in 2018 and 2019, about whether they would feel comfortable talking to their manager about poor mental health. Some 55% of members in 2019 said they would, an increase of almost 20% from 2018, when just 46% said they would feel comfortable.



The portal offers a toolkit of practical information, resources, powerful stories and contacts for helpful organisations, and aims to help individuals cultivate a healthy mind in order to reach their full potential.

It also includes podcasts with financial services professionals talking about their own experiences with mental health, plus an interview with Dr Stephen Pereira MD, FRCPsych, DPM, MSc, MBBS, a consultant psychiatrist, which explores ideas that have arisen from our mental health surveys.

Visit the portal at [cisi.org/mentalhealth](http://cisi.org/mentalhealth)

## JACQUELINE LOCKIE CFP™ CHARTERED FCSI JOINS THE FPSB BOARD

In November 2019, our head of financial planning, Jacqueline Lockie CFP™ Chartered FCSI, joined the Chief Executives Committee (CEC) of the Financial Planning Standards Board (FPSB), a global standard-setting body. The appointment is for two years.

The CEC is comprised of the chief executives from the seven FPSB Affiliates with the largest CFP professional populations (US, Japan, China, Canada, Australia, South Africa, Hong Kong); three Affiliate chief executives chosen by the FPSB Council; and the FPSB chief executive.

The CEC's purpose is to establish leadership, efficiency and accountability in the execution of the activities that are carried out jointly in the FPSB's global network by the FPSB Board of Directors, FPSB Affiliates and staff to advance the global financial planning profession, through CFP certification and standards setting, for the benefit of the public worldwide. The CEC is accountable as a body to the FPSB Board of Directors.

FPSB CEO Noel Maye said: "With Jacqueline's demonstrated commitment to leadership, cooperation and financial planning excellence, she is a strong addition to the CEC's efforts, on behalf of our global network, to advance the financial planning profession for the benefit of the public."



## GHANA

Senior international manager: Praneet Shivaprasad



In November 2019, we were at the launch of the Ghana Investment and Securities Institute (GISI), where our senior international manager, Praneet Shivaprasad, (pictured centre at the event) spoke about the upcoming partnership between GISI and CISI. This follows the signing of an MoU in June.

Since January 2020, GISI has been using CISI examinations as part of the Ghana Securities and Exchange Commission SEC recognised licensing pathways.

## ROMANIA

**Senior international manager:** Karolina Pajor

In partnership with the Romanian Banking Institute (Institutul Bancar Român), we've launched our level 3 International Certificate in Wealth and Investment Management (ICWIM) in Romania.

Since January 2019, ICWIM has been recognised jointly by the National Bank of Romania, and the Financial Supervisory Authority.

Karolina Pajor visited Bucharest in October 2019 to participate in the annual International Banking Compliance

Summit, organised by the Romanian Banking Institute (RBI), during which she announced the official launch of ICWIM.

Karolina also introduced Alan Burr, Chartered FCSI, who will be collaborating with the RBI on the face-to-face delivery of the CISI training in Romania.

The day before the summit, Karolina met with representatives of the top Romanian banks to talk about the knowledge, skills and behaviour that build trust in banking and finance.



Romanian candidates can also register for the Global Financial Compliance as well as Risk in Financial Services training.

We look forward to supporting the local market with the growing demand for international certification.

**1 in 4**  
new members are  
from outside the UK

## KENYA

**International manager:** Lisa Elo



In November 2019, we renewed our MoU with the Capital Markets Authority (CMA), Kenya. CISI CEO Simon Culhane, Chartered FCSI attended the signing alongside CMA CEO Paul Muthaura (pictured above at the ceremony).

The event followed an announcement by the CMA in August 2019 that it would introduce mandatory continuing professional development (CPD) from January 2020 – a move that will promote professionalism and protect investors.

We look forward to supporting CMA as an accredited CPD partner.

## MALAYSIA

**Country head:** Andrella Guzman-Sandejas



In November 2019, we signed an MoU with the Islamic Banking and Finance Institute Malaysia (IBFIM) to recognise IBFIM's certifications as part of our membership progression route, and provide a seamless process for IBFIM certification holders to join as CISI members. IBFIM will promote and distribute our international membership to its network.

At the exchange ceremony in Kuala Lumpur, IBFIM CEO Yusry Yusoff (pictured front row, centre right) said: "This MoU will provide an opportunity to more than 3,000 [of] IBFIM's certification holders to join CISI's membership. Under this arrangement, 2,904 Associate Qualification in Islamic Finance and 194 Intermediate Qualification in Islamic Finance certificate holders will be eligible to join as Affiliate members, while 207 Certified Qualification in Islamic Finance holders will be qualified as Associate members."

Kevin Moore, Chartered FCSI, CISI global business development director (pictured front row, centre), said: "This partnership between our two institutes will enhance employability and equip the next generation of talented Malaysian practitioners to succeed in the fast-paced, ever-evolving world of global financial services."

# NEWCASTLE INSIGHT EVENT

Forty students from five schools and colleges took part in our first Newcastle Insight event, held at EY's fantastic modern offices on Friday 27 September 2019. They were joined by experienced and junior professionals from Access Wealth Management, Brewin Dolphin, EY, Julius Baer International, Rathbones and UBS.

Nick Swales, Chartered FCSI, regional head, north east, Rathbones, (pictured above right) began the event with a talk providing an energetic insight into the financial services landscape in Newcastle, and the opportunities for those looking to pursue a career in the city. Matthew Bolton, CISI teaching and learning specialist, then led a workshop introducing the students to networking skills.

This was good preparation for the main element of the day – speed networking with the professionals (pictured below right). Students practised their newly acquired networking skills to gain a better understanding about the breadth of roles and potential career pathways within financial services. The event concluded with a networking lunch.

Teachers and students provided positive feedback. A teacher from Newcastle Sixth Form College said, "This was an excellent opportunity for young people to find out about the sector and learn about the importance of communication". A student from Excelsior Academy said, "The conference was useful and opened my eyes to lots of options in the financial sector that I wasn't aware of."



## NEW PRESIDENT FOR THE CISI JERSEY BRANCH



Niall Husbands MCSI, director at Ogier Global, is the new president of the Jersey branch. He takes over from Ed Loader, Chartered FCSI, managing director at Integritas Wealth Partners, who held the position for two years.

Prior to joining Ogier Global, Niall was head of private wealth, treasury & investment and board director at one of Jersey's largest fiduciary services providers, having returned to the island with his family in 2012 after serving as an international manager with HSBC in France as head of wealth, Europe and in the United Arab Emirates as head of wealth management, MENA.

He is a judge for the Private Asset Management Awards and is vice president of the Channel Islands Treasurers Association.

Niall has been a CISI member for 26 years. He said: "I'm looking forward to working with my fellow committee members to promote the work and values of the Institute, with a particular focus on the next generation of wealth management professionals in Jersey, and on Jersey's role as an international financial centre."

## 'Purpose' moves centre stage in the world of Islamic finance



The fifth CISI-Deloitte Islamic finance symposium – highlights now on CISI TV – in London on 10 December 2019 featured top-flight speakers from across

Eurasia, London, the Gulf and Kuala Lumpur. The overarching theme was 'designing investment strategies to create social impact'.

Farmida Bi, one of the world's leading Islamic finance (and general banking) lawyers, set the tone when she stressed the fundamental role of 'purpose' in the field, rather than the processes and mechanics that have been the focus until now, echoing and amplifying the theme taken up lately by regulators such as the UK's FCA. "No more articles on asset-based securities are necessary," she said, reinforcing her point that the objectives trump the technicalities.

*Photograph left to right: Peter Casey, adviser to the Islamic Financial Services Board and UAE's Securities and Commodities Authority; Anjalika Bardalai, chief economist and head of research, TheCityUK; Farmida Bi, chair, Europe, Middle East and Asia, Norton Rose Fulbright; Stella Cox CBE, managing director DDCAP Group and chair of TheCityUK Islamic Finance Market Advisory Group; and Dr Hatim El Tahir, director, Deloitte (who leads on this annual event).*

## Events preview

We offer many opportunities to help you meet your requirements for professional development. Below are just some of the highlights of the Institute's CPD events programme, but for comprehensive details and to book, please visit [cisi.org](http://cisi.org) and click on the 'Networking & events' section. Please note that dates listed below are subject to change.

### ANNUAL INTEGRITY EVENT: OUTSIDE THE 9 TO 5

Wednesday 12 February 2020, Plaisterers' Hall, London  
Well-known figures debate relevant and topical dilemmas consistent with the aim of the Institute to promote high standards of ethics and integrity

### LONDON CPD

**12 FEB** Bond Forum: Bond outlook 2020

**17 FEB** Responsible banking

**20 FEB** Corporate Finance Forum: 2020 Vision

### REGIONAL CPD

**12 FEB** The evolution and communication of sustainability investing (Birmingham)

**13 FEB** Engaging with your business protection clients; The challenge of saving for later life; and Whistleblowing – encouraging openness in your business (Nottingham)

**14 FEB** Purpose (Cardiff)

**25 FEB** Cyber psychology: client centric design and build (Edinburgh)

**5 MAR** Mental health awareness in the workplace (Leeds)

### ANNUAL DINNERS

**13 MAR** Jersey annual dinner (Jersey)

### SOCIAL EVENTS

**13 FEB** Guernsey branch Young Professionals Network launch and networking drinks (Guernsey)

**26 FEB** CISI Manchester Young Professionals Network: Mental health awareness in the workplace (Manchester)

- If you have an idea for an event or would like to contribute at one of our events, please email [cpdevents@cisi.org](mailto:cpdevents@cisi.org)
- For details of conferences and social events available to members, please visit [cisi.org/events](http://cisi.org/events)

## QUICK QUIZ

The Review's quick quiz features questions from CISI Professional Refresher, an online learning tool. This popular product consists of more than 150 modules covering topics including anti-money laundering, the UK Bribery Act, information security and data protection. The answers are on page 47.

**Which of the following firms is most likely to be excluded from a negatively screened ethical fund?**

- A** A distillery
- B** A supermarket chain selling alcohol
- C** A wind-farm operator
- D** A firm that uses animal testing for medical research for a crucial new drug

**Which of the following best describes sovereign wealth funds?**

- A** Government-owned investment funds
- B** Privately-owned pools of capital
- C** Government-owned private equity funds
- D** State bodies investing in private equity

**Bonds with an environmental, social and governance (ESG) purpose are known as:**

- A** Ethical bonds
- B** Governance bonds
- C** Environmental bonds
- D** Green bonds

Access to Professional Refresher is available on an annual licence basis. The full suite of modules is free to CISI members or £250 for non-members. If you or your firm would like to find out more, visit [cisi.org/refresher](http://cisi.org/refresher) or contact the CISI on +44 20 7645 0777.

## Disciplinary findings: Daniel Coleman, Chartered FCSI 11 December 2019

Mr Coleman notified that he had been subject to disciplinary action by his employer and was invited to appear before a Disciplinary Panel. After the Panel considered the matter and submissions, they found him in breach of the CISI Membership Regulations and Code of Conduct. Mr Coleman received a suspension of Chartered status for a period of 18 months, only being permitted to use FCSI designatory letters during this time, and is required to

complete an additional five hours of CPD within a six-month period.

*CISI members agree to abide by the Membership Regulations. An important aspect of this is the obligation to promptly inform the CISI (by emailing [standards@cisi.org](mailto:standards@cisi.org)) of any matter which may impact your suitability to remain a member. Failing to do so may be considered an aggravating factor in a disciplinary case.*





# Financial planning news

*A snapshot of financial planning news and events, by Jacqueline Lockie CFP™ Chartered FCSI, CISI head of financial planning*

## ENHANCED CERTIFIED FINANCIAL PLANNER™ PROFESSIONAL PATHWAY



Results of the first sitting of the new exam in the pathway to the CERTIFIED FINANCIAL PLANNER™ designation are in. I'm pleased to say that everyone passed the level 6 exam and many are now moving on to the level 7 case study that will lead them on to become CFP™ professionals. The CFP mark is the only global mark that recognises financial planning skills and that all-important application of knowledge around the world.

We've had many positive conversations with financial planners and wealth managers who are interested in becoming CFP professionals. With an ever-increasing recognition that the CFP examination is the real test of application of knowledge, the numbers of CFP professionals seems set to grow in the UK in 2020. Make 2020 the year you enter the CFP professional pathway. Order your workbook, book your exam and start studying now. The next level 6 Advanced Financial Planning exam is on 4 March 2020, followed by the autumn sitting on 2 September 2020.

## LOOKING BACK AND FORWARD



WORLD  
FINANCIAL  
PLANNING  
DAY PROMOTED BY FPSB

At the start of 2020, it is customary to look back at our achievements over the previous year, identify what lessons we can learn, and plan more progress in the year ahead.

### Highlights of 2019

We launched the new CFP professional pathway and the CISI Financial Planning mentoring scheme, both of which have been enthusiastically received by the community. The Accredited Financial Planning Firms™ conference was extremely successful and both the Paraplanner and flagship Financial Planning conferences were a big hit with delegates. There is real engagement within the financial planning community and that is great to see. On top of that, with your help, we responded to FCA consultation papers on vulnerable clients and defined benefit pensions contingent charging, and we shared your views about matters relating to financial planning at an international level within 27 countries of the Financial Planning Standards Board organisation.

### What's new for 2020?

One of our main tasks will be to grow the existing interest in the CFP designation and encourage more to join the global community of financial planners. We will be supporting those wealth managers who are looking to offer full financial planning services. On top of that we have a fantastic suite of conferences for the growing financial planning community. The Accredited Financial Planning Firms™ conference is all about the value chain of financial planning, while the Paraplanner and flagship Financial Planning conferences will both be in a new location, with a new look and feel. Look out for details in the ebulletins that you receive every fortnight and on other media channels such as LinkedIn.

We will also be building on the huge success of the UK Financial Planning Week and the FPSB's World Financial Planning Day as part of IOSCO's World Investor Week, and we will continue to encourage and help coordinate press articles and opinions of our CFP professionals. Perhaps you could commit to join in the UK FP Week in 2020? If you are a CISI member and a member of the CISI Financial Planning Forum, then you can join in. Add it to your to-do list and look out for the emails seeking your participation.

### YOUR THOUGHTS AND IDEAS

If you have any thoughts or ideas about engaging the public to aid understanding of financial planning, or encouraging other professionals to take up financial planning, we'd love to hear from you. As always, please contact me with any questions or ideas on [jacqueline.lockie@cisi.org](mailto:jacqueline.lockie@cisi.org). Building our profession and educating the public about financial planning requires all of us to pull together to promote public confidence and awareness.

# SHIFTS TOWARDS INDIVIDUALISATION ARE DRIVING A TECH EVOLUTION

**Innovations in technology are helping advisers and investment managers bring more tailored solutions to more clients**



American academic Joseph Wood Krutch said: “Technology made large populations possible; large populations now make technology indispensable.”

Krutch, born in 1893, would not have been aware of platform technology. However, with more clients requiring financial planning and investment management for longer, technology must enable each client to get the outcome they want and need.

In recent years, the advent of centralised investment propositions (CIPs) has seen platforms develop technology to support managed portfolio solutions.

Well-run CIPs are an excellent, scalable solution that help deliver good outcomes for large volumes of clients and their advisers. But many clients have needs that don’t always fit within set boxes.

In other industries, such as retail and telecoms, customers expect a service tailored to their

needs. The opportunity must be there to offer advisers’ clients a similar service.

But providing a tailored investment solution for each client can be costly and time-consuming and, as Krutch said, technology must help us service larger populations.

Standard Life has delivered an innovative Individually Managed Accounts (IMA) proposition to the Wrap platform, which can help advisers deliver individual client outcomes within a CIP.

Advisers need to be able to depend not only on a platform partner that is scalable and supports the growth in their business, but also one that is preparing for the demands of the future through developments in technology.

*For more information on Standard Life’s IMA to create client-led investment outcomes, visit [standardlifeadviser.co.uk/adviser](http://standardlifeadviser.co.uk/adviser).*

*The value of investments can go down as well as up, and could be worth less than originally invested.*

*Views expressed in this article should not be regarded as financial advice.*

## CISI FINANCIAL PLANNING CORPORATE SUPPORTERS Q4 2019

### Gold

#### Just

[www.justadviser.com](http://www.justadviser.com)  
**Schroders Investment Management**  
[www.schroders.co.uk/adviser](http://www.schroders.co.uk/adviser)

### Silver

**Dimensional Fund Advisors**  
[www.dfauk.com](http://www.dfauk.com)  
**Standard Life**  
[www.standardlife.co.uk](http://www.standardlife.co.uk)

### Corporate

**AIC**  
[www.theaic.co.uk](http://www.theaic.co.uk)  
**BMO GAM**  
[www.bmogam.com](http://www.bmogam.com)  
**First Trust Global Portfolios**  
[www.ftglobalportfolios.com](http://www.ftglobalportfolios.com)  
**HANetf**  
[www.hanetf.com](http://www.hanetf.com)  
**Independent Health Care Solutions**  
[www.ihcs.co.uk](http://www.ihcs.co.uk)  
**James Hay Partnership**  
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[www.adviser.royallondon.com](http://www.adviser.royallondon.com)  
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# SUSTAINABILITY THROUGH ACTIVE OWNERSHIP



At Dimensional, we integrate environmental, social and governance (ESG) considerations within the investment process for our equity strategies to manage risk and add value.

The primary mechanism for which we believe ESG data can be used to add value for investors is through investment stewardship. We believe prices quickly incorporate information and reflect the aggregate expectations of market participants, including information about a company’s current governance practices and oversight of ESG-related risks.

As such, it is our view that improvements to a company’s governance practices may improve

shareholder value through a combination of lower discount rates and higher cash flows to shareholders.

These views lead us to the conclusion that an effective way to incorporate ESG considerations in investment strategies is through the promotion of good corporate governance practices at the companies we hold in our portfolios.

We advocate for strong boards representing shareholder interests, which includes the avoidance and mitigation of material environmental and social risks. In other words, we think issues across the ESG spectrum that may affect shareholder value

should trigger stewardship activity aimed at protecting the interests of our clients.

Our stewardship activity on behalf of our portfolios is extensive, including over 500 total engagements\* globally over the one-year period ending 30 June 2019.

We communicate to our investors regularly about these engagements. We believe that such transparency helps investors understand why we do what we do, contributing to their investment experience.

\* Dimensional can discuss governance matters with portfolio companies to represent client interests, though Dimensional does not, on behalf of its clients, acquire securities with the purpose or intended effect of changing or influencing the control of a portfolio company.



Top row, from left to right: Andrew Brook-Dobson CFP™ Chartered MCSI, managing director; Matthew Kiddle CFP™ Chartered MCSI, operations director; Amy Traher, finance manager; Samantha Hawken, analyst; Gill Fabretti, client administrator

Bottom row, from left to right: Oliver Smith, executive assistant; Anick Sharma, trainee analyst; Catherine Sherwood, office administrator; Fred Brook-Dobson, trainee administrator

# True success

**ANDREW BROOK-DOBSON** CFP™ CHARTERED MCSI, MANAGING DIRECTOR AT BROOK-DOBSON BREAR, HELPS CLIENTS LEAD SUCCESSFUL LIVES THROUGH A COMBINATION OF LIFE PLANNING, FINANCIAL PLANNING AND WEALTH MANAGEMENT

**WHY DID YOU DECIDE TO BECOME ACCREDITED AND WHY SHOULD OTHERS SEEK TO DO SO?**

We wanted to network and be associated with our peers. To learn from them, to help them learn from us, to tackle together shared challenges.

**WHAT ACCOLADES AND AWARDS HAS THE FIRM PICKED UP IN RECENT TIMES?**

We prefer to maintain an outward focus on clients and their outcomes; helping them make positive improvements to their lives, adding real value and delivering a remarkable client experience rather than an inward sector focus.

This seems to have been hugely effective: we have a Net Promoter Score of 100 (the highest score in an index measuring willingness of customers to recommend a company's products or services), massive client engagement, high referral rates and lots of goodwill. We've decided this

external measure is the way we wish to be judged.

**WHAT SORT OF BUSINESS IS IT AND WHAT SERVICES DOES IT OFFER? WHAT'S YOUR USP?**

Our mission is to "help couples lead truly successful lives, not just materially successful ones". True success is different for every person and couple and we have the ability, skills and tools to help clients identify what that great life looks like and what obstacles are in the way of making it a reality. We coach them through overcoming those obstacles and understanding how their money sits in supporting that life. We help them become financially organised, and build and implement a tactical financial plan to ensure that their money is working efficiently with the appropriate level of risk. We specialise in doing this for executives of large companies and entrepreneurs three to five years pre-exit.

We offer one service that encompasses the three elements: life planning, strategic

// WE HAVE THE ABILITY, SKILLS AND TOOLS TO HELP CLIENTS IDENTIFY WHAT THAT GREAT LIFE LOOKS LIKE //

financial planning, and tactical financial/wealth management.

### **HOW DID YOU GET INTO FINANCIAL PLANNING?**

In 1992, I finished my time at Cambridge doing a PhD in materials science. I needed a job, and I got one as a financial planner with an American Express subsidiary called Acuma. It was way ahead of its time, offering a fee-based financial planning service. We were doing a sophisticated lifetime cashflow even then. It's funny now looking back because we often struggled with getting people to 'buy' a comprehensive financial plan at £295!

### **WHAT'S THE BEST THING ABOUT BEING AT A FINANCIAL PLANNING FIRM?**

We change people's lives beyond measure. We add so much intangible value that it's difficult communicating that to prospective clients. We also add loads of tangible value, but saving 100bp on your investments won't change your life!

### **WHAT ARE YOUR BIGGEST CONCERNS FOR YOUR CLIENTS OR THE FINANCIAL SERVICES SECTOR IN GENERAL?**

There are several:

- When we consider the recent defined benefit pension misselling, it looks as though little has changed since the 80s and 90s; the lessons of that pension misselling scandal seem not to have been learnt. I'm uncertain whether this is down to a lack of integrity, a lack of competence or a combination of the two.
- Even after the Retail Distribution Review (RDR), we see reports of 'advisers' who are more like salespeople, representing the interests of the firm, not the client. Only an independent financial adviser can be the client's representative and identify what's best for them. The sooner we start getting that message out the better.
- The number of CERTIFIED FINANCIAL PLANNER™ professionals in the UK – I hope that the revised assessment process will be the start of significant growth.
- I have a long-standing concern about how the general population gains access to quality financial advice and quality financial planning services. There are some fantastic advisory businesses out there, but they tend to focus on serving the more affluent in society.

- From the work we do with our clients' youngsters, it is evident that the formal education system is not equipping them with the financial knowledge or skills they need for the life ahead of them.

### **WHAT IMPACT HAS REGULATORY CHANGE HAD ON YOUR BUSINESS OVER THE PAST FEW YEARS?**

Not too much really:

- **RDR was largely a non-event at Brook-Dobson Brear (bdb):** we already held level 7 qualifications, we have always been fee based and not taken commission, we were already and have remained an independent firm.
- **Markets in Financial Instruments Directive II:** we have invoiced our clients for many years, so cost disclosure from our perspective and discussions about our 'value' have not been an issue. One of our clients gave us some fantastic input regarding how we could communicate the investment costs and this has gone down really well.
- **General Data Protection Regulation has required a little bit more work:** about six years ago we identified that the reputational damage resulting from a data breach would be significant and we went about reducing and managing that risk. We introduced procedures and made changes to others to ensure that data was being handled appropriately, and did some streamlining so that we know where information is being held. Without this knowledge you can't be sure that you've deleted it all if someone exercises their right to be forgotten (or ensure that it's stored securely).

### **WHAT DO YOU LIKE ABOUT THE CISI?**

The continuing professional development resources are outstanding. I enjoy my continued involvement in the Integrity & Ethics Committee and the capability and professionalism of the team running that area are exceptional.

### **WHAT DOES A TYPICAL DAY LOOK LIKE?**

I get up at 5am every morning, write in my journal, meditate, plan my day and do some work on my most important priorities, then workout for an hour. I leave home at 7.45am with my youngest son to take him to school. My time at the office begins with two client meetings of two hours each, followed by a meeting with a prospective client,

ambassador or centre of influence. Then I have a couple of short internal meetings with members of my team. I leave between 6 and 7pm.

### **WHAT ARE YOUR KEY TIPS FOR OTHER PLANNERS?**

- **Always put clients' interests first** (even when it's inconvenient or has negative implications for you).
- **Build empathy:** that ability to 'walk in another person's shoes'.
- **Build your technical knowledge with exams:** the CFP certification is the most important and transformational qualification you are likely to do.
- **Build your people knowledge:** how we make decisions, how we struggle (and overcome obstacles), how to influence, how to help people, how to coach people, how to communicate.
- **Build your self-knowledge:** meditate, do the Belbin Team Inventory behavioural test (team role traits), the Kolbe personality test, the Gallup StrengthsFinder. Understand yourself.
- **Learn to prioritise and say no.**
- **Read:** there is so much great work out there, but very little of it appears on any qualification's curriculum. ●



**ANDREW BROOK-DOBSON CFP™  
CHARTERED MCSI**

Andrew holds multiple qualifications in financial planning, including the internationally recognised CFP certification.

He served two terms as board director to the Institute of Financial Planning and chaired its Ethics, Practice Standards and Disciplinary Committee. He sits on the CISI Integrity & Ethics Committee.

He is a firm believer in leveraging the power of financial planning over product-related financial advice and founded bdb on this ethos.

Andrew has since grown the business to become one of the UK's leading financial planning organisations that considers money as an enabler for its clients to live life to the fullest while also enjoying financial security.

FORMER CHAMPIONSHIP CHESS PLAYER DUNCAN GLASSEY CFP™ CHARTERED MCSI SEES MANY PARALLELS BETWEEN LIFE AND CHESS, ILLUSTRATING GARRY KASPAROV'S ASSERTION THAT "CHESS IS LIFE IN MINIATURE". BY **JANE PLAYDON**

# The chess game of life

**A**s a former chess prodigy who still practises daily, Duncan has learnt the value of strategising – a skill he applies to his professional life as partner at financial planning firm Wealthflow LLP. “Planning for potential obstacles three or four moves ahead while preparing for the here and now is crucial in both chess and financial planning,” he says. “Helping our clients think forward to their potential next few moves, and planning accordingly, allows them to move with confidence.”

Duncan took to chess “like a fish to water” at the age of nine, joining his school and local chess teams in Falkirk, Scotland, progressing quickly to a professional level and playing in tournaments around the world. Four years ago he played the Millionaire Chess Tournament in Las Vegas, against some of the best players in the world. His most notable result was a draw against American grandmaster and three-time US women’s chess champion Anjelina Belakovskaia after 4.5 hours of play.

“It is not uncommon for tournament chess matches to last three to four hours,” says Duncan, noting more parallels between competitive chess, financial planning and

wealth management: “Chess teaches us to be patient. Financial planning and investment management supports clients to be patient, without looking for the quick fix, in order to achieve and maintain their desired lifestyle.”

With the ongoing expansion of his business, Duncan has shifted his focus from tournament chess to “daily online play and weekly team matches in the Central Scotland Chess League”. But he remains “passionate about sharing the many life-changing benefits of playing chess with others, both young and old”.

In 2017, he organised a chess fundraising event in Edinburgh for several client-related charities. “I played 25 matches simultaneously over a two-hour period against 25 Wealthflow clients and local professional connections. I won all 25 games, much to my surprise and delight. Each participant was gifted a chessboard and chess set, provided they agreed to teach at least one young person the game.

“Following that experience, I travelled with my son to Kosovo to support The Ideas Partnership, an NGO supporting marginalised ethnic groups. My son and I spent time coaching the kids and Wealthflow donated chess sets and beginner chess books to the group. Local people didn’t think it appropriate for young girls to learn chess, so I took pride in letting the girls know about the many female grandmasters around the world. The charity now runs the chess club for both boys and girls.”

Duncan has helped to establish three chess clubs: one in Kosovo; one in his local primary school, and is in the process of establishing a chess club within the New Club in Edinburgh. This requires “little more than a few chess sets and keen participants,” says Duncan.

With its capacity to exercise intangible but priceless qualities, such as strategising, concentration and intuition, chess is often used as an analogy

for life. Duncan’s chess hero, grandmaster and former world champion Garry Kasparov, even wrote a book on the subject: *How life imitates chess*. “He believes the power of intuition is at the heart of success in all things: the power of intuition and the ability to harness and use it like a master,” says Duncan. “The biggest problem I see among people who want to excel in chess – and in business and life in general – is not trusting their instincts and intuition enough.”

// CHESS ISN'T JUST ABOUT WINNING; IT'S ABOUT CHALLENGING YOUR OWN EXCELLENCE //

In another parallel with life, chess, unlike some other games, doesn’t allow you to “skip a turn if you can’t identify a direction that suits you,” says Duncan. “One of the great challenges of the game is how to make progress when there are no obvious moves, when action is required, not reaction. Here is where we find what separates pretenders from contenders.”

Duncan, as a serious contender, has gained a great deal from chess – even the ten-minute matches he plays daily, which require an intense focus for a short period. “The result is an almost innate ability to think on your feet while quickly determining long-term strategies. I love it!

“Chess isn’t just about winning; it’s about challenging your own excellence, looking for new strategies and truly understanding the psychology of the game. It’s a much easier game to learn than you might think and the benefits might just change your life. Give it a try!” ●



Contact [jane.playdon@cisi.org](mailto:jane.playdon@cisi.org) if you have a hobby you think will interest other CISI members. You will receive a £25 voucher if we publish your story.



# global insights



PHOTOGRAPH: CHARLIE SURBEY

“It’s been exciting to work with a group of firms who are committed to achieving change on a global scale to the way business is done in wholesale markets”

*Mark Yallop, chair, Fixed Income, Currencies and Commodities Markets Standards Board  
Profile: Man on a mission, pp.32–34*

“Women CEOs generally have a much harder route to get to the top, and it does not end there”

*Anthony Hilton  
FCSI(Hon), p.16*

“London attracts the best from around the world. If you are ambitious and have talent, this offers a wide range of opportunities”

*Tony Solway, chair of Sionic  
2020 Mudlark vision, pp.38–40*



*pp.17–24  
Special report:  
Social mobility*

*pp.25–27  
Sharing  
the business*

*pp.28–31  
Sovereign  
wealth funds*

*pp.35–37  
Defined benefit  
pension transfers*



**Anthony Hilton**  
FCSI(Hon)

**FIRST  
PERSON**

WE STILL DON'T HAVE ENOUGH WOMEN CHAIRING COMPANY BOARDS. A GENUINE ATTEMPT TO FIX THIS WOULD REQUIRE A CULTURE CHANGE IN BOARDROOMS ACROSS THE WORLD AND WE ARE A LONG WAY OFF FROM THAT

# The battle isn't won yet

“ In early October 2019, the 30% Club announced that the proportion of women on boards of the FTSE 350 companies had reached 30% for the first time. It has been quite a journey. As one of the club's founders, Dame Helena Morrissey, the then head of personal investing at Legal & General Investment Management, said: “Most of the letters I wrote asking for support in 2010 were met with flat rejection. Hitting the target today has given me hope that change is possible, that the mindset around gender and other forms of inequality can shift.”

Well, up to a point, Dame Helena! It was on the same day that one of the women who was a CEO of a FTSE 100 company, Alison Cooper of Imperial Brands, said she would quit. There were only five women CEOs in the FTSE 100 anyway – though that will continue now that Alison Rose has taken the top job at Royal Bank of Scotland.

Cooper, however, is falling on her sword because Imperial has run into regulatory and political problems with the vaping products it hoped would be its future. As a result, Imperial's shares have lost roughly 50% of their value in little more than two years. Some shareholders agitated, so the board dumped her although they didn't have a replacement.

Perhaps there is a trend here. Women CEOs generally have a much harder route to get to the top, and it does not end there. If they do not turn the company around, or take too long, the board decides to try someone else.

Institutional shareholders do not help either. They are largely short term. Portfolio managers are by and large men – fund management is one of the worst places for women in the financial sector. According to a study by Warwick Business School, the inclusive, longer-term style that women tend to personify is not for these investors.

Nor is it just that few women CEOs have long-term tenure and fewer still have another woman to follow them on. In Dame Inga Beale's case at Lloyd's of London, several other female executives followed her out of the door just a few months after she left.

It may be that many women don't want the CEO's job anyway. There are endless books like Sheryl Sandberg's *Lean in*, but they are written by the women who have made it. On the other hand, Christine Armstrong uncovered a different truth when researching her book *The mother of all jobs*. On the record, her interviewees avowed the importance of hard work and exceptional organisation in order to effectively juggle the dual tasks of working full-time and raising children. But off the record it transpired that the reality was altogether different: “The children are anorexic because I'm never home”; “Did I tell you I am halfway through a divorce?”; “I feel like I am heading for a breakdown”; “I work so many hours a week, I can't go to bed without three glasses of wine. Then I wake up at 2am and do my emails. Then I get up at 6am to do it all again”.

Ann Francke, now head of the Chartered Management Institute, was at one time a senior executive at Procter & Gamble. A single mother, almost every day she jetted all over Europe and back

again to put her child to bed. Then a new boss arrived who said she had to stay overnight in whatever country she was in to take the local executives out to dinner. She quit a few months later.

Dame Helena adds that “nine out of ten men said they thought they should play as big a part in childcare as their wives, (but) the majority of men with caring responsibilities hide it from their employers because they don't think it is compatible with career progression or job security, and that is a real indictment”.

Business is still predominantly a male culture – it should not be, but it is. Headhunters and chairs of the board need to widen their pool of potential candidates by making a genuine attempt to employ half of the population according to their ability. And the ludicrously long hours required to climb the executive pyramid need to be cut.

But business needs a culture change, and we are a long way from that. ●

“ **Business is still predominantly a male culture – it should not be, but it is** ”

ILLUSTRATION: PADDY MILLS/SYNERGY





# Getting in, and getting on

TO HAVE TWO GENERATIONS OF THE SAME FAMILY WORKING IN THE SAME SECTOR IS AN INDICATOR THAT SOCIAL MOBILITY ISN'T HAPPENING. FOR FINANCIAL SERVICES, THAT INDICATOR STANDS AT THREE TIMES THE NATIONAL AVERAGE IN THE UK ALONE. **ALEXANDER GARRETT** REPORTS ON WHY THIS IS BAD NEWS, AND WHAT EMPLOYERS CAN DO TO TURN IT AROUND

&gt;&gt;

or someone who left school at 16 because he needed to find a job, Steven Cooper has made a remarkable success of his career. Having joined Barclays in an entry role doing administrative tasks – “I was promoted to a cashier, that’s how junior I was,” he says – his potential was soon spotted and he was one of the first four non-graduates to be enrolled on the bank’s graduate programme. Steven subsequently rose through the ranks over 30 years to become Barclays’ chief executive of personal banking across the UK and Europe and chief executive of Barclaycard Business.

Today, he’s in the top job at private bank C. Hoare & Co and is one of the commissioners on the Social Mobility Commission – a government-appointed advisory body – a position from which he’s able to play an instrumental role in promoting opportunities for young people from similarly disadvantaged backgrounds to his own.

Reflecting on the challenges he faced in his own career, Steven says: “One was my own lack of confidence. I hadn’t developed the confidence you get at a private school, or from university, or the social network that comes with a certain type of privileged background.” He also suffered from not having the career development structure that many of today’s potential leaders can



Steven Cooper,  
CEO, C. Hoare & Co

take for granted. “Today, organisations that are progressive in developing talent will put in place a structured programme to ensure people get the breadth of experience they need, the knowledge and skills to be the best they can be, and to become future leaders of the organisation. I didn’t benefit from that structure,” says Steven.

“I didn’t have any career counselling at school; I took some brave decisions in order to broaden my experience,” he says, through, for example, moving to Africa for a leadership role and to experience a different culture, and spending a year’s secondment at McKinsey.

As his career progressed, Steven “felt occasionally there was a glass ceiling,” and had the sense that he was being looked down on because he “didn’t have a certain level of education”. But, on the positive side, he also became acutely aware of how big a difference help and support from others in the organisation could make.

#### A vital issue

At a time when there is growing polarisation of wealth in many countries, including the UK, as evidenced by the *World inequality report 2018*, social mobility has become a vital issue for governments and other policymakers, and one that employers are increasingly recognising they need to get to grips with.

There’s no universally accepted definition of social mobility, but in colloquial terms it is widely understood to mean the ability of people to improve their socio-economic circumstances, or to move up the social ladder. The UK government defines social mobility as “the link between a person’s occupation or income and the occupation or income of their parents. Where there is a strong link, there is a lower level of social mobility. Where there is a weak link, there is a higher level of social mobility.” It can also be seen as a measure of the degree to which any society is meritocratic.

In the UK, social mobility has been something of a political hot potato in recent years. In 2017, former Labour minister Alan Milburn resigned as chair of the Social Mobility Commission, criticising the government for not giving enough support to the commission’s agenda. His other three fellow board members also stood down at the same time in solidarity.

But the issue is now gaining traction among many leading organisations.



IMAGE: ISTOCK

The Social Mobility Employer Index, inaugurated by charity the Social Mobility Foundation (SMF) in 2017, has seen participation from 172 UK employers representing more than 1.5 million people, and expanded from ranking the top 50 to the top 75 employers in 2019.

### Financial services

Around 41% of employees in financial services have parents working in the same sector – more than three times the national average of 12% across other sectors, according to widely reported research from KPMG in April 2019. In insurance, more than half of workers have followed their parents into the sector.

// PROFESSIONAL BODIES CAN PLAY AN IMPORTANT ROLE IN PROMOTING THE AGENDA OF SOCIAL MOBILITY //

As part of a wider research project on social mobility, the CISI recently commissioned research from market research and data analytics firm YouGov, looking at how parents and teachers view the importance of work experience, particularly in relation to their children/charges gaining employment in financial services. Of the 513 primary and secondary school teachers, and 1,013 parents in total that responded, the research finds that 77% of parents with children at independent schools feel their child is aware of financial services as a career path, compared to 50% of those with children at a local authority school.



IMAGE: ISTOCK

The CISI believes that professional bodies can play an important role in promoting the agenda of social mobility, both in financial services and elsewhere. The research mentioned above shows that 45% of parents with children in grammar schools believe having good contacts and connections is key to getting into the financial services sector. Interestingly, both parents and teachers think professional qualifications in financial services are more important than university qualifications in financial services, with 32% of parents with children aged 14 to 18 and 37% of teachers feeling that professional qualifications are important, compared to 24% and 27% respectively for university qualifications.

Membership of organisations like the CISI provides an essentially meritocratic approach for those who want to pursue a career in financial services, with more senior membership status awarded to those who sit higher level exams. Susan Clements, CISI global director of learning, says: “The brightest and best don’t always enter the workplace with a traditional academic pedigree. Vocational qualifications are an efficient and effective way for anyone to ‘earn while they learn’, enabling them to progress and reach their full potential within the financial services sector.”

**32%** of parents with children aged 14 to 18 and  
**37%** of teachers feel that  
**professional qualifications in financial services are important to get young people into the sector**



**24%** of parents with children aged 14 to 18 and  
**27%** of teachers think  
**university qualifications in financial services are important to get young people into the sector**

>>

Membership of a professional body provides recognition and an opportunity to build and maintain a network of useful contacts.”

**Mixed picture**

David Johnston, the former chief executive of the SMF (he stood down at the end of 2019), says that, overall, the financial sector presents a “mixed picture”. Retail banks, for example, which have traditionally recruited locally for their high street branches, have less of a problem, while in contrast some of the more niche areas such as private equity and asset management have less of a track record for hiring and developing people from diverse backgrounds. Investment banks, he says, are making efforts, but while J.P. Morgan is the standout at number 17 in the SMF Index, others have tended to import a model of diversity from the US that focuses primarily on gender and ethnicity.

Accountancy firms, on the other hand, have a strong record to show on social mobility, and two firms in particular, KPMG and PwC (see box below), have topped the SMF ranking.

Steven Cooper says that “at one level, financial services is doing exceptionally well and better than most other sectors”. He believes that the sector can claim a strong record on providing apprenticeships and reaching out to disadvantaged communities to help people with different aspects of job hunting, as well as developing basic financial literacy skills.

“When I was running personal banking at Barclays, we hired 2,000 apprentices,” says Steven. “We were reaching into parts of society with high levels of unemployment. We put a lot of structure around these people, often young people, to give them additional training around literacy and numeracy, so that they were ready for the workplace.”

The CISI is actively involved in outreach programmes to help promote upward social mobility in financial services. Since September 2013, it has been sponsoring teachers in Liverpool, Manchester and London, via its Educational Trust, to deliver its level 2 and 3 foundation qualifications to sixth-formers in disadvantaged areas in these

**CASE STUDY**  
**PwC**



PwC, ranked as the leading employer in 2019’s Social Mobility Foundation Employer Index, has a dedicated team working on social mobility. It

is involved in outreach within schools and communities as well as recruitment. Hollie Crompton, social mobility lead, says, “As a very large business, we absolutely think it is the right thing to do, but there are also strong business reasons: our clients are really diverse and we need an equally diverse group of employees to serve them.”

In 2017, the firm decided to make a difference in one community and became the cornerstone employer for the Bradford Opportunity Area (OA), the largest of the 12 ‘opportunity areas’ – areas of the country where social mobility

is lowest – identified by the UK government nationally. The firm’s strategy covers recruitment, development and progression, community outreach and advocacy. PwC already had a long-standing office in nearby Leeds, and one of its senior partners there, Will Richardson, took an active role in the OA partnership board, while employees volunteered for initiatives such as going into schools and offering advice on interviews and the recruitment process. “According to the Careers & Enterprise Company, research shows that if you have four or more encounters with employers in your secondary school career, you are 86% less likely to become NEET [not in education, employment or training],” says Hollie.

In 2019, PwC opened an office in Bradford, which now employs 135 people, many of whom are drawn from the local community. The firm has also pioneered a paid work experience programme aimed at

underprivileged students in Year 12, with a national target of offering 1,000 places to disadvantaged students in the five years to 2022.

PwC is a strong believer in setting targets and measuring progress, which is published via a scorecard in its annual report. For example, it aims to bring the proportion of new hires who received free meals at school – in England and Scotland, children in Year 3 and above are entitled to free school meals at state-funded schools if their parents receive state benefits – up to the national average, which is approximately 15%. The base year was 2015 at 6% and that has already risen to 10%. “At the recruitment stage, we have been gathering data for a number of years and people are relatively comfortable with it, but getting data on our existing employees is a real challenge and many organisations will say the same,” says Hollie. “You need to be really clear why you want that data and what you are using it for.”

cities. Matthew Bolton, CISI teaching and learning specialist, says: “As part of these educational programmes, students are also provided with mentoring, work experience placements and the opportunity to develop their employability skills, all with fantastic support from members in our regional committees. The aim has been to develop the next generation of professionals by providing them with the baseline knowledge not traditionally taught in schools and colleges, as well as opening doors to careers that these young people may not have been aware of or felt were out of their reach. So far, we have reached over 400 16 to 18-year-olds in these areas.”

Research by the CISI also explores financial services firms’ attitudes towards work experience. At the time of writing, responses are still coming in, but preliminary results from around 40 firms show that work experience is a key factor that firms consider when recruiting. Firms were asked how highly they value previous work experience in the sector when recruiting. Some 47% say that previous work experience is ‘essential’, while a further 29% believe it to be ‘very essential’. In contrast, just 18% of firms think it’s ‘not essential at all’.

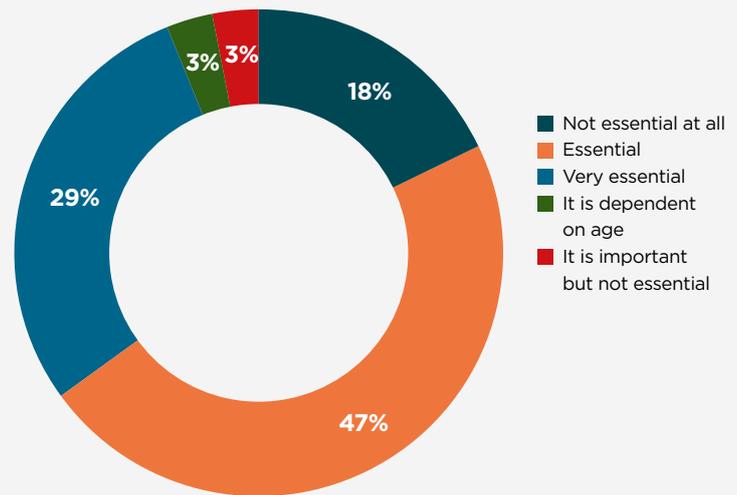
Firms also say that schools and teachers have a vital role to play in terms of helping pupils secure placements. Over half (52%) think that schools/teachers are responsible for providing young adults with advice and support when it comes to finding work experience placements, while 50% also state that the majority of placements stem directly from schools, colleges or universities, in response to the question: ‘Where do the majority of your work experience placements come from?’

#### Greater imperative

Financial services arguably has a greater imperative to deal with social mobility than other sectors. Among the public at large, many blame the banks for having triggered the financial crisis, an event that led to austerity and further setbacks for already disadvantaged communities. Access to finance and financial products is also key to achieving social mobility, while lack of access to a bank account is seen as a characteristic of deprivation.

In 2018, the Open University Business School’s True Potential Centre for the Public Understanding of Finance published *A review of social mobility in financial services*. It argues that “the

GRAPH 1: HOW HIGHLY DOES YOUR FIRM VALUE PREVIOUS WORK EXPERIENCE IN THE SECTOR WHEN RECRUITING?



Source: CISI

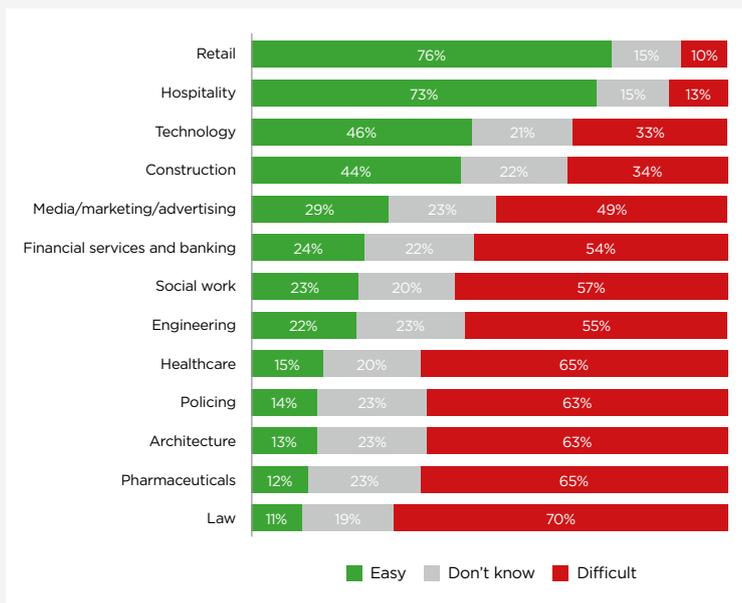
choices, decisions and actions that financial services companies make can influence, in a positive way, the social mobility of many people now and in the future, directly and indirectly through their recruitment and training practices, their policies and products and their corporate and social responsibility initiatives. A concerted effort and emphasis on improving social mobility in the sector could therefore have a major impact on the prosperity of the whole nation.”

## // SUPPORTING SOCIAL MOBILITY, AND CASTING YOUR NET WIDE IN RECRUITMENT, CAN PAY BUSINESS DIVIDENDS //

Liz Moody, one of the authors of that paper, says: “Financial services is more prominent than other sectors in terms of its influence on our economy. And the number of people employed in financial services is significant. When things go wrong with financial services, if we have a banking crisis or a breakdown in technology, it’s serious. If people can’t access money and credit, that has an impact on social mobility.” According to TheCityUK, the sector employs 2.3 million people across the UK. Financial and related professional services accounts

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**GRAPH 2: EASE OF FINDING WORK EXPERIENCE IN THE FOLLOWING SECTORS (ALL TEACHERS)**



Source: YouGov | Overall, how easy or difficult would you say it is for young people (those under 18) to find a work experience placement in each of the following sectors?

say they would support the compulsory reintroduction of work experience. Financial services ranks in the middle of sectors for ease of obtaining work experience, but only one in ten teachers and parents believe that careers in financial services are easily accessible.

Liz says that as well as developing products that are inclusive, diversity in employment practices is crucial to maintaining the public's trust. It's not just about doing the right thing, she stresses. Supporting social mobility, and casting your net wide in recruitment, can pay business dividends. She believes that diversity of backgrounds and experience can bring in different values and change the worst aspects of the culture in financial services. "It might reduce the groupthink that got us into the banking scandals and the financial crisis," she adds.

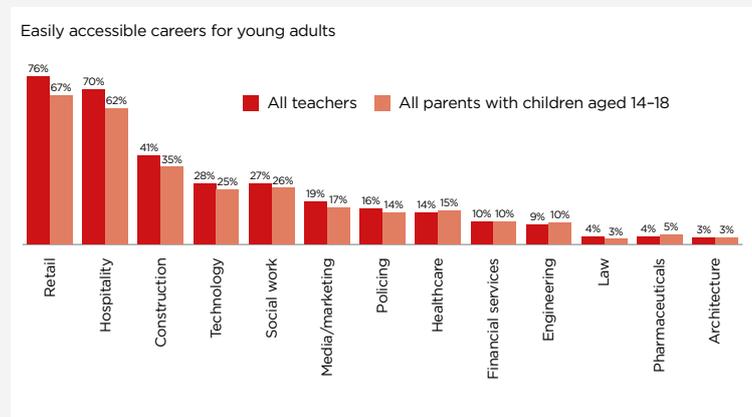
David Johnston concurs: "There are plenty of fairness arguments, but we think you should do this because you can get better people – after all, how could all the best people possibly come from a tiny number of schools and universities? But, also, by having people from diverse backgrounds, you can attract different customers and enter different markets in a way your traditional colleague may not be able to help you to." A 2016 article in *Harvard Business Review* surveys evidence from numerous studies to show that different kinds of diversity, including

>> for £11 in every £100 of tax paid to the exchequer and is the generator of the largest trade surplus of any UK sector: £60.9bn in 2017.

These figures point to a need to encourage more into the sector. Yet, in the UK, work placements were removed from the curriculum for Key Stage 4 pupils (usually aged between 14 and 16) in 2012 after a recommendation in the 2011 Wolf review of vocational education. The report said the education system should instead focus resources on providing longer internships for older pupils over the age of 16. Research by the Career Colleges Trust, published in February 2018, finds that of the 1,000 14 to 19-year-olds asked, the vast majority (83%) would like work experience to be part of their education, and the call for work experience to be reintroduced has been echoed by bodies such as the Federation of Small Businesses in April 2019. The CISI-commissioned YouGov research clearly shows the potential of work experience to promote social mobility, with a fifth of parents saying that their first job was in the same sector and influenced by their work experience.

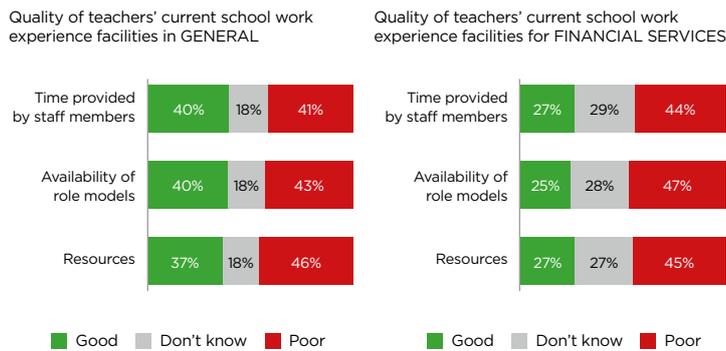
The YouGov research reveals that 75% of teachers and 65% of parents

**GRAPH 3: PARENTS BELIEVE THAT CAREERS IN RETAIL AND HOSPITALITY ARE THE EASIER TO ACCESS. ONLY 1 IN 10 TEACHERS AND PARENTS FEEL THE SAME ABOUT FINANCIAL SERVICES**



Source: YouGov | Which, if any, of the following sectors would you say are easily accessible careers for young adults (those aged 18 and over) today?

**GRAPH 4: SCHOOLS ARE LACKING ROLE MODELS AND RESOURCES WHEN PROVIDING SUPPORT AND INFORMATION ON A CAREER IN FINANCIAL SERVICES**



Source: YouGov | How good or poor do you think each of the following is at your school with regards to advising pupils about work experience opportunities? | How good or poor would you say each of the following is at your school for advising pupils on work experience opportunities in financial services?

race, gender and culture, lead to better performance.

**Practical measures**

For employers, what does promoting social mobility mean in practice? It is often framed primarily in terms of recruitment practices – the academic backgrounds and specific universities that firms hire people from. “In the first year we did the Index, we found that employers visited Oxford and Cambridge more times than the 110 other universities combined,” says David. “In 2019, employers made 72 visits to Oxford and Cambridge. That is still hugely disproportionate, but it’s on a downward trend.”

// IMPROVING SOCIAL MOBILITY IN THE SECTOR COULD HAVE A MAJOR IMPACT ON THE PROSPERITY OF THE NATION //

As well as broadening the range of universities they recruit from, companies are encouraged by the Social Mobility Foundation to remove filters such as UCAS points – a number which indicates qualifications grades for aspiring university students – from their initial screening of applicants and, more importantly, to introduce alternative routes to employment for candidates who prefer a more hands-on approach to career development, such as through work experience and

apprenticeships. Some companies are even developing artificial intelligence-based systems that can predict how well somebody will perform in the job, which is seldom down to academic qualifications. IBM’s Watson Recruitment solution, for example, claims to be able to identify high-potential candidates by matching against key success profiles, “surfacing candidates who may have been missed by recruiters, thus eliminating any steps in the search process that may have introduced unconscious bias”.

But it’s not just about hiring people from different backgrounds, it’s also about enabling them to break through the ‘class ceiling’ and progress at the same speed as those who’ve come through the more familiar and trusted route – “getting on” as well as “getting in”, as David puts it.

**Collecting data**

If companies are to make serious inroads on social mobility, they need to first have awareness of the issue, then to understand what it means for them, says Steven. And key to that is collecting data. “Few businesses in reality collate information on the socioeconomic backgrounds of their people,” he explains. “How do you



IMAGE: ISTOCK

>>

understand what data you need, what questions you need to ask? And how do you give confidence around providing that information, for example, in terms of the General Data Protection Regulation?” Steven says that collecting this data is important so firms avoid what he calls “an unconscious biased filtering process” – in other words subconsciously favouring people from particular backgrounds over others from differing backgrounds.

// THE CISI IS ACTIVELY INVOLVED IN OUTREACH PROGRAMMES TO HELP PROMOTE UPWARD SOCIAL MOBILITY IN FINANCIAL SERVICES //

One way to tackle this could be through ‘reverse mentoring’, which, according to the *Harvard Business Review*, pairs junior employees with senior employees, with the latter benefiting from the former’s worldview and skillset.

Both the Social Mobility Commission and the CISI are set to launch a toolkit in early 2020 that will help companies identify what actions they need to take. Social mobility matters, says Steven,



IMAGE: ISTOCK

because nobody should be limited in terms of opportunities because of the circumstances in which they were born. Giving a chance to young people from underprivileged families or those with no working role model has one other bonus, he says. “It’s a far more enjoyable day job if you connect with people who are very different from you, and you learn and grow with each other.” ●

## THE UK SOCIAL MOBILITY DIRECTORY

### Social Mobility Commission

The Social Mobility Commission (SMC) is a government-appointed body that monitors progress towards improving social mobility in the UK, and promotes social mobility in England. SMC is an advisory non-departmental public body, sponsored by the Department for Education. [gov.uk/government/organisations/social-mobility-commission](http://gov.uk/government/organisations/social-mobility-commission)

### Social Mobility Foundation

A charity that aims to make a practical improvement in social mobility for young people from low-income backgrounds, particularly by providing opportunities and networks of support for 16 to 17-year-olds who are unable to get them from their schools or families. [socialmobility.org.uk](http://socialmobility.org.uk)

### Social Mobility Employer Index

The Index is a benchmarking initiative that ranks Britain’s employers on the actions they are taking to ensure they are open to accessing and progressing talent from all backgrounds. It was launched by the Social Mobility Foundation in 2017 and expanded from 50 to 75 top companies in 2019. [socialmobility.org.uk/index](http://socialmobility.org.uk/index)

### Social Mobility Pledge

A cross-party campaign to improve social mobility in the UK, founded by then politician, Justine Greening MP. Employers are invited to sign up to three steps covering partnership, access and recruitment practices in order to become accredited. [socialmobilitypledge.org](http://socialmobilitypledge.org)

### The Sutton Trust

The Sutton Trust is a charitable organisation that champions social mobility from birth to the workplace so that all young people have the chance to succeed in life. Activities include evidence-led programmes, agenda-setting research and policy influence. [suttontrust.com](http://suttontrust.com)

### upReach

A charity that helps young people achieve their career potential by providing an intensive programme of support that addresses socio-economic barriers to employment. The organisation also runs the Student Social Mobility Awards. [upreach.org.uk](http://upreach.org.uk)

ILLUSTRATION: GREGORY BALDWIN/IKON



# Sharing success

WITH 40% OF UK FINANCIAL ADVISERS EXPECTED TO RETIRE IN THE NEXT FOUR TO TEN YEARS, ACCORDING TO LIBERTATEM'S *HEATH REPORT THREE*, SHOULD ADVISORY FIRMS ADOPT AN EMPLOYEE-OWNED STRUCTURE TO AID STAFF RETENTION AND SUCCESSION PLANNING? **GILL WADSWORTH** REPORTS

Ever since the UK government deregulated financial markets in October 1986 – known as Big Bang – private share ownership has been commonplace among UK businesses. However, the legislation of the time encouraged mass share ownership – typically by institutions on behalf of investors – rather than by individuals in the companies for which they worked.

As a result, according to the Employee Ownership Association (EOA), there are just 370 employee-owned firms out of the more than 4.2 million registered businesses in the UK. But this number could be set to grow in response to predictions of a “huge drop” in access to advice in the coming years, according to the *Heath Report Three*, published in January 2019. It examines the

availability and future of professional financial advice in the UK, covering 249 adviser firms representing 865 advisers. It says that unless advisers are replaced, the number of consumers accessing advice could be under one million within a decade, and it outlines key actions to take (see [cisi.org/sharingbusiness](http://cisi.org/sharingbusiness)), including training and retaining advisers.

The EOA defines employer ownership as relating to British firms where “25% or more of the ownership of the company is broadly held by all or most employees (or on their behalf by a trust)”. Under direct employee ownership – or substantial share ownership – employees become registered individual shareholders of a majority of the shares in their company using one or more tax-advantaged share plans. Reasons to consider

a direct ownership arrangement include a need by the retiring owners to retain some shares because the employees cannot afford to purchase their whole shareholding in one go, or capital may be needed to bridge a purchase price gap. In such cases, employees are invited to buy shares through a tax-efficient employee share incentive plan to make up the difference.

Under an indirect employee ownership model, shares are held collectively on behalf of employees, normally through an employee trust. Combined direct and indirect ownership means a combination of both.

Of those 370 firms that the EOA identifies, 60% converted from private to employee ownership following the 2014 Finance Act, which introduced a complete exemption from capital gains tax on the sale >>

of shares to an employee ownership trust (EOT) – see box below for definition.

The 2012 government-commissioned *Nuttall review of employee ownership* also had an influence. Among the 28 recommendations, the review advises that government should encourage take up of EOTs and raise awareness of the benefits, reduce the complexity of the structure, and avoid regulatory burdens. Its author, Graeme Nuttall OBE, a partner in Fieldfisher’s Employee and Mutual Ownership Team, says the number of EOT businesses can only increase and believes financial planners are well suited to the model.

“Since the [2012] review, there are hundreds more employee-owned companies. Many architects adopted the employee-owned model, and now there is real momentum. I foresee something similar within the world of financial planners,” Graeme says. He explains that architect practices follow similar structures to financial planning firms, therefore he believes the model will work well for this sector, too.

Moving to an employee ownership structure is not just about benefits for the companies and owners. Employees also stand to gain substantially from taking a share in the business. First, there is the

opportunity to benefit financially. Profits made will be returned to employees, and there is also the opportunity to gain tax breaks on bonuses and make contributions to retirement savings at no extra cost to the employee (see table below). Employees are also more directly involved in the company’s objectives, since shareholders naturally have more of a say in how the business is run.

Whether the existing structure of a financial planning or advisory firm is a limited liability partnership (LLP) or a limited liability company, it is possible to convert to an employee-owned arrangement.

There is no size limitation. For example, consulting firm BDO says it worked with

**TABLE 1: DEFINING THE BUSINESS MODEL**

Model	How it works	Pros	Cons
Direct employee ownership	Staff become shareholders, each holding a set number of shares and using one or more tax-advantaged share plans.  Shares cannot be sold for more than the valuation, but can be sold for less.  Owners do not need to sell the entire company, but more than 50% must be employee-owned.	Employee motivation through engagement and cash bonuses.  Can reinvest profits in the business.  Buying shares in the business directly is motivating for employees when the business goes well.	A direct share ownership policy can burden the owners with the obligation to use reserves to buy shares from departing employees.  There are costs associated with the establishment and administration of an employee ownership share plan.  Share ownership, specifically option plans, can be dilutive, as with each share issued, individuals gradually own a smaller percentage of the company.  A minority shareholding is more difficult to sell and less attractive to potential buyers than a majority holding.
Indirect ownership via an employee-owned trust	The trust manages shares on behalf of the employees. Shares cannot be sold for more than the valuation, but can be sold for less. The trust must have control of a minimum of 51%. Employees can indirectly buy the company from its shareholders without them having to use their own funds, thereby creating an immediate purchaser and addressing succession issues.	There may be tax incentives for a seller of the business to an employee ownership trust (EOT). If a business is 51% owned by an EOT, it can pay certain bonuses free of income tax.	Demotivating when the business is doing badly, causing shares to decline in value. The business pays no dividends and there is no market for the shares.  Problems can arise from employees seeking to sell shares and finding no buyers among employees, the company or the EOT.
Hybrid	A combination of direct and indirect share ownership.	Trust ownership is structured, while also offering individual share ownership.  Provides a modest amount of capital growth and a direct feeling of ownership.  In limited companies, financial liabilities fall on the company, rather than on the person(s) running the company.	As above.
Limited companies	A company comprising one or more people. One person can be both the sole shareholder and director. Companies are registered at Companies House and must meet filing and reporting requirements for security by the public. The liability of members of a company is limited to the nominal value of their shares.	Other advantages include increased credibility and trust, financial protection, and potential for savings and professional improvement.	Minor disadvantages include a need to pay registration fees to Companies House, while personal and corporate information must also be disclosed.  Accounting requirements may be more complex, and accountants may need to be hired as a result.
Limited liability partnerships	Must have two members at all times. Members’ liability is determined between them in the partnership agreement.	Limited liability protects the member’s personal assets from the liabilities of the business.  You can have an unlimited number of members.	You cannot pay yourself wages.  It could be hard to raise financial capital, as investors may favour corporations.  Renewal fees or publication requirements can be expensive.

numerous companies from all sectors in 2019, including LLPs and groups, to establish EOTs. They have ranged from companies with just 20 employees to over 1,800, with values from £1m to over £80m.

### Options to exit

Financial planners wishing to exit the business can enter a trade sale, a management buyout (MBO) or sell shares to employees directly or indirectly.

Chris Budd, who moved his own financial planning firm, Ovation Finance, to an indirect EOT structure in 2018, says the reasons for moving to an employee-owned arrangement are twofold: money and legacy. “I wanted my business to continue after I had left, and I wanted to receive a fair value. An EOT offers both those things,” he says. Neither a trade sale nor an MBO appealed to him, because with the former there was a danger that the “business could disappear along with your employees and clients”, and the latter because “it needs requisitely skilled employees with money”.

### Getting buy in

Moving to a direct or indirect employee-owned arrangement is a relatively simple process, but it cannot be rushed. “It is easy to set up and it is an approved HMRC model, so it should be straightforward, but success depends on employee engagement,” says Chris, adding that it is a cultural shift and future profitability depends on employees buying into the new conventions. “You get paid from the future profit of the business, so you need to take time to prepare the business and the employees so that it will continue without you and therefore pay you.”

This success also depends on securing client support; they must be reassured that their service levels and access to expertise will not be jeopardised by the new structure. “The owner needs to make themselves the least important person in the business so that they can leave but the clients will stay,” Chris explains. “This is key to the process and may take a few years.”

### Retention tool

If firms can achieve it, however, moving to either a direct or indirect EOT model is very powerful as an employee incentive, since their own motivations are aligned with those of the business. Critically, it is not just the typical fee-earning employees that are rewarded, which is a key difference from traditional performance-related bonus structures. Chris says all employees have a voice in an employee-owned business, with

## CASE STUDY: PARADIGM NORTON

Paradigm Norton’s move to an employee ownership trust (EOT) was five years in the making and finally came to fruition in 2019. Barry Horner CFP™ Chartered MCSI, Paradigm’s founder and CEO, says it was critical to the management team that if anyone left, their legacy would be intact and that employees could shape their own future and that of the business for themselves. At the same time, clients had to receive equivalent service and support. Fortunately, the 2014 Finance Act had given new legitimacy to an age-old solution – the EOT – which was, Barry says, perfect for Paradigm.

“Employees could direct the future of the business, but the clients would not notice any difference,” he explains. Employees have already

those who cannot earn fees still receiving a bonus, which helps them to stay motivated, remain with the firm and ensure its success.

And unlike share incentive plans, which often require employees to sacrifice salary to own the shares, employees do not have to come up with money to receive profit from the EOT. Selling shares to just those employees who can afford it can be divisive, whereas employee ownership arrangements are designed to motivate everyone equitably.

## // EMPLOYEES STAND TO GAIN SUBSTANTIALLY FROM TAKING A SHARE IN THE BUSINESS //

### Not for everyone

Moving to an employee-owned arrangement will not be suited to every business. Barry Horner CFP™ Chartered MCSI, founder and CEO of financial planning firm Paradigm Norton, which moved to an EOT structure in 2019, says, “We have a collegiate style of operating, so the EOT works well, but if you have a dictatorial management style, moving to an employee-owned model would be challenging.”

Graeme Nuttall agrees that employee ownership is not suitable for every business and highlights several other challenges with the model. “Once the majority of the shares are locked up indefinitely, it makes it less

received their first bonus and the EOT is working well. “The team doesn’t need to think about what is around the corner, they can invest for the future and see they have a career here until they retire,” says Barry.

It is also reassuring for clients. “We have created a structure to allow team members to just continue with clients, and there is no fear that we will be taken over in the future.”

Barry says setting up the EOT was straightforward, but concedes that the firm benefited from having its own in-house tax and accounting specialists. However, Paradigm hired an external lawyer to ensure all the contracts were in place.

“The EOT won’t be for everyone,” Barry admits, “but it has ticked all our boxes.”

attractive to sell the company to a trade buyer and makes it harder to attract private equity investment, as there is no exit for the company.”

He adds: “Owners must be willing to share their profits with the many rather than the few, and they will mostly need to rely on loan finance because they won’t want to issue shares to third parties.” Ultimately, there is no hard and fast rule as to which companies are more suited to employee ownership, but companies need to have strong management teams delivering robust financial results to stand a chance of success.

Despite Chris’s view that employee-ownership structures are straightforward to set up, there can be challenges in finding legal support with the requisite skills, which may deter businesses from continuing. The Employee Ownership Association’s *Employee ownership impact report* says that “most professional advisers, drawn from legal, tax and accounting professions ... lack a developed understanding of employee ownership” and because of this, “they often perceive that the legal complexities and financial barriers outweigh the benefits, and advise clients accordingly”.

Employee ownership has received a boost since 2014 and offers another option for financial planners wishing to exit the sector. But there is more to the EOT model than that; companies with an eye on securing the long term for themselves, their clients and their employees could do worse than give the workforce a true slice of the success. ●



SOVEREIGN WEALTH FUNDS ARE HEAVYWEIGHTS IN THE GLOBAL INVESTMENT MARKET AND THESE DAYS THEY ARE INVESTING IN AN EVER-WIDER RANGE OF ASSETS. HOW WILL THIS AFFECT THE WIDER INVESTMENT COMMUNITY? **DOMINIC DUDLEY** REPORTS

# Sovereign power

**T**he world's biggest rainy-day fund, Norway's Government Pension Fund Global, holds US\$1.1tn in assets, or around 1.4% of all listed companies globally. Halfway around the world, the Bhutan Economic Stabilization Fund has assets of just US\$1.5m – no more than a rounding error for the Norwegians.

The two funds have little in common other than being sovereign wealth funds (SWFs) – state-owned investment vehicles that are a growing presence in capital markets. It is a diverse sector, and not just in terms of the size of individual funds – their aims, initial sources of funding and what they invest in can all vary widely. But one thing that seems unarguable is the collective impact of SWFs on the investment sector globally. According to one estimate by research firm Preqin, SWFs are now comparable in scale to the entire alternative assets sector.

“SWFs are an ever-increasing influence on the global economy, with growth in terms of numbers, size and investment sophistication,” says Tarek Shoukri, global director for private equity and sovereign funds at PwC.

This is something that continues to develop as the funds themselves become larger and more numerous and, in some cases, start taking a more active approach as shareholders – trends that hold implications for wealth

managers and anyone else involved in investment. “Active ownership, stewardship and shareholder engagement are all things SWFs are becoming more involved in,” says Danae Kyriakopoulou, chief economist and director of research at the Official Monetary and Financial Institutions Forum (OMFIF).

## The growth of SWFs

Some SWFs are set up to save money for future generations, others are designed to protect a country from volatility, others to assist with economic diversification. Whatever the motivation, governments are hopping on the bandwagon. OMFIF estimates there are 85–90 SWFs with assets of around US\$8.6tn – a figure which grew by US\$632bn between 2018 and 2019. At least 40 SWFs have been set up since 2005, according to the Sovereign Wealth Fund Institute.

The oldest examples date back to the mid-19th century, when some US states set up funds to support public services. Among them was the Texas Permanent School Fund, created by the state legislature in 1854 with seed capital of US\$2m for the benefit of public schools. Its most recent annual report, covering the fiscal year to 1 August 2018, shows assets of US\$46.5bn, with holdings comprising domestic and international

equities, US Treasuries and other instruments.

Among the newest is the New South Wales (NSW) Generations Fund, launched in 2018 with seed capital of AU\$3bn (US\$2bn). The AU\$3bn starting point sounds like a significant sum, but it is not enough to make it into the 50 largest SWFs. The ranks of the largest funds are dominated by institutions from Asia and the Middle East which, between them, account for more than half of the 50 largest funds and three-quarters of the top 20. At this level, the funds have tens of billions of dollars' worth of holdings and, in the case of the 16 largest funds, more than US\$100bn each. For example, China Investment Corporation, the world's second largest fund, has assets of US\$940bn.

More are set to join their ranks, as other governments recognise the benefit of developing a rainy-day fund for the future or seek to avoid any negative effects from a natural resources windfall, which can sometimes unbalance an economy and make other sectors uncompetitive. The Fund for Israel's Citizens, for example, is due to start making investments in 2020, using income from offshore gas fields. Using commodity revenues is a popular way of funding an SWF, but they can also be seeded with the proceeds of privatisations or budget surpluses. In all, more than 50 countries have at least one SWF, with governments often attracted to them because of their flexibility.

"A lot of countries are setting up sovereign funds to take advantage of the fact that such vehicles can have flexible rules around what kind of assets they can invest in," says Danae. "Central banks cannot invest reserves in ways that are centred around making a return, whereas for sovereign funds in many countries, their whole purpose is to increase wealth."

#### How SWFs work

How and what they invest in continues to evolve. Some are run as stand-alone institutions, others are managed by central banks or other state-owned bodies. Their degree of independence varies as widely as any other factor and some have been manipulated for nefarious purposes a little too easily (see box to the right).

A look at some of the largest funds gives an idea of the variation in governance models used. While all remain close to their governments, the nature of those links differs considerably.

In Norway's case the Stortinget, the Norwegian parliament, set out the formal framework for its SWF in the Government Pension Fund Act of 2005. The country's Ministry of Finance has overall responsibility for the fund, but it is the executive board of Norges Bank (the country's central bank) that manages it and the Norges Bank Investment Management team that implements the board's instructions.

China Investment Corporation was set up under the country's Company Law in 2007. Its 11-strong board of directors is led by three executive directors and also includes five non-executive directors nominated by the National Development and Reform Commission, the Ministry of Finance, the Ministry of Commerce, the People's Bank of China and the State Administration of

#### AT ARM'S LENGTH?

One aspect of sovereign wealth funds (SWFs) that makes them stand out is the fact they are government-owned. When things go wrong – as they have so spectacularly with the 1Malaysia Development Berhad (1MDB) scandal – it is often because they are too open to manipulation.

Details of the 1MDB affair continue to emerge, but among the accusations is that almost US\$700m found its way into a bank account owned by former prime minister Najib Razak – whose tenure lasted from 2009 to 2018 – and that others embezzled billions of dollars. The scandal has spread far beyond Southeast Asia. In the US, the Department of Justice has been pursuing Chinese-Malaysian financier Jho Low and former Goldman Sachs banker Roger Ng, alleging they conspired to launder billions of dollars from 1MDB and paid bribes to Malaysian and Abu Dhabi officials.

All this may suggest it is better to keep an SWF at a distance from government to avoid any temptation to interfere. However, the closeness between a fund and its government is not always a problem and, while it has become accepted wisdom for central banks to be given greater independence, the same is not necessarily true for SWFs. For example, some funds are used to pursue specific policy aims, such as the development of new economic sectors. In such cases, it makes sense to have close coordination between a fund and government ministers.

Even SWFs that are kept at a greater distance from their owners need to be aware of the political agenda a government is following. Funds in Australia, Norway and elsewhere no longer invest in tobacco firms, for example, falling in line with official efforts to curb smoking.

"SWFs can't completely go against a government initiative," explains Danae Kyriakopoulou, chief economist and director of research at the Official Monetary and Financial Institutions Forum. "When you have a big contradiction, it tends to attract public attention. They have to align to some extent with what governments are doing because of the reputational issues that may arise."

Beyond the 1MDB affair, there have been scandals elsewhere, such as the alleged US\$5bn fraud at the Fundo Soberano de Angola, which led to its former chairman, José Filomeno dos Santos, being arrested in 2018.

In the end, the risks of impropriety may be more to do with the prevalence of weak governance in a country, rather than how close or distant a fund is to its government. "In countries where you see scandals, corruption and governance issues around the government, you may see similar for sovereign funds," says Danae.

>>

>> Foreign Exchange. The fund’s day-to-day operations are overseen by a nine-member executive committee.

ADIA was set up by the Abu Dhabi government in 1976 as an independent institution. It says it carries out its investment activities without reference to its government and with no visibility on the government’s spending requirements or the activities of other Abu Dhabi-owned bodies. However, there remains a close link between the two sides: the government provides ADIA with funds to invest and in turn ADIA is required to hand funds back to the government on request, although the fund says that “in practice, such withdrawals have occurred infrequently.”

When deciding what to invest in, there are two basic models: smaller funds generally lean on outside advisers, but larger ones tend to have an in-house investment team. As a fund develops, it can shift from one model to the other.

“Some of the funds set up in the Middle East started with outsourcing when they didn’t have the expertise in-house,” explains Danae. “But ADIA, for example, now has access to a new generation of Emiratis who have worked in global financial centres and it is taking on more tasks in-house.”

Historically, many funds have had a relatively conservative investment approach, with portfolios dominated by bonds, stable currencies or minority equity holdings. Norway’s giant fund, for example,

has small stakes in more than 9,000 companies, including the likes of Apple, Nestlé and Samsung. All of its investments are outside Norway, so it doesn’t overheat the local economy.

Others are more adventurous. Saudi Arabia’s Public Investment Fund (PIF) is used as an engine for economic diversification. It invests at home and abroad, but one of its remits is to form international partnerships to bring technology and know-how to the local economy.

Each fund has its own investment preferences, but there is now a general trend for SWFs to expand into more asset classes and make more co-investments. In this, they are acting like some other big investors. “We see a closer trajectory between SWFs and select pension funds in increasing allocations to alternatives, expanding direct investment team capabilities and increasing partnerships with traditional general partners,” says Will Jackson-Moore, global leader for private equity, real assets and sovereign funds at PwC.

One large example of the co-investment trend was in October 2016, when Saudi Arabia’s PIF announced it was partnering with Japan’s SoftBank Group to set up the SoftBank Vision Fund.

According to the International Forum of Sovereign Wealth Funds (IFSWF), in 2018 some 211 investments were made by SWFs acting as part of consortiums, in areas including private equity, real estate and infrastructure; more than double the 92 deals completed

**CURRENT LINABURG-MADUELL TRANSPARENCY INDEX RATINGS\***

Fund	Transparency Index	Fund	Transparency Index
Alaska Permanent Fund Corporation	10	China Investment Corporation	7
Alberta Investment Management Corporation	10	GIC Private Limited	7
Chile Pension Reserve Fund	10	Heritage and Stabilization Fund	7
Fondo de Ahorro de Panama	10	Public Investment Fund	7
Future Fund	10	Russian Direct Investment Fund	7
Mubadala Investment Company	10	Abu Dhabi Investment Authority	6
Mumtalakat Holding	10	Kuwait Investment Authority	6
National Pensions Reserve Fund	10	Pula Fund	6
New Zealand Superannuation Fund	10	Fundo Soberano de Angola	5
North Dakota Legacy Fund	10	Investment Corporation of Dubai	5
Norway Government Pension Fund Global	10	National Council for Social Security Fund	5
Samruk-Kazyna	10	National Development Fund of Iran	5
Social and Economic Stabilization Fund	10	Qatar Investment Authority	5
State Oil Fund of Azerbaijan	10	Libyan Investment Authority	4
Temasek Holdings	10	Oman Investment Fund	4
Alabama Trust Fund	9	Oman State General Reserve Fund	4
New Mexico State Investment Council	9	SAFE Investment Company	4
Nigeria Sovereign Investment Authority	9	State Capital Investment Corporation	4
Timor-Leste Petroleum Fund	9	Emirates Investment Authority	3
Wyoming Retirement System	9	Kazakhstan National Fund	2
Hong Kong Monetary Authority Investment Portfolio	8	Brunei Investment Agency	1
Ireland Strategic Investment Fund	8	FEM	1
Khazanah Nasional	8	National Fund for Hydrocarbon Reserves	1
Korea Investment Corporation	8	Revenue Regulation Fund	1

Source: SWFI – Sovereign Wealth Fund Institute

\*As at December 2019

as solo investors. The number of co-investments has been steadily increasing, from 133 deals in 2015, to 143 in 2016 and 206 in 2017.

### Calls for transparency

It is, though, hard to know what many SWFs are investing in, given the widespread secrecy in the sector. Many funds are quiet about their investment strategies and other aspects of their operations, as is made clear by the Linaburg-Maduell Transparency Index. This rates funds according to how open they are, based on criteria such as the availability of audited annual reports, details of their holdings and their ownership structure. The performance of funds varies widely. While Singapore's Temasek Holdings and Ireland's National Pensions Reserve Fund both score a maximum ten points, the Brunei Investment Agency and Algeria's Revenue Regulation Fund score just one.

However, there have been some moves towards greater openness. In 2008, several large funds signed the Santiago Principles for governance and transparency, which are maintained and promoted by the IFSWF. Among the 24 principles agreed are that “there should be clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWF's general approach to funding, withdrawal, and spending operations” (principle 4), and that “relevant financial information regarding the SWF should be publicly disclosed” (principle 17).

There remains plenty of scope for development though. SWFs typically do badly on gender diversity, according to OMFIF's annual survey on the topic. The Santiago Principles remain voluntary, and while the transparency of some funds has improved in recent years, others have struggled to make progress. In a review of the sector published by the IFSWF in September 2018, Edwin Truman of the Peterson Institute for International Economics notes that the compliance of many funds with the principles has improved. Among the standout performers was Nigeria's Sovereign Investment Authority, whose compliance score rose from 18% to 76% after it was admitted to the IFSWF in 2014. On the other hand, two funds which left the IFSWF – Bahrain's Mumtalakat and Equatorial Guinea's Fund for Future Generations – saw their scores fall “substantially below the average”.

The newer funds often have better governance than their older peers, being less opaque in terms of their investment strategies and the make-up of their portfolios. “Governance and transparency have come a long way,” says Tarek. “Newer SWFs established as economic development funds are keen on establishing robust governance models to attract partnerships, co-investments and development bank engagement.”

### Positive potential

That suggests that some SWFs are now taking their role as market participants more seriously. The size of some



ILLUSTRATION: ROY SCOTT/IKON

SWFs means they can Hoover up liquidity and squeeze out smaller investors, but they can be a positive influence too. In the wake of the global financial crisis, for example, SWFs were among the few investors able to inject capital at scale where it was needed. As one review of the sector remarked in 2008, “SWFs quickly turned into the white knights of Wall Street”. More recent research, published in the *Human Resource Management Journal* in 2018, looked at the impact that Norway's Government Pension

Fund Global had on its portfolio companies. It finds that the fund helped those businesses avoid making mass redundancies following the 2008 crisis.

As that example highlights, SWFs can have the ability to force positive change on the

companies they invest in. “SWFs seeking a more active role in investments is leading to talent development and technology adaptation,” says Tarek.

Going forward, the impact SWFs have on the market may hinge on the extent to which they decide to become more active shareholders. “There are different approaches. You either use your shareholder power to have a positive influence or you divest entirely, and, in certain sectors, a lot of funds have chosen to divest,” says Danae. But she adds that funds have the potential to make a positive difference in some particular sectors. “Given their long-term investment horizon, sovereign funds have the opportunity to act as very positive forces in terms of advancing sustainable asset classes, helping to generate more green growth projects. We are not there yet, but there is potential.” ●

// SWFs HAVE THE ABILITY TO FORCE POSITIVE CHANGE ON THE COMPANIES THEY INVEST IN //



# Man on a mission

## CV

**2016** Appointed chair of the FICC Markets Standards Board

**2014** Begins a five-year term as an external committee member of the Prudential Regulation Authority, and a three-year term as an external member of the Prudential Regulation Committee

**2013** Appointed UK group chief executive of UBS

**2005** Takes up the group COO post at ICAP

**1995** Appointed group COO of Deutsche Bank AG

**1985** Joins Morgan Grenfell as swap trader

**1982** Graduates from the University of Oxford with a degree in natural sciences (chemistry) and joins Barings Bank

AS CHAIR OF THE FIXED INCOME, CURRENCIES AND COMMODITIES MARKETS STANDARDS BOARD, MARK YALLOP IS TASKED WITH HELPING THE WHOLESALE MARKETS CLEAN UP THEIR ACT. HE'S HAPPY WITH PROGRESS SO FAR, BUT, HE TELLS **EILA MADDEN**, THERE ARE NEW CHALLENGES ON THE HORIZON

When the London interbank offered rate (LIBOR) manipulation scandal broke in 2012, Mark Yallop was horrified. He had been trading derivatives since 1984 and knew how LIBOR, which informs interest rates charged on a wide range of financial products, was set. He subscribed to the widely held view at the time that the rate-setting process involved a broad enough group of parties that it would be impossible for a single agent or group of agents to manipulate it. And yet, investigations by regulators in the UK and the US revealed that bankers in many of the world's leading financial institutions had colluded to report false interest rates to manipulate the markets and boost their own profits.

Eighteen months later, there was more bad news as reports emerged of further manipulation – this time in the foreign

exchange markets. “Because I’d been deeply involved in the foreign exchange markets, it was equally horrifying to see the kind of collusion that was reported between market makers,” Mark remembers. “Sharing information about what their customers’ orders were, what their hedging strategies were going to be, the abusive way in which they talked about their customers – all of that was a million miles away from the responsible, ethical approach to doing business that I had been taught by my seniors in the 1980s and the 1990s.”

For this reason, when he was asked in 2016 to chair the Fixed Income, Currencies and Commodities Markets Standards Board (FMSB), he felt that it was an important mission – and one that he could contribute to effectively. The private sector-led board is tasked with creating voluntary standards to help guide best practice on ethical dilemmas in the FICC

sector. For example, how should you deal with conflicts of interest? Or how should you treat privileged information that you come into possession of because of your role as a market maker?

### Chemist turned banker

Mark has been used to tackling such questions during an impressive 35-year career in the wholesale markets. However, if his university professor had had his way, life would have been very different. Mark applied to read chemistry at the University of Oxford; the subject had been a long-time “obsession” for him. Once there, though, he was exposed to a much broader array of discussion and debate about other subjects, and his horizons started to widen.

When it came to graduation and finding a job, he was ready to do something different that would take him outside of his comfort zone. It was 1982, Margaret

Thatcher had been in power for three years, the UK economy was struggling and jobs were hard to find. The City was alluring, but with no previous family history of financial services careers, Mark would be attempting to navigate a course through uncharted waters. (See more about breaking the link between a person’s occupation and that of their parents in our special report on social mobility, pp.17–24 of this issue.)

**Entering the City**

Mark entered the City as a graduate trainee with Barings Bank, which, at the time, was one of the oldest British merchant banks in the Square Mile. Assigned to the Banking and Capital Markets division, Mark was dropped into the world of interest rate swaps, syndicated lending and leasing transactions.

“I’ve been incredibly fortunate over 35 years to have had a huge variety of experiences and to almost completely change my career every three or four years because of opportunities that have been put in front of me,” he says. It’s difficult to pick a single career highlight, but three periods in particular stand out for Mark.

In the mid to late 1990s, he was at the heart of Deutsche Bank’s expansion into investment banking. It took place at a very different economic, political and regulatory time compared to today’s environment. The euro didn’t exist, but Europe had started down the path towards a single currency.

“I was privileged at Deutsche Bank to work with an inspirational man called Edson Mitchell [a trader who was instrumental in turning the bank into a major Wall Street player],” he says. “From, I have to say somewhat unpromising raw materials, we were able to forge in the course of five years the number one fixed income business in the world. That was a five-year period of extraordinary opportunity and excitement, and something I look back on with great pride and a lot of pleasure.”

**A radical shift**

In 2005, Mark joined another inspirational figure – Michael Spencer – at interdealer broker ICAP. When Mark was trading interest rate swaps at Morgan Grenfell in the mid-1980s, Spencer had covered him as a voice broker. They had been friends for 20 years by the time Mark went to join him at ICAP, a company Spencer founded in 1986.

There, Mark led the automation of ICAP’s interbank trading and post-trade activity. When he joined the business, 90% of profits came from voice broking and 10% from other activities. By the time he left in

2011, 55% of profits came from voice broking and 45% from electronic market and post-trade business. It was, he says, a radical and sector-transforming shift.

Mark says his role as chair of the FMSB marks the midst of the third standout phase of his career. Currently, membership comprises 50 of the largest firms in the global wholesale markets, from banks and asset managers to clearing houses and data providers. As mentioned, they have come together to collaborate on identifying best practice in the wholesale markets in order to ensure a scandal such as the manipulation of LIBOR never happens again.

“If you pick up a newspaper, you’re not short of negative coverage of financial services,” says Mark. “It’s been exciting, in contrast to that media coverage, to work with a group of firms who are committed to achieving change on a global scale to the way business is done in wholesale markets, and to see the early results of that initiative in the publication of standards that lay out how business should be done in a whole variety of areas. There’s a great deal more to do. We’re only in the very early stages of our journey, but it’s been an extremely rewarding one from a personal perspective.”

**A response to anger**

The FMSB is in part a response to the regulatory, political and public anger resulting from the instances of LIBOR and foreign exchange manipulation. Those events prompted the then chancellor, George Osborne, to commission the Treasury, Bank of England and FCA to conduct a joint review of what had gone wrong in wholesale markets. That led to the conception of the Fair and Effective Markets Review, which uncovered a variety of questionable practices taking place in this sector, and to the launch of the FMSB.

“There had been a view before 2012 that wholesale markets would look after themselves,” says Mark. “They consisted of a group of large, sophisticated,

// WITH NO PREVIOUS FAMILY HISTORY OF FINANCIAL SERVICES CAREERS, MARK WOULD BE ATTEMPTING TO NAVIGATE A COURSE THROUGH UNCHARTED WATERS //

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**THE SEVEN TECHNIQUES OF MARKET MANIPULATION**

The FICC Markets Standards Board’s *Behavioural cluster analysis* has identified seven ways in which people have manipulated the wholesale markets over time:

- 1) Price manipulation
- 2) Circular trading
- 3) Collusion and information sharing
- 4) Inside information
- 5) Reference price influence
- 6) Improper order handling
- 7) Misleading customers

>> well-resourced firms trading amongst themselves and with little to do with the retail markets. They were all, as it were, grown adults and they could look after their interests perfectly effectively.”

But, with banks using LIBOR to set retail mortgage interest rates, it became apparent that wholesale markets were highly relevant to the man and woman on the street. In the absence of formal regulations and laws defining appropriate conduct, the wholesale markets realised they needed to think more carefully about how they were operating.

### Working with the CISI

The FMSB is playing a leading role in the drive to clean up the wholesale markets sector. As part of this, it has joined forces with the CISI to create a globally recognised qualification in best practice and standards for the sector. The qualification will complement existing ethics training that organisations might already offer and will focus more on imparting a basic level of knowledge and understanding about standards, as opposed to knowledge about the laws and regulations of particular jurisdictions.

In July 2018, the FMSB released the findings of its *Behavioural cluster analysis* – a study of instances of misconduct in wholesale markets between 1792 and 2017 that covered 26 jurisdictions around the world. The study reveals that offenders essentially use seven different techniques to manipulate wholesale markets and these techniques have remained constant over the centuries (see box on page 33).

“One of the purposes of this qualification will be to alert everybody who has a role in wholesale markets to these basic types of misconduct; what they are, how they occur, what conditions make those techniques possible, and what to do when you think you’ve got an example occurring in front of you. We want to bring everybody up to the same level of understanding,” Mark explains.

“The FMSB is not equipped to create a global qualification programme in any way. We don’t have the expertise or resources to do that, but the CISI is the pre-eminent qualifications provider, so I was delighted when Simon [CISI CEO Simon Culhane, Chartered FCSI] and Michael [CISI chair, Michael Cole-Fontayn MCSI] suggested that they would be willing to collaborate with us to create such a qualification.”

The FMSB estimates that around 300,000 people work in the global wholesale fixed income markets.

In the next five years, it hopes that a high proportion of that group will have attained this voluntary qualification.

“One of the things that the Fair and Effective Markets Review strongly suggests is that there was a link between people operating in markets who didn’t regard themselves as professionals in the commonly accepted understanding of the term, and the fact that misconduct and malpractice was happening,” says Mark. “This qualification is the FMSB’s response to that challenge; it will reinforce tenets of professionalism.”

### The AI challenge

Eight years on from the exposure of the LIBOR scandal, Mark says that behaviour in the wholesale markets is beginning to change. That’s down to a number of drivers, including the work of the FMSB and initiatives such as the FX Global Code, which is supported by 16 central banks. There is, however, a new challenge on the horizon – automation.

Training humans to behave ethically is one thing, but as the wholesale markets move towards a greater use of technologies such as artificial intelligence (AI), programming computers to behave appropriately is a whole new ball game. When machines are programmed to maximise profits and they have no ethical safeguards, AI will almost certainly trade in an unethical fashion because it will teach itself that manipulative behaviour is the more profitable route. It will be crucial, says Mark, to program electronic trading systems to operate according to principles that support fair and effective markets.

“If that can be achieved, we will end up with a highly desirable world where markets are both cheaper to operate and more efficient, as well as fairer, more effective and less prone to manipulation by humans. If we don’t do that, we’re going to end up with a real problem where machines are potentially manipulating markets as badly as humans have done in the past.” ●

// AI WILL ALMOST CERTAINLY TRADE IN AN UNETHICAL FASHION BECAUSE IT WILL TEACH ITSELF THAT MANIPULATIVE BEHAVIOUR IS THE MORE PROFITABLE ROUTE //

### MARK YALLOP ON CAREER ADVICE FOR YOUNG PROFESSIONALS

“I see some people who come into financial services just because they want to earn lots of money or achieve a position of authority. I don’t think they are very good reasons to pursue a career in finance. Decide what your passion is. It may lie outside financial services and if so, that’s what you should do. But if it lies inside financial services then follow that and you’ll have a fabulous time.”

ADVISERS OPERATING IN THE DEFINED BENEFIT TRANSFER MARKET HAVE BEEN SUBJECTED TO A RAFT OF TOUGH NEW FCA RULES IN RECENT MONTHS. WITH SOME ADVISERS FEARING THE RULES WILL PUT THEM OUT OF BUSINESS AND OTHERS SAYING THEY DON'T GO FAR ENOUGH, THE REGULATOR CLEARLY STILL HAS WORK TO DO. **GILL WADSWORTH** REPORTS

# Transfer tightrope



ILLUSTRATION: PETER MAC/IKON

When the FCA published proposals in July 2019 to ban contingent charging (where clients pay fees only if they decide to accept their adviser's recommendations) in the defined benefit (DB) pension transfer advice market, its assessment of current practice was damning: "We are concerned that too many advisers are delivering poor advice, much of it driven by conflicts of interest in the way they are remunerated."

Are the remedies that have been put in place by the FCA, and those still to come, protecting DB pension scheme members from unscrupulous advisers enticing them away from their DB schemes with 'free' initial advice in the hope of securing hefty fees after the transfer? Or has the regulator gone too far and made the DB transfer advice market so prohibitively expensive, thanks to rocketing personal indemnity insurance, that advisers are struggling to participate?

## FCA changes

The July 2019 consultation – CP19/25 – is the latest in a long line of missives from the regulator designed to halt the rising number of transfer recommendations that may not be in members' interests. The proposals to ban contingent charging mean advisers could no longer offer 'free advice' and then deduct charges from funds if the transfer goes ahead.

This follows more than two years of exploration and legislation that ended with CP18/20, published in October 2018, that sets out a timetable of changes for advisers operating in the DB transfer advice market (see table on page 36). These rules build on those that have been in place since 2017 but that have so far failed to prevent, in the FCA's words, "too much advice [of] an unacceptable standard". The CP19/25 consultation reveals that a 69% rate of recommendation to transfer is too high given that the starting point for advisers is that it is not in the members' best interests.

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>> The CISI's response to the FCA consultation represents the views of CERTIFIED FINANCIAL PLANNER™ professional members of its Financial Planning Forum. While the rules may need review, the CFP professionals are clear that “a pensions transfer is a valuable, viable and sustainable action that represents to many savers the embodiment of pensions freedoms”.

Kevin Wood CFP™ MCSI, founding director of Watson Wood Financial Planning, says, “Advisers I have spoken to in north Scotland all agree that anything that takes away some of the unconscious bias that may come into the advice process is a good thing.

“However, while the banning of contingent charging looks like a good way to mitigate some of the conflicts of interest that exist in the DB advice process, the proposals need more consideration to ensure they do not result in the withdrawal of advice in this area.”

A ban on contingent charging means that any member exploring a transfer will have to pay an upfront fee, in the region of £3,000, according to CP19/25.

Peter A Sudlow CFP™ Chartered MCSI, founder of Sapienter Wealth Management, agrees that consumers could be disadvantaged by a contingent charging ban: “It is not uncommon for health, or other reasons, to drive clients to seek to alter pension arrangements that will help finances. With a [contingent charging] ban, consumers will be disadvantaged twice. They will likely be unable or unwilling to commit to fees, not knowing the outcome.” Peter also believes that since advising firms will have to tell consumers there will be a fee for non-transfer, and they will be pursued for non-payment, client relationships may be strained from the start.

In addition, there are discrepancies between the FCA's more stringent and prescriptive interpretation of the rules on transfer advice, and that of the broader view taken by the Financial Ombudsman Service (FOS). FOS chief ombudsman Caroline Wayman argues in the November 2018 issue of the *Ombudsman News* newsletter that “the challenge for advisers isn't just to know the rules, but to apply them to real lives – understanding where people have come from, their hopes for the future, and what really matters to them”.

CISI members have expressed concern that while they may have given watertight advice on a pension transfer in accordance with FCA rules, the FOS might find against them if a complaint is brought at a later date, on the basis that the average person could not have understood all of the technicalities involved in the process. This creates a challenging environment for advisers who wish to assist in pension transfers to the best of their ability, but who also recognise the very real danger that they may fall foul of the FOS.

**Obligatory advice**

Part of the challenge in improving the DB transfer advice market lies in the fact that advice is obligatory for pots over £30,000. Members wanting to transfer must seek a certification from a registered adviser, which has resulted in less reputable firms approaching members and offering to release them from their DB schemes with the promise of huge lump sums and tax-free cash.

The advisers have offered the ‘advice’ for free and then charged ongoing percentage fees. Research from pensions, investment and insurance consultancy Lane Clark and Peacock (LCP) finds that with the average transfer value paid now over £400,000, and with advice charges of 2–3%, these fees can typically be £10,000.

David McKendrick CFP™ Chartered MCSI, a partner at wealth manager Equilibrium, says: “I spoke with a client to whom I was recommended. He said all his friends were going to another adviser who was transferring their DB pensions one after another, like a conveyer belt. He didn't want that; he wanted to be challenged and to get the right outcome.”

**Backlash on PI payments**

Alongside tightening the rules, the FCA has increased the compensation payments to be awarded by the FOS in cases where poor advice has been given. Since 1 April 2019, the compensation award limit has increased from £150,000 to £350,000.

There has been some backlash from advisers

TABLE 1: TIMETABLE OF CHANGES FOR DB TRANSFER ADVISERS

Change	How it affects advisers	Implementation date	Set out in
Introduction of appropriate pension transfer analysis and transfer value comparator (TVC).	These must now be personalised and include all the analyses needed to make an assessment.	1 October 2018	PS18/6
Suitability reports for all advice.	Irrespective of whether the member transfers out or stays, they should receive a report detailing why the adviser came to their conclusion.	4 October 2018	PS18/20
Guidance on assessing attitude to transfer risk.	There is an over-reliance on computers to assess attitude to risk. More discussion is needed to assess attitudes and to ensure the language is not misleading.	4 October 2018	PS18/20
Guidance on working with another adviser.	To help provide better outcomes, the adviser who works on the transfer should collaborate more closely with all other advisers, specifically those providing investment advice on any transferred funds.	4 October 2018	PS18/20
Perimeter guidance on triage services.	This is designed to prevent regulated advice being given during the triage process that might prevent an individual proceeding with formal advice. Triage services should be restricted to giving factual information.	1 January 2019	PS18/20
Updated assumptions to use when revaluing benefits.	Advisers should no longer rely on critical yield assumptions alone, but should also use the TVC framework.	6 April 2019	PS18/6
Updated pension increase assumptions.	Advisers should use fixed rates.	6 April 2019	PS18/20
New qualification requirements.	All advisers should hold the level 4 RDR qualification.	1 October 2020	PS18/20

Source: FCA

who argue that professional indemnity (PI) insurance premiums have risen in direct relation to the increase in FOS compensation limits. FCA figures show that 1,000 advisers might be forced out of the market and only 500 claimants will benefit from the compensation hike.

Sir Steve Webb, former pensions minister and current director of policy at pensions provider Royal London, says: “The insurance that advisers are obliged to buy will more than double in price. There is already clear evidence that PI insurers have been hiking premiums in anticipation of this policy change, yet the FCA is pressing on regardless. This is a shocking decision. If far more members of the public are unable to access advice, consumers will lose out as a result.”

## // PART OF THE CHALLENGE IN IMPROVING THE DB TRANSFER ADVICE MARKET LIES IN THE FACT THAT ADVICE IS OBLIGATORY FOR POTS OVER £30,000 //

There are concerns that this increase in PI premiums will create a two-tier system in which corporates conducting large cash equivalent transfer exercises and moving large numbers of members out of the DB scheme will be able to absorb such costs without too much trouble. Meanwhile, an individual who has a pot just over the £30,000 threshold may struggle to justify paying £3,000 to receive advice.

Kevin chose to renew Watson Wood’s cover in the summer of 2019. He says: “There were no great changes to the terms of our cover, [although] we did see an increase in the premium and excess for DB work. It would appear that insurers are nervous about being in this market and are looking to carefully cost any policies for advisers who provide DB advice.”

A reduction in the number of insurers actively offering cover could result in a lack of competition and “a continuation of the upward trend in pricing”, he adds.

### Members lose out

It stands to reason that if an adviser’s insurance bill rises, they may pass some of those costs to clients.

Clive Harrison, a partner at LCP, says that only those members who are particularly keen to transfer and who believe they are suitable and have enough disposable cash to pay the fees up front will generally take up advice. He adds, “As a result, some members for whom a transfer might be suitable will lose out.”

However, the FCA is considering an exemption to the contingent charging ban for “groups of consumers with certain identifiable circumstances that mean a transfer is likely to be in their best interests”. These members are typically in very ill health or impoverished.

Clive is uncomfortable with these exemptions and suggests both groups should receive greater protection from making transfers, rather than be given exemptions. “It is very difficult to get evidence that someone has a particular life expectancy and sometimes people get [diagnoses] wrong,” he says. “It is also dangerous in my opinion to give exemptions to those in financial difficulty;

their DB pension could be the most stable income they have, and they might be better off getting debt advice.”

Clive’s recognition of the types of individual that may need special protection from substandard advice on pension transfers links to the FCA’s renewed focus on vulnerable clients. In July 2019, the regulator launched a consultation on improving the guidance for vulnerable clients, reiterating its commitment to protecting those clients who may suffer financial detriment due to their personal circumstances or background.

### Tougher rules needed

Despite concerns that members may not be able to access advice, there are those who believe transferring out of a DB scheme is such a fundamental decision that the rules do not go far enough.

Geraint Davies, founder and managing director of independent financial adviser Montfort, says the FCA regulations should be a minimum standard and that advisers should go beyond this base level to ensure members get the best advice. He is an advocate of ‘the triple check process’, where three transfer specialists always check the advice. “One person can make a mistake, so we get three people to look at everything. We ask what is odd here, what are the quirks,” he adds.

### Giving clients value

Equilibrium’s David McKendrick agrees and says he follows a four-step process. The first step is to talk about the member’s circumstances and not about the transfer in isolation. Stage two is ‘number crunching’. The FCA expects advisers to use the transfer value comparator framework, which presents the client with a comparison between two lump sum figures: the actual cash equivalent transfer value they have been offered, and the lump sum that would likely be required, if it were invested at a ‘risk-free’ rate up to scheme pension age, to generate a pot of money large enough to buy benefits equivalent to those being given up. All this leads to stage three, cashflow modelling, which is stress tested. Finally, the recommendation is given and options are discussed.

Completing a process to this level takes time and money, but David believes it provides value for clients. “[The client] might have spent £3,000, but they should feel they have reached a conclusion as to the best outcome for them based on rigorous testing. Once you transfer, you can’t go back; you must get this right,” he says.

David accepts a contingent charging ban – if it goes ahead – and rising PI costs could push advisers out of the DB transfer market, but believes it is the right thing. “It increases the likelihood that recommendations to transfer are made for the benefit of the client, not to cover the cost of advice,” he says.

Operating in the DB transfer advice market is challenging. The rules are tight and will likely get tighter, and the risks are great if advisers get a decision wrong. Yet leaving a DB scheme is one of the biggest financial decisions an individual can make. The challenge for the regulator and the sector lies in ensuring that there is something of a ‘sweet spot’ in the cost of advice and the service received. A step too far in either direction can leave consumers terribly exposed. ●

# 2020 Mudlark vision

**WILLIAM MONROE** CATCHES UP WITH FORMER MUDLARK INTERVIEWEES TO CHAT ABOUT WHAT THEY'VE LEARNT, CHANGES THEY'VE EXPERIENCED AND ADVICE THEY CAN OFFER TO YOUNGER FINANCIAL SERVICES PROFESSIONALS

In January 2008, financial journalist Clay Harris produced his first Mudlark column for *The Review*. Clay had written a column of the same name previously for the *Financial Times*, celebrating back office workers who were not usually in the limelight.

In historical terms, the word 'mudlark' denotes the scavengers who searched for washed-up items of value on the banks of the river Thames in the 18th and 19th centuries. Clay's column – which he wrote for *The Review* between 2008 and 2013 – sought to unearth the 'jewels' buried in the back office and shed light on the achievements and career paths of people who might otherwise have been overlooked. Clay even created an award to celebrate the unsung talent of the back office that endures to this day: the Mudlark Award for Exceptional Performance in the Back Office is awarded each year at the City of London Wealth Management Awards.

We caught up with four Mudlark interviewees to find out how their careers have developed in the years since they were interviewed, explore the changes they've encountered in the sector, and highlight the insights and advice they can offer younger financial services professionals at the start of a new decade.

**Tani Nagele, senior manager, JM Finn**

**Date originally interviewed:**

January 2008

**Role when interviewed:** Client administration manager, JM Finn

compliance role that required her to take Personal Investment Authority exams, and temporary roles at organisations including RBS Trust Bank and Citi Private Bank. Her career progression was blocked when she “ran into policies that only graduates could be managers”. But in 2001 she was recruited to JM Finn by Frank Reardon, Chartered FCSI, now chair of the CISI Operations Forum and a member of the Review Editorial Panel, to help run the back office.

## What's changed?

Tani is now a senior manager within the Investment Administration Department, with responsibility for overseeing four out of eight departments. She provides support and training for managers and staff, ensuring compliance with FCA regulations.

An increase in regulation – and the subsequent automation that has been brought in to match this cultural shift – are two major changes that she's experienced: “We have seen people's daily workloads turning more towards monitoring and controls, rather than the traditional 'inputting' role.” Other changes she's observed include those in communication and training. Tani now communicates with clients predominantly through email, unlike the days when “your favourite stockbroker would wander round for a leisurely chat”. Training has become more structured, with the one-to-one, on-the-job training of the past gradually replaced by individual training plans, internal seminars and workshops and online courses. As Tani says, “There's really no longer an excuse not to learn.”

## Lessons learnt and tips for younger financial services professionals

Tani has learnt the value of research and asking questions, together with a thorough understanding of a process or regulation – “unfortunately the regulators don't accept ignorance as an excuse” – as key enablers, while communication, she believes, is also crucial.

“Learn as much as you can and study for the sector exams. In today's regulatory environment, it's important to keep up with the current requirements. A good grounding in the broader aspects of the sector also helps to prepare people

Tani was the first ever interviewee for the Mudlark column. She now has 40 years of experience in the sector.

## Tani in Mudlark, January 2008

Tani had benefited from internal training throughout her career. At 18 years old, she received training in the stocks and shares department at Coutts – notable at the time for its all-male sherry club – then took on several different roles at other firms, including a



ILLUSTRATIONS: LUIS TINOCO

for more senior roles. This can be through background reading, working within different departments, or volunteering to help with special projects within the firm.”

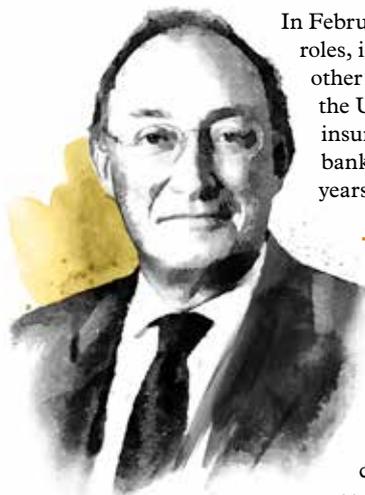
**Tony Solway, chair, Sionic**

**Date originally interviewed:**

February 2008

**Role when interviewed:**

Head of securities services, UK division, BNP Paribas



In February 2008, Tony held multiple roles, including that of chair for nine other BNP Paribas businesses in the UK in the fields of general insurance, property and private banking. Tony is now 60, with 40 years' experience in the sector.

**Tony in Mudlark, February 2008**

Like Tani, Tony benefited from internal training. After graduating from Cambridge university with a degree in history, he began his financial services career with an induction course at Andersen Consulting, then joined the Henderson investment management group. There, Tony devised and actioned an IT strategy in his role as director of systems. He was instrumental in creating Henderson Investment Services (later renamed Cogent), an investment operations business that really took off when Aberdeen Asset Management came on board as a client at the instigation of its CEO, Martin Gilbert. He joined BNP Paribas when Cogent was acquired by the firm in 2002.

**What's changed?**

Since leaving BNP Paribas in March 2008, Tony has been serving as a non-executive director or chair of a number of different companies. One of his main roles is chair of Sionic, a global financial services consulting firm based in London.

Tony has witnessed numerous changes to the sector over the past four decades. In particular, he emphasises the greater diversity in the workplace and broader opportunities offered in today's firms compared to the cloistered City partnerships of old. He's been "disappointed by the failures in recent times" – notably the recent misselling scandals that have resulted in "the erosion of trust between consumers and financial services firms". Tony feels that the resulting regulatory environment, while "absolutely necessary", needs to be less stifling to innovation and more encouraging to start-ups.

On a more positive note, he says that "the sector has done a tremendous amount to the benefit of all consumers and society at large, such as providing a wider range of choice of investments in global markets at significantly lower prices and lower operational risk than was the case when I started work in 1980".

**Lessons learnt and tips for younger financial services professionals**

Tony says the City is a "great place to be" for younger financial services professionals. "London has global scale, is the most competitive market and attracts the best from around the world. If you are ambitious and have talent, this offers a wide range of opportunities."

**Neil Atkinson, Chartered FCSI, managing director, global head, strategic client management, HSBC Securities Services**

**Date originally interviewed:**

September 2013

**Role when interviewed:**

Vice president, head of strategy & product, Depository Receipts APAC, BNY Mellon, Hong Kong

When Neil spoke to Clay in 2013, he was two years into a six-year stint in Hong Kong. He joined the CISI's Asia-Pacific Regional Advisory Board towards the end of his time in Hong Kong. 2020 marks his third decade in the sector.

**Neil in Mudlark, September 2013**

Neil started his career as a 17-year-old with Bank of Scotland in Edinburgh, dealing with the filing and post, having responded to a newspaper advert. He then moved to an investment accounting firm, where he gained experience in corporate actions and securities contracts, before leaving for London in 1999. He managed a corporate actions team at Cogent, moving on to international focused roles at CREST and Euroclear, before landing a job at BNY Mellon, having contacted current CISI chair, Michael Cole-Fontayn MCSI, who was then BNY Mellon's chair for Europe, the Middle East and Africa.

**What's changed?**

Neil returned to London in 2017, taking up a strategic client management role, still with BNY Mellon, before joining HSBC in March 2019, where he is responsible for a global team of client



>>

>> executives, who manage HSBC's direct custody and clearing relationships for the firm's largest bank and broker-dealer clients.

As with his fellow interviewees, Neil notes the huge effect of fintech solutions on financial services. "Ten years ago, I wouldn't have imagined the significance of data and digital solutions in our sector," he says. "At HSBC, we've adopted application programming interfaces to update trade status enquiries with our clients. We're using distributed ledger technology in private placements, artificial intelligence, robotics process automation and other exciting developments that reduce cost, enhance the client experience and increase operational efficiency."

#### Lessons learnt and tips for younger financial services professionals

Neil is a big advocate of networking, saying that it is "incredibly important" for career development. He notes that "organisations like the CISI provide great opportunities" for this. He's also learnt the value of teams. Tellingly, when asked about his own personal career successes, he instead chooses to focus on the teams that he has been a part of. "For me, success is about the high-performing teams I've been fortunate to work in, build and develop," he says. "I enjoy coaching and mentoring diverse teams. Ultimately, people are at the centre of everything we do."

#### Deepa Chandrasekhar, Chartered MCSI, Chief compliance officer & MLRO, United Gulf Bank

##### Date originally interviewed:

July/August 2011

##### Role when interviewed:

Chief compliance officer, United Gulf Bank

Deepa landed her first role in the sector in 1988 at Citibank, having studied economics at the University of Alberta in Canada. She is a member of the CISI Advisory Council in Bahrain.

#### Deepa in Mudlark, July/August 2011

Deepa seized opportunities to further her career after earning her BA and her MBA (in finance). She moved from Alberta, Canada to Mumbai, India to join Citibank's corporate foreign exchange department, then moved to Bahrain when her husband, a senior retail banker, was transferred there. She decided while job hunting to move from front office to back office, and took the opportunity to learn a credit risk role at Bahrain International Bank.



A stint as head of risk at Rakbank in Dubai followed, before she returned to Bahrain as head of compliance at United Gulf Bank (UGB). She took the CISI's Islamic Finance Qualification in 2010 and gained the Investment Operations Certificate in 2013.

#### What's changed?

Deepa is still in the same job at UGB, but additional responsibilities include her role as money laundering reporting officer, Foreign Account Tax Compliance Act responsible officer, as well as the bank's designated corporate governance officer. As UGB's chief compliance officer, she's the main contact point for regulators, while the second part of her role centres on supervising the bank's anti-money laundering (AML) framework.

The field of compliance has, according to Deepa, "changed drastically" in the past nine years. She notes the "raft of regulation" that has been introduced in the wake of the global financial crisis. Practically, the need to disseminate the changes across all levels of the bank has meant that she has become a skilled cross-department communicator: "A compliance officer has to be friendly. They have to be someone to whom colleagues at all levels can turn to if they seek assistance or clarifications."

On the increase of fintech, she cautions: "I know that we live in an era that is becoming automated and digital, but I urge professionals not to stop asking questions if the results don't add up, or something doesn't seem quite right."

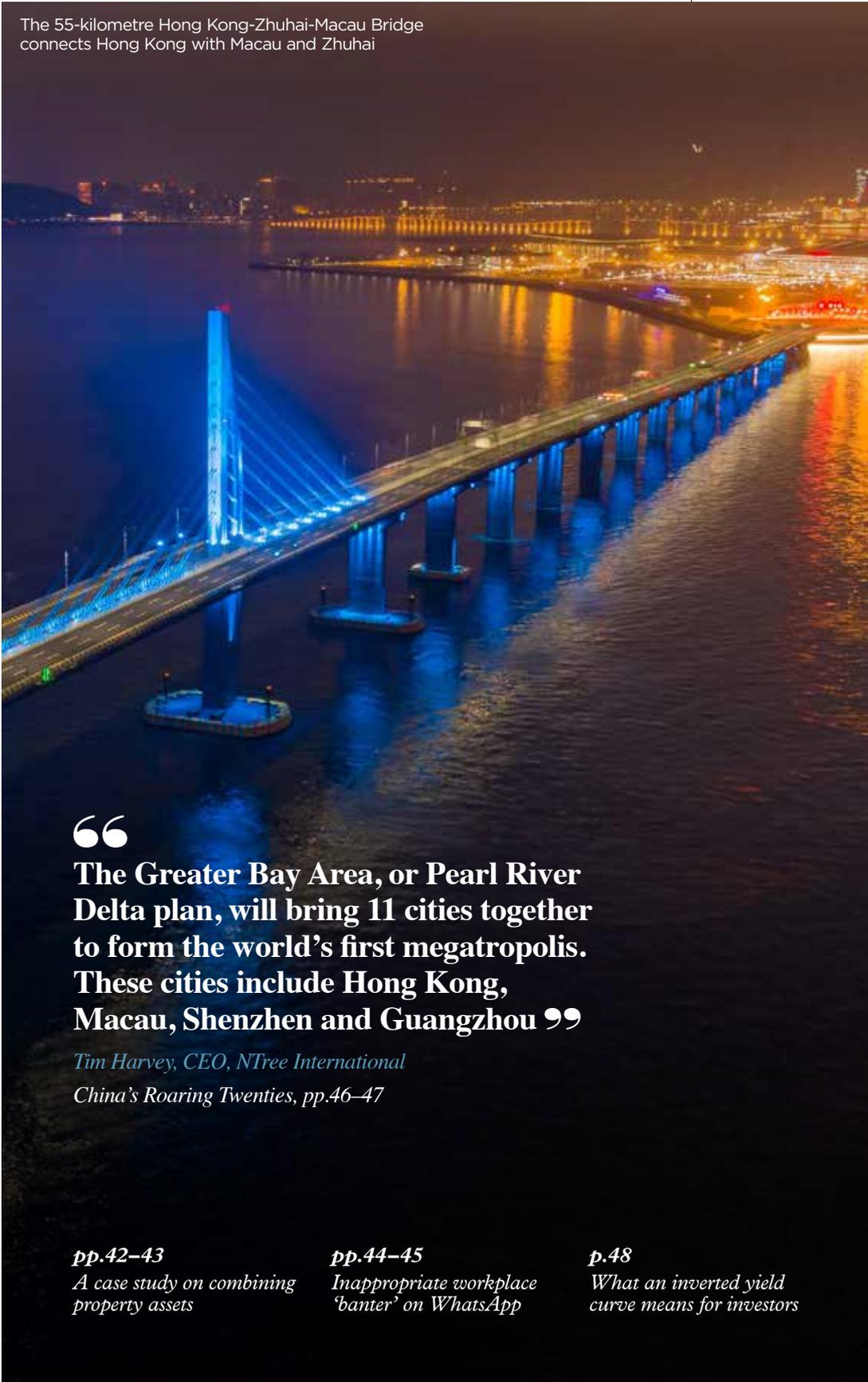
One of Deepa's chief career successes is closely linked to the changes technology has brought about. Realising "the need for a robust compliance system that would be the repository of all the rules and regulations" that UGB is subject to, she provided inputs and worked with a local software provider to build a brand-new compliance system from scratch in 2012. The scalability of the system meant that it could be easily adapted to adhere to new regulations and modern-day reporting requirements.

#### Lessons learnt and tips for younger financial services professionals

Certifications have played a key role in her career to date. "My mantra is that the process of learning never stops," she says. "Gone are the days when a master's signified the end of academia. My certifications in risk, compliance, fraud, AML, and CISI courses like the Islamic Finance Qualification, equipped me with the knowledge to tackle the requirements of my job."

Deepa wishes she had a stronger background in maths. "Many of the regulations in the area of risk require strong modelling and programming skills. If I could wind back the clock, I would have taken more of those maths and statistics courses that I shied away from during my university days." ●

The 55-kilometre Hong Kong-Zhuhai-Macau Bridge connects Hong Kong with Macau and Zhuhai



“  
**The Greater Bay Area, or Pearl River Delta plan, will bring 11 cities together to form the world’s first megatropolis. These cities include Hong Kong, Macau, Shenzhen and Guangzhou**”

*Tim Harvey, CEO, NTree International  
China’s Roaring Twenties, pp.46–47*

**pp.42–43**  
*A case study on combining property assets*

**pp.44–45**  
*Inappropriate workplace ‘banter’ on WhatsApp*

**p.48**  
*What an inverted yield curve means for investors*

IMAGE: ISTOCK



IMAGE: ISTOCK

# Combining property assets

**NICOLA WATTS** CFP™ CHARTERED FCSI, DIRECTOR OF JANE SMITH FINANCIAL PLANNING, EXPLAINS HOW THE FIRM HELPED A COUPLE PURCHASE A PROPERTY AND MAINTAIN THEIR HOBBIES AND INTERESTS DURING RETIREMENT

## THE BRIEF

**Martin and Vanessa (names changed to protect identities) came to us in 2014, having attended a seminar we held. They had been married to each other for several years and had both been married before. They had been living in Vanessa's property, while Martin rented out his former home. However, with Vanessa planning on retiring, their aim was to move away from the area. They had reached the decision to sell both of their properties, combine assets and finally purchase a property together.**

They wanted to take this opportunity to retire and wondered how they would be able to maintain their busy lifestyles, including lots of hobbies and interests, and regular holidays both in the UK and abroad. They were keen to receive advice as to how to proceed.

They were concerned that they simply couldn't create the income they needed for their lifestyle, and were also keen to pay off their existing outstanding mortgages and own their new home together outright.

## The plan

At our initial meeting, it became clear that not only did Martin and Vanessa wish to buy a new property together and formulate a retirement strategy, they had other important areas they wanted to address:

- Inheritance was a concern for them. They had their respective children and grandchildren's inheritances to consider and protect. How could they ensure that in the event that one of them should die, that person's share of assets should be left to that person's family, while also ensuring each other's continued financial security?
- The potential impact of long-term care in the future for Vanessa, who was several years older than Martin, was a further concern they wished to address. They hoped that she would be able to remain in their own home, but were worried about the financial impact of this expense.

With Vanessa retiring imminently, Martin hoping to work just part-time until age 60 and a planned house move away from the local area, they needed a detailed plan. They hoped this move and change in lifestyle would give them more time to pursue their hobbies and interests, as well as give them more time to travel and visit family abroad.

However, as is often the case, they each had slightly different views on spending money. Vanessa was more cautious and wanted to keep money for the future, just in case, but Martin wanted to avoid regrets and live life to the full while they were both fit, healthy and able to do so.

Our first step in the creation of their financial plan was to produce what we call their Life Roadmap Report. The initial part of this process is to help clients define their priorities – what is really important to them and how do we balance their different ideas? Using cashflow modelling we were able to help Martin and Vanessa visualise the impact of their financial decisions and our planning recommendations.

Our approach to financial planning gave them confidence that they could afford to purchase the house they wanted, while providing for their current income needs. We were able to balance Martin's desire that they continue with their current lifestyle with Vanessa's concerns regarding possible future care needs.

With financial security at the forefront of their minds, our plan consisted of:

- Selling both of their existing properties, fully repaying both mortgages, and purchasing a new property together in Shrewsbury outright. They were able to complete all the improvements that they planned, making this a home that would meet their needs both now and in the future.
- Forming a cohesive investment strategy, in line with the clients' attitude to risk and investment objectives. Although we deal with them jointly, it was agreed that accounts should be held separately. Martin and Vanessa are aware that this may slightly reduce tax efficiency overall, but it meets with their objective that they are able to leave inheritances to their respective families. We're happy that should either of them die, in coordination with other planning, the survivor would maintain enough assets in their own name to remain financially secure.
- Ensuring their investments, along with

their defined benefit pensions (some already in payment and some due to start later), provide them with the income that they need in retirement, plus lump sums as needed; for example, for future car purchases or improvements to the property.

- Ensuring there are enough funds available from when Vanessa turns 85 to provide care in her own home.
- Recommending they update their wills following the house move, despite inheritance tax not being an issue for them. Working in collaboration with their solicitor, it was agreed that they should include life interest trusts in relation to their property.
- Encouraging them to draft Lasting Power of Attorney documents to ensure that people they choose are able to make decisions regarding property and financial affairs, and health and welfare, in the event of incapacity.

#### What happened next

They purchased their new home outright in the area they love. Living in Shrewsbury, they are now spending their retirement enjoying the theatre, culture and social scene this has to offer. Vanessa volunteers with Dementia Friends, using her skills gained in her career as a counsellor, while Martin has found a part-time job that fits around their lifestyle, hobbies and regular holidays. I love hearing the stories of their travels whenever we speak!

We have not only helped them plan their financial affairs, but also their retirement – they're clear on what they can achieve. ●

// WE WERE ABLE TO BALANCE MARTIN'S DESIRE THAT THEY CONTINUE WITH THEIR CURRENT LIFESTYLE WITH VANESSA'S CONCERNS REGARDING POSSIBLE FUTURE CARE NEEDS //



#### NICOLA WATTS CFP™ CHARTERED FCSI

Nicola has been qualified to provide financial advice since 2001 and has been a director of Jane Smith Financial Planning since 2006. Since the retirement of her mother (Jane Smith), Nicola now bears sole responsibility for the management of the firm, and the advice provided to clients.

As well as holding the CFP licence, Nicola holds the ISO 22222 quality standard. Although Nicola's advanced level qualifications and expertise mainly lie in the areas of pensions, investments and inheritance tax planning, her focus is on financial planning and helping her clients to achieve their goals in life.



# Most likely to ...

THIS GREY MATTER, CONCERNING INAPPROPRIATE WORKPLACE 'BANTER' OVER SOCIAL MEDIA, IS ONE OF THE SCENARIOS DISCUSSED AT THE CISI'S 2020 ANNUAL INTEGRITY DEBATE, HELD AT PLAISTERERS' HALL ON WEDNESDAY 12 FEBRUARY, AND BROADCAST VIA LIVE WEBCAST

Freddie has recently joined an investment firm. It's his first job, and he is eager to integrate himself within the team.

Everyone he works with is really friendly and they regularly socialise and build friendships that extend beyond the workplace.

One Friday evening, after work, Freddie and several of his colleagues head to the local pub for a drink. They occupy their 'usual' table, and strike up conversation. Freddie's line manager, Samantha, offers to buy a round for the group, saying she's impressed at the hard work they've all put in during the week, and the drink is a 'thank you' for their efforts. Samantha has been at the firm for 12 years, and is regularly praised as a manager for the way she thanks and values her team, so this is not an unusual gesture. She leaves her mobile phone on the table while she heads to the bar.

The pub is busy, and Samantha has a large order to place, so she is away from the table for some time. Her phone is constantly lighting up with incoming

messages, and Freddie is sitting right next to it. He tries not to look, as he doesn't want to pry, but the bright light from the phone is very distracting, and he can't help but glance at it from time to time. Most of the messages seem to be coming from a WhatsApp group called 'MOST LIKELY TO ...'.

At one point, Freddie notices his own name flash up on the screen. The message says, "Most likely to quit when the pressure gets too much ... FREDDIE (I give him three months)", and has been sent from one of his teammates who is not at the pub. Immediately after, another colleague responds "No way! Freddie is tougher than you think ... JANINE is waaaaay more fragile." Freddie glances over at Janine, another young team member who has recently taken some leave to attend her grandfather's funeral, and is completely oblivious to what's going on. Over the course of a few minutes, messages come in suggesting staff members who are 'most likely to' in a number of categories, including: get drunk at the Christmas party, get pregnant, get fired, not make

// FREDDIE NOTICES, WITH DISAPPOINTMENT, THAT ONE OF THE PEOPLE IN THE GROUP IS A PARTICULAR FRIEND OF HIS //

bonus, get the biggest bonus, get caught with cocaine, pull a sickie, hit on the 18-year-old intern, have a nervous breakdown, and be late for the next team meeting. The people sending the messages are a mixture of staff members from different teams, and include young and old staff members, men and women, people of different ethnicities and different levels of seniority. Freddie notices, with disappointment, that one of the people in the group is Dan – a particular friend of his who started at the firm around the same time. At one point, Freddie takes out his own phone and surreptitiously takes a photo of Samantha’s phone with all the notifications from this group clearly visible.

At that point, Samantha comes back from the bar and starts handing out drinks. Freddie, gathering his courage, asks her what the ‘MOST LIKELY TO ...’ group is. She doesn’t seem at all worried, and replies, “It’s just a bit of a joke, don’t take it too seriously.” Freddie, however, insists that it’s not OK, and Samantha responds reassuringly, saying “All right, if it means that much to you – and I can see you’re upset – I’ll tell everyone to stop. I was never that involved anyway, and I have the group muted most of the time.” At that point, another colleague changes the subject and makes a joke, and Freddie laughs along, not wanting to ruin the positive atmosphere.

Next day, though, Freddie regrets ‘laughing along’ and thinks he could have done more. But what?

1. On reflection, it’s a bit of a laugh and saying something more will only make it worse. Also, Freddie is keen not to ruin his relationship with his line manager.
2. Freddie should encourage Samantha to tell HR about the group, as it’s clearly unacceptable.
3. Freddie should report the group to HR, using the photo he took on his own phone as evidence.
4. Freddie could encourage Dan to report the group to HR (either with Freddie, or on his own) – using the argument that it would be better to be the person that confesses rather than the person who gets caught. ●



#### WHAT WOULD YOU ADVISE?

Visit [cisi.org/mostlikelyto](https://www.cisi.org/mostlikelyto) to share your views. The survey results and CISI’s opinion will appear in the April 2020 print edition of *The Review*.

## Jane Doe: The verdict

**This Grey Matter, published in the October 2019 print edition of *The Review*, presents a dilemma that arises when a firm replaces an employee with a chatbot. When things start to go wrong, senior managers must decide what to tell clients and the regulator.**

Should you wish to suggest a dilemma or topic to be featured in a future Grey Matter, please contact us at [ethics@cisi.org](mailto:ethics@cisi.org).

#### Suggested solutions and results are as follows:

1. If the firm does not wish to escalate complaints about an AI program to the regulator, the complaints should be assigned to Sammy, the person responsible for finding and implementing the program, or to Alfie, the head of client services, and escalated to the FCA. (14%)
2. The chatbot should be amended to inform clients that they are talking to a robot. However, Alfie has dealt with the complaints to the satisfaction of the clients, so the FCA need not be informed on this occasion. (9%)
3. All clients should be written to, informing them that for the past two months, they have not been speaking with Jane, but with a robot. A message will be put on the website noting that the *Jane* program has been running for two months, and it will be made clear on all future communications that clients are speaking with a robot. The complaints will be logged, in case of a visit by an FCA supervisor. (68%)
4. *Jane* is clearly a liability. This is a failed experiment, and the company should either stop using the program, or hire a junior client services administrator to work alongside the bot, and monitor responses. (9%)

Responses received: 403

This dilemma highlights some difficulties associated with the increasing use of AI and chatbots. A key principle to remember is, just because clients are interacting with a bot, it does not mean company/professional values can be disregarded. In this case, Identity Finance should have been mindful of the values of honesty and transparency, which the CISI defines as follows:

**Honesty:** Have I been truthful about my action or decision ... and told no lies or ‘half-truths’?

**Transparency:** Have I been clear and not misleading to any party involved?

The CISI Code of Conduct also sets out that professionals within financial services should comply with regulations and the law in both letter and spirit, which one reader astutely observed was a consideration within this dilemma: “By arguing that the chatbot is a program and not an employee, the firm is complying with the letter of its policy, but not the spirit.”

**Our recommended solution is option 3**, as it best encompasses the values set out by the Institute of honesty, openness, transparency and fairness. Many respondents in the comments also suggest a mixture of all four options.

FRESH BACK FROM ONE OF HIS REGULAR TOURS OF CHINA, **TIM HARVEY**, CEO OF N'TREE INTERNATIONAL, REPORTS ON ITS COMING GOLDEN FUTURE IN THE 2020S

# China's Roaring Twenties

China's development over the past 40 years has been dramatic. The country's rapid economic growth has lifted real income per capita from amongst the lowest in the world to around world median income levels. Today China has the world's second largest economy and second largest capital markets.

Key to its success has been poverty reduction, with poverty rates falling significantly over the past 40 years. The direct consequence of China's rapid growth has been the development of its domestic economy. Chinese disposable income per capita was over US\$4,000 in 2018 and continues to grow at over 6.5% per annum. With nearly 20% of the world's population being Chinese, the country is a key driver of global consumption and growth.

China has moved from an agriculture-based economy in 1978 to a global manufacturing powerhouse. It continues to develop and today is the world leader in ecommerce, technology and artificial intelligence (AI). This introduction to China is designed to help professional investors understand its recent history and development and where it is going.

## The next 50 years

If the 19th century was the British century and the 20th American, then the 21st belongs to China. For most of history, China has been an important and large economy. It was surpassed by the US in the 1890s. Today we are perhaps only a decade away from China retaking its place as the world's dominant economic force.

The changes the world will experience over the next 50 years will be far greater than those of the past 50. AI and technology will transform our lives in ways we can only imagine today. Will we still own cars or even drive in 50 years' time, or will we travel via shared autonomous vehicles? Will the internal combustion engine be as irrelevant in 50 years as the steam engine is today?

Today we don't know the answer to these questions, but we do know China will be at the forefront of the global economy and will be driving AI and technological development. The re-emergence of China as the world's largest economy will lead to many exciting and world-changing investment opportunities to rival the Industrial Revolution and the internet age.

## Where has China come from?

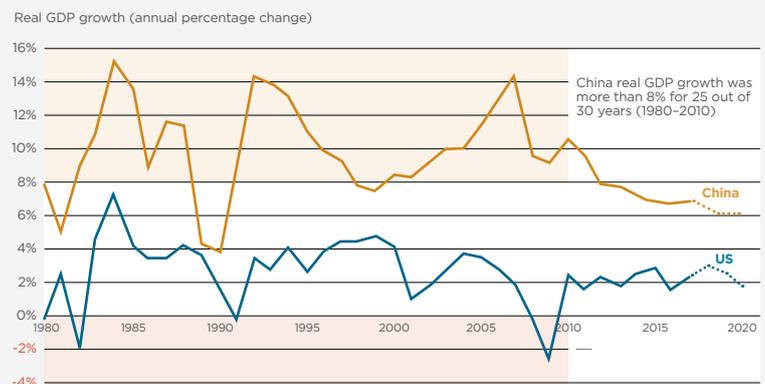
In 1976, Mao Zedong died, and the political purges of the Cultural Revolution ended. Over the next four years China's leadership evolved, and in 1980, Deng Xiaoping emerged as the new 'paramount leader' of the People's Republic of China. Deng's reforms started with the decentralising of agriculture, allowing farmers to sell any excess production at market prices. Previously, there was no incentive for farmers to outperform their production quotas. The agriculture reforms were quickly followed by Deng's 'Open Door Policy', which opened China to foreign investment for the first time since the 1949 Chinese Communist Party Revolution.

China continued to reform throughout the 1980s with wide scale decentralisation and active encouragement of increased private enterprise. Deng's reforms culminated in 1990 with the reopening of the Shanghai Stock Exchange and privatisation of large, state-owned enterprises, and the privatisation of other state-owned assets. By the time of Deng's death in 1997, he had set China firmly on the road to its current 'socialist market economy'. Since 1978, China has seen four decades of rapid economic growth. The Chinese economy has almost doubled every seven years.

## The great urbanisation

China is planning 13 megatropoli, the largest of which is the Yangtze River Delta (Shanghai) with a

CHART 1: CHINA VS US: REAL GDP GROWTH COMPARISON



Source: MGM Research

combined population of 150 million, and the smallest is Changzhutan with a population of 13 million. But perhaps the best known megatropolis project is the Greater Bay Area.

The Greater Bay Area, or Pearl River Delta (PRD) plan, will bring 11 cities together to form the world's first megatropolis. These cities include Hong Kong, Macau, Shenzhen and Guangzhou. The PRD will have a combined population of over 70 million – 75% more people than the state of California but only 12.5% of its size. The PRD is already being referred to as the Workshop of the World – a term first used to describe England 175 years ago when the Midlands produced 20% of all of the world's manufactured goods. In the 1950s the title was held by America, which was also producing 20% of the world's goods. Today it is China, with the PRD as the centre of its production.

Perhaps the greatest benefit China will see from these megatropoli and continued urbanisation will be the focusing of human and financial capital. China has eight times as many STEM graduates as the US and ten times as many as the EU. Couple this immense pool of talent with ready and available capital and government-supported infrastructure, and the PRD's place as the centre of the world's technology, design and manufacturing seems assured.

### Belt and Road

China's Belt and Road Initiative (BRI), started in 2013, could be the global game changer for the 21st century; a US\$1tn global opportunity. The BRI may well be a key economy driver for global growth in the next 25 years. The current BRI has direct geographical impact on over 60 countries, representing over 4.5 billion of the world's population. It will help raise the standard of living of many of the world's poorest nations. The economic transformation of these countries will create new global consumers and increased living standards for billions.

The BRI already connects China and UK trade via the Yiwu–London freight train service. The train service is considerably cheaper than air freight and, at 18 days, takes half the time of the sea route. Additionally, the BRI train links between Europe and China enable many developing nations along the line to manufacture and deliver quickly and cost effectively to European and Chinese consumers.

### China's capital markets

From the first steps in late 1990, China now has the second largest capital markets in the world, behind the US. Today China's two exchanges have a combined market cap of over US\$7.5tn and list more than 2,800 companies. If we include Hong Kong's market as a China market, the value easily passes US\$10tn.

Accessing China's equity markets has never been easier. Since 2000, China has slowly been relaxing barriers to entry for foreign investors, who today can access Shanghai and Shenzhen-listed A Shares via Hong Kong's Stock Connect platform. Stock Connect

### CHART 2: CHINA IN THE NEW WORLD

The Asian economic zone now represents 50% of global GDP and 70% of global economic growth



Measured in PPP terms, China has already surpassed the US as the world's largest economy

Sources: *European Business Review*, *World Economic Forum* (adapted from original)

was launched in November 2014 and enables any person or company with a Hong Kong trading account to trade over 2,000 China-listed A Shares.

China has also embraced the global exchange-traded funds (ETF) movement, and China A Shares can be accessed by multiple Chinese ETFs. The London Stock Exchange has several Chinese-issued Undertakings for Collective Investment in Transferable Securities ETFs listed and available to UK and international investors, enabling easy and direct access to China and its economic performance. ●

To hear Tim Harvey on China, watch his latest programme on CISI TV. Email: [tim.harvey@ntree.co.uk](mailto:tim.harvey@ntree.co.uk)

### Quick quiz answers:

1.A, 2.A, 3.D

### CHINA'S CAPITAL TIMELINE

China's stock exchanges trace their origins to 1866. After the 1949 revolution, China's capital markets were suspended until 1990. Since 1990, China's capital market highlights have included:

- 1992 – B shares were issued for foreign investors on the Shanghai Stock Exchange and Shenzhen Stock Exchange
- 2002 – First foreign investment for Qualified Foreign Institutional Investors (QFII) granted
- 2012 – QFII quota increased to US\$80bn and Renminbi Qualified Foreign Institutional Investor issued
- 2014 – First UCITS A Share ETF issued in Europe by CSOP (CHNP)
- 2014 – Shanghai/HKEX Stock Connect launched
- 2016 – Stock Connect expands to include Shenzhen Stock Exchange
- 2017 – Bond Connect launched between China and Hong Kong
- 2018 – CEINEX and Deutsche Börse launch D Shares
- 2019 – London and Shanghai Connect launch first IPO



# Ask the experts:

## The inverted yield curve

**Graham Secker**, chief European equity strategist at Morgan Stanley, explains why the yield curve is used as an indicator of economic health and considers the implications of an inverted curve for investors

### What are yield curves and how should they be interpreted?

A yield curve is a graphical representation of yields on bonds of similar quality against their duration. It is used as a guide to economic activity because, in a normal cycle, interest rates are higher the further out you go along the curve, as lenders are compensating for the higher risk profile of lending money over a longer period in the form of capital losses or inflation, for example.

The yield curve inverts when the interest rate lending long falls below the interest rate lending short, which indicates that investors are increasingly nervous about the future growth outlook.

If ten-year yields are below two-year yields, this is historically a reliable indicator that the economy is slowing down.

### What is a normal yield curve and why is it usually upward sloping?

There is no 'normal' yield curve as such. If we look at the US yield curve over the past 30 years, the maximum steepness of the curve (the gap between ten-year yields and two-year yields) is around 250 basis points or 2.5 percentage points. At its lowest point it tends to stop between zero and minus 50 basis points.

The average is somewhere between 100 and 150 basis points, but the curve would have been at this level for less than 50% of the time over that 30-year period.

The US yield curve tends to move in sweeping cycles – six years ago it was at 250 basis points, and since then it has fallen fairly consistently, although it recovered in the final quarter of 2019.

### What is an inverted yield curve and why is it a cause for investor concern?

The theory is that when the yield curve is inverted, so that long-term interest rates are lower than short-term interest rates, it indicates that bond investors

expect central banks to cut rates, which they would only do if the economy was deteriorating.

The yield curve is the only leading indicator that has correctly predicted just about every recession over the past 40 to 50 years – it tends not to generate false signals. An inverted yield curve doesn't mean that a recession is imminent, but it suggests that over the next 12 to 24 months there is a high chance of a downturn.

### The yield curve recently inverted. What led to this?

The yield curve was in and out of inversion regularly for much of 2019. The question in the market is whether this means growth is slowing a little or a lot.

Some investors suggested that quantitative easing and negative interest rates had skewed the signals from the yield curve and that these signals were not as reliable as they had been in the past.

### The inverted yield curve is said to be a harbinger of recessions, but is it also a cause of them?

There is no definitive answer to the question of whether yield curve discussions become a self-fulfilling prophecy – the average person does not trim their spending because the yield curve is inverted.

What we can say is that cutting interest rates can be a double-edged sword in that it reduces borrowing costs and puts more cash in consumers' pockets, but it also encourages consumers to save rather than spend because they see it as a warning that times are getting harder.

### What does an inverted yield curve mean for GBP-based investors?

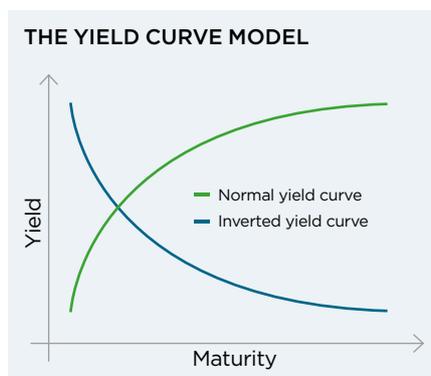
The UK yield curve is close to zero – ten-year UK gilt yields are currently 75 basis points and two-year bond yields are 105 basis points. The challenge for GBP investors is that if we look at global bond markets, bond yields generally move in a similar direction.

Most of our clients spend more time looking at the US yield curve because this tells them more about the global economy. Around 80% of the FTSE 100's revenues come from outside the UK, so the UK yield curve is of less relevance to those large companies and most relevant to other corporates with more UK exposure.

### A large part of the bond market is offering negative returns at the moment, yet investors are still investing. Why is this the case, and where are they putting their money?

Investing in bonds with negative yields may seem strange, but it needs to be considered in the context of very low or negative European interest rates. With the latter at minus 50 basis points, it can make sense to invest money in bonds if they yield more than this – for example, banks could borrow money at minus 50 basis points and buy a bond yielding minus 25 basis points and make a profit. Banks also need to maintain substantial bond holdings for regulatory purposes irrespective of their valuation. ●

**GRAHAM SECKER** is chief European equity strategist at Morgan Stanley.



“ Artificial intelligence and machine learning will be two of the biggest themes for CISI members in all walks of our sector through the 2020s ”

*George Littlejohn MCSI, senior adviser, CISI, p.54*

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THIS SECTION PROVIDES REGULATORY AND STRATEGIC INFORMATION FOR SENIOR MANAGERS. IT DESCRIBES THE POSITION AS AT DECEMBER 2019. THE REPORT CAN ALSO BE ACCESSED AS A PROFESSIONAL REFRESHER AT [CISI.ORG/PR](http://CISI.ORG/PR) OR BY LOGGING IN TO MYCISI.

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### REGULATORY CHANGES

#### 1. The FCA

The FCA has had a difficult few months. It has been criticised by the administrators of Lendy, the failed peer-to-peer platform, for authorising it last year when its finances were “increasingly strained”, according to its administrators, as new investments declined. The Office of the Complaints Commissioner (to which complainants against the FCA can appeal) is unhappy with the “unjustified delays” complainants face. The FCA has replied that it aims to deal with most complaints within eight weeks. However, there are examples of this process taking much longer – up to 20 months. It has also decided not to commission an independent inquiry into its supervision of the Woodford funds, although others may do so. Of equal concern is the inquiry into the FCA’s supervision of London Capital & Finance, which affected 14,000 investors; and the refusal by the Treasury to give it more powers to police the regulatory perimeter, even though this was recommended by the Commons Treasury Committee.

However, Andrew Bailey, CEO of the FCA (who will take over as governor of the Bank of England on 16 March 2020, having been appointed as Mark Carney’s successor), has come out fighting in its defence. He accepts that some of the criticism of the FCA is “justified” amid a climate where the public and sector as a whole increasingly demand “stronger and faster” intervention. However, he also notes the “very big achievements at the FCA in recent years – our work on high-cost credit in its various forms being a well-known example”. He accepts that the FCA should improve

its efficiency, linking this to a major investment in data analytics. Importantly, Bailey reopens the debate on the “balance” between risk-taking in investments and consumer protection: “What are the boundaries for this risk-taking [by investors] and when should the regulator intervene, and with what consequences?” He makes clear his own position on this in an important statement: “Part of our role is to facilitate investment in the economy to support jobs and the livelihoods of the people in this country. Innovation and start-ups are an important part of that activity. We therefore cannot hold to a standard where people do not lose money and where the value of assets does not decline. Investing is inherently risky.” He is clearly a central banker at heart (compare one of his predecessors, Martin Wheatley).

The same spirit can be seen in the FCA’s “open invitation” to firms to help shape future regulation. In particular, the FCA will be asking for input on future market dynamics, its principles and the proposed duty of care. Bailey sees a potential benefit for small firms in particular: “We know this (the large Handbook potentially swollen by onshoring EU rules after Brexit) affects small business – those lacking compliance departments – most. While they see the benefit that regulation brings to their firms, many struggle to understand how FCA regulation applies to them.” Christopher Woolard, executive director of strategy and competition at the FCA, says the review will move away from narrower compliance towards “delivering the outcomes we want for users of financial services”. The FCA will be publishing discussion and consultation papers “in the next few months”. Separately, the

FCA has been holding round tables on the 'purpose' of firms.

There are two interesting developments in the FCA's enforcement division. First, there is a change in the areas in which it has commissioned skilled persons reports on firms – there are now more on conduct of business issues (such as controls and risk frameworks) than on financial crime. Second, it is focusing on online financial promotions – for example, whether they properly explain financial risks or total costs. A further interesting element is its cooperation with tech firms such as Google, and promotions by unregulated firms, such as lead generation sites (eg, unregulated comparison websites), that collect data from customers and sell it on to regulated firms.

## 2. Senior Managers and Certification Regime

Project teams in most firms spent a lot of time preparing for the Senior Managers and Certification Regime (SMCR), especially in some difficult areas, such as drafting the statement of responsibilities, identifying certified staff, training senior managers in their increased responsibilities and certified staff in the conduct principles (with examples relevant to their roles), making and recording the competence assessment of senior managers and certified staff, identifying reportable conduct rule breaches, and demonstrating the firm's culture.

When studying the regulator's approach to enforcing SMCR, it is useful to look at banks and insurers that have been in the regime for three and a half years. There have been few enforcement cases – the Barclays/Staley case is the most obvious. However, more has been happening behind the scenes, with the FCA reportedly investigating several cases. There is also the tougher FCA approval requirement for senior managers, some of whom have withdrawn. It may also be used as a tool for implementing a range of policies.

Megan Butler, director of supervision – investment, wholesale and specialist at the FCA, links the regime to the Woodford scandal, "We've seen



## REGULATORY UPDATE NOVEMBER 2019

instances in recent months where if we'd seen stronger levels of personal accountability it might have led to different outcomes." Some doubt the FCA's appetite to enforce personal responsibility. Lord Myners says: "The FCA has throughout its life shown a remarkable lack of nose. I am disappointed with the pace and ambition of the FCA. They are so afraid to get something wrong they will not get something right." One way in which it will use the new regime is to give some teeth to its policies on hot issues – for example, it has recently warned insurers and their staff on bullying culture.

### 3. Brexit

Many firms had prepared for a 'hard' Brexit and the decision to postpone the leaving date until December 2020 came too late for a number who had already shifted EU customers and assets to the Continent. These changes are unlikely to be reversed anytime soon.

One consequence of this preparation has been the difficulty of persuading EU nationals to come to work in the UK, and the unsettling of many of those already here. December's general election added to this uncertainty. As a consequence some left, and those staying have accelerated their applications for settled status – currently over two million have made applications since 2016. The Home Office claims processing takes five days on average, but many report much longer delays and constantly changing information requirements. Clearly this

matters greatly to the individuals, as well as to the many firms that employ EU nationals.

Large global investment banks are divided as to the impact of Brexit on the City. Citi believes it will remain pre-eminent in Europe (and has shown this by buying its London headquarters in Canary Wharf for £1bn). Others, such as Goldman Sachs and UBS, have chosen to lease rather than buy as they adopt a wait-and-see approach. Even Citi has created 200 new positions in

the EU (in Dublin, Frankfurt and Paris). Meanwhile, the Conservative party has signalled its interest in

## // LARGE GLOBAL INVESTMENT BANKS ARE DIVIDED AS TO THE IMPACT OF BREXIT ON THE CITY //

facilitating more initial public offerings on the London Stock Exchange in competition with New York and Hong Kong. Apparently, no legal changes are proposed, but the focus is on the listing rules. In recent months, some well-known tech firms have hesitated to go public.

### 4. Financial crime

Money laundering continues to be the main focus of regulators internationally. There are three major strands. First, investigations are continuing into Danske Bank's Estonian branch, with German authorities scrutinising Deutsche Bank's role in suspicious transactions. Second, Dutch authorities are investigating ING – which received a

This update is available as a Professional Refresher in MyCISI. Log in and take the test after reading. You will earn one hour of CPD from passing the test.

€775m fine in 2018 after admitting errors in its policies to prevent financial crime – and are continuing a probe into ABN Amro over insufficient due diligence and a failure to report suspicious transactions. Third, the EU is approving tougher policing powers for either the European Central Bank, or a totally new authority. In the UK, the FCA continues its push on anti-money laundering (AML), though now it is looking beyond the finance sector to professionals such as solicitors as well.

One practical matter for firms is how often they review the AML information and documents they hold for existing clients. The FCA has not changed the rules, but sometimes this is inadequate because customer due diligence standards have increased over the years, or because customer circumstances have changed. If customers do not comply – some banks have cut off accounts for this reason – firms must decide what action to take.

The FCA also continues its focus on insider trading using ever more sophisticated fintech methods. Its current concern is personal account dealing by employees of firms. *Market Watch 62* contains its views and recommendations for firms on disclosure breaches and conflicts of interest (such as spread bets in the firm's parent company's shares and fund managers buying shares they had sold in the funds they manage). This is important reading for all firms, even if they would not normally have sensitive

information in their work. This also has international dimensions – US federal prosecutors have charged several investment bankers in different countries (including the UK) with being part of a ring to exploit inside information.

There is a related issue in market manipulation. In stocks, the controversy continues as to whether selling a company's shares and then publishing a highly critical report on it is manipulation (see the case of Burford Capital). In commodities, a J.P. Morgan trader in the US has been charged with 'widespread spoofing' (placing an order and then cancelling it) in the gold market. There are only a few market makers there, which makes the practice easier.

### SECTOR CHANGES

#### Wealth management

► A recent survey by Square Mile Investment Consulting & Research has confirmed the findings of an earlier survey by Nucleus that many advisers are spending around 40% of their time on administration. Nucleus found that only one in seven advisers spend more than 40% of their time with clients, compared with one in five the year before. While many advisers consider meeting clients the most important job, it ranks third in terms of time devoted after administration and

compliance. Some advisers accept that the solution is to outsource compliance services (to a regulatory services firm), and do likewise with some investment processes. However, the FCA questions the use of regulatory advisers by smaller firms. It sees a conflict in designing processes as simple as possible, which may result in firms needing less of their services. It does not go as far as saying that firms should not use their services.

► The Woodford saga continues, with the Woodford Equity Income Fund set to be wound up, while Schroders has taken over management of the Woodford Patient Capital Trust. The episode has given a focus to some firms' 'best-buy' lists. Hargreaves Lansdown had a noisy annual general meeting at which retail investors in the Equity Income Fund criticised the decision by Hargreaves to keep the fund on its best-buy list until

// MANY ADVISERS ARE SPENDING AROUND 40% OF THEIR TIME ON ADMINISTRATION //

redemptions were suspended. The Hargreaves website makes it plain that it does not provide advice. However, some investors complained that its marketing

wording describing the robust due diligence it does on the listed funds sounds like advice. About 30 complaints have been made to the FOS, though it is not known whether they are against Hargreaves or another firm. The FCA has not yet commented on the discounts negotiated with the manager by advisers, but it is likely to be thinking about it. It's complex because the discounts benefit the client, not the firm. This again raises the question of the definition of 'advice' and of 'personal recommendation'.

► Importantly, the FCA has stated again that advisers are responsible for suitability of products for clients, and that it is not the regulator's job to ban high-risk ones. Debbie Gupta, director of life insurance and financial advice at the FCA, says: "Unsuitable investments are, by definition, a



Spirit or letter? How the Woodford saga reminds the world of the need for ethics and integrity in financial services [cisi.org/spirit-or-letter](http://cisi.org/spirit-or-letter)

subjective judgement based on the individual to whom they are sold. Unsuitable investments are suitable for some people in some circumstances with proper controls. So I don't believe it is the FCA's job to go in and ban products that might be suitable for some people in niche parts of the market." That said, the FCA has imposed restrictions on whether retail investors can buy some products (such as binary options) and limited the sale of others to high-net-worth individuals or experienced clients, such as venture capital trusts.

- ▶ The FCA has changed its position on duty of care for customers. Christopher Woolard, executive director of strategy and competition at the FCA, says that it is time to accept that disclosure requirements are not an effective solution for delivering good outcomes for users of financial services. It is a big step for the FCA to question disclosures and risk warnings. For advised clients this could go beyond the existing duty of suitability (for example, in keeping a portfolio suitable for the client), and for execution-only products where providers rely heavily upon disclosures and risk warnings.
- ▶ In a new supervisory prevention step, the FCA has asked some firms advising on defined benefit pension transfers to send it their professional indemnity (PI) policies. The interesting development here is that this practice could well be used for advisers outside the defined benefit transfer market, and therefore any conditions of cover would be seen by the regulator. Since PI policies are very important for regulatory purposes, this is significant.

#### Asset management

The big news is the FCA's concerns about liquidity in open-ended retail funds following the suspension of redemptions by the Woodford Equity Income Fund. The FCA has written to authorised fund managers warning them to ensure liquidity for redemptions in their open-ended funds. They have a duty to make sure assets can always be liquidated quickly enough to meet redemption requests.



For more on the defined benefit transfer market and the tough new rules advisers have been subjected to, turn to page 35 of this edition

The letter suggests that firms take all necessary action in advance of new rules. These new rules will require firms to look at the make-up of the fund assets, including the 'spread of risk', to meet the daily dealing requirement. Firms must apply this to listed securities too (some Woodford investee companies were listed on the Guernsey Stock Exchange and were rarely traded). The letter set out some elements of FCA 'good practice'. These include processes for the appropriate dealing for the type of fund, appropriate types of asset for the fund's objectives, regular assessment of portfolio liquidity using liquidity buckets of liquidity demands, available liquidity (including of the buckets) to be assessed by an independent risk function which reports any breach of set limits, and stress testing of extreme but plausible scenarios.

If there is a breach of the fund liquidity policy, the role of fund administrators becomes critical. The balance of authority between the fund manager and the administrator in making a decision to suspend redemptions is one that is likely to be tested more frequently post Woodford than before. Administrators are concerned that they may be penalised by regulators.

The FCA has particularly warned property open-ended funds to check

their liquidity – even before the M&G property fund was 'gated'. This is in part due to its fears of a possible fall in property prices post Brexit or because of the fall in commercial retail prices, and of the difficulty of selling property assets fast to meet redemptions. In the financial crisis a number of property retail and multi-asset funds were suspended.

In addition, the FCA is considering whether retail and institutional investors should be allowed to invest in the same fund. This arose because of one large institutional investor's (Kent County Council's) decision to redeem the whole of its £260m investment in the Woodford Equity Income Fund. Andrew Bailey describes the council's request to withdraw its investment as

#### // THE FCA HAS CHANGED ITS POSITION ON DUTY OF CARE FOR CUSTOMERS //

"the very proximate cause" of the fund's suspension. Others in the sector think this would narrow investor choice if funds were

separated: "Such a move would vastly reduce the range of strategies that retail investors are able to access and would likely lead to much smaller retail funds with higher costs than at present." There may also be practical difficulties in defining what 'institutions' are. One property lending vehicle (Landbay) has acted on this in exiting its retail lenders.

## TURNING INTELLIGENCE INTO MAGIC

'Big data' is the future for finance. Until recently, most processes needed predictable data structured in regular ways, stored in relational databases. Simple, but limiting. Then quietly, about a decade ago, advances in computing driven by a convergence of technologies – with vast amounts of data collected on the internet meeting hugely enhanced processing power and cloud storage, together with machine learning (ML) algorithms – opened the door to a new world. But ML and its twin, artificial intelligence (AI), for all their power for good, open up challenges for skills, ethics, consumer protection, and systemic risk.

'History does not repeat itself, but it rhymes.' Often misattributed to Mark Twain, this neat aphorism nonetheless sums up much of life. In this issue of *RoFM*, we are honoured to have two distinguished contributions, from Dr Oonagh McDonald CBE and Sheriff Michael Mainelli, Chartered FCSI(Hon), on two key history lessons: one recent, one relatively ancient, but both highly valid today. Peering through the looking glass into the future, we consider measuring impact in investments – one of the hottest of hot topics for 2020 and beyond – and generating decent retirement income for clients.

AI and ML will be two of the biggest themes for CISI members in all walks of our sector through the 2020s. These technological innovations paired with big data are creating more rapid business evolution and disruption than ever before.

Not only must senior managers understand these complex and opaque new digital offerings, but as a sector we must ensure that this data and technology are used responsibly to benefit our clients and wider society.

Education, including the CISI world of professionalism, is no slouch when it comes to deploying new technologies. The CISI for instance, remains way ahead of the pack when it comes to delivering continuing education to its worldwide membership electronically. In the AI and ML domains, most initial educational developments have been, almost inevitably, in the worlds of computer science and more broadly the STEM subjects – science, technology, engineering and maths. Now the worlds of economics, business and finance are catching up, with four widespread initial

applications in educational support services: profiling and prediction; assessment and evaluation; adaptive systems and personalisation; and intelligent tutoring systems.

We'll be covering these in *RoFM* in the course of 2020. If you have experiences of AI and ML in education or beyond – particularly if you are a recent recruit to our global students ranks – then please give us your views.

While technology marches ahead ever faster, a little poetry still goes a long way. We are privileged to count some of the best and brightest brains in the world of finance amongst our membership. One such is Nigel Pantling, Chartered FCSI, an

officer in the British Army of the Rhine during the Cold War (and in Northern Ireland during the Troubles).

// WE MUST ENSURE  
THAT THIS DATA AND  
TECHNOLOGY ARE  
USED RESPONSIBLY //

Later, he served British Home Office ministers, including Leon Brittan, as private secretary. Now, he brings this and subsequent experience in finance, gained as an investment banker at Schroders and Hambros (whose corporate finance department he headed), to advise chief executives of major businesses. And to our events he brings his pen, as a poet. His fourth poetry collection will be published in September 2020. We are delighted to welcome him therefore as Poet-in-Residence here at *RoFM* with his first contribution, on page 63, on operational risk.

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# IMPACT MEASUREMENT IN PRIVATE EQUITY – CUTTING THROUGH THE COMPLEXITY

**JIM TOTTY AND RICHARD BURRETT** OF EARTH CAPITAL CONSIDER THE THEORY AND PRACTICE OF MEASURING IMPACTS AND OUTCOMES FROM PRIVATE EQUITY INVESTING, BASED ON A 'WHOLE LIFE' SCORECARD APPROACH

As global capital markets embrace the urgent need for impact investing, private equity is at the forefront of this dramatic change. However, there is currently a wide range of bespoke approaches to impact measurement, and the lack of standard methodologies in private equity is hindering capital inflows. In this paper, the authors set out a straightforward framework for impact measurement in the private markets.

At Earth Capital, we believe a 'whole life' scorecard is the approach that delivers consistent and robust impact measurement in private markets. It is easy and quick to implement and allows comparison and aggregation across portfolios.

## DRAMATIC MARKET GROWTH IN IMPACT INVESTING

There has been a rapid increase in impact investing in recent years. At the end of 2018, Morgan Stanley Wealth Management commented that 84% of investors say they are interested in impact investing or putting their money behind companies that make a positive difference in the world.<sup>1</sup> In April 2019, the Global Impact Investing Network (GIIN) assessed the size of the global impact investing market to be US\$502bn.<sup>2</sup> Nonetheless, this still remains a small subset of environmental, social and governance (ESG) integration and responsible investment. The Principles for Responsible Investment membership represents assets under management in excess of US\$80tn.<sup>3</sup> A key question is whether a simple framework for impact and its measurement is needed to promote positive impact investing, as opposed to investment that is merely doing 'less harm' through ESG integration.

<sup>1</sup> <https://www.morganstanley.com/access/impact-investing-why-it-matters>

<sup>2</sup> <https://thegiin.org/research/publication/impinv-market-size>

<sup>3</sup> <https://www.unpri.org/pri/about-the-pri>

## KEY DIFFERENCES BETWEEN IMPACT INVESTING AND ESG INTEGRATION

Both the agreement of climate goals in the Paris Agreement in December 2015, and the broader delivery of the 17 UN Sustainable Development Goals (SDGs) from earlier that year, have done much to increase the flow of capital into the low carbon, sustainable and 'just' economy, particularly galvanising new investor focus in impact investing. With this impetus has come a clear recognition of the distinction between traditional ESG integration and the new impact investing market.

Impact investing involves making investments with the conscious 'forward looking' intention to generate positive, measurable, social and environmental impact, alongside a financial return.

This goes beyond ESG integration which is only a 'backwards-looking' reporting of ESG performance, and which may still permit investment in industries that can have negative environmental and social outcomes. In contrast, impact investing looks to anticipate future societal and environmental needs and deliver positive returns for people, planet and profit.

An ESG integration strategy identifies companies in a sector that perform better than peers in ESG metrics, and implements tilts, exclusions, or active engagement to weight and improve portfolios' ESG performance. If this is not combined with some form of exclusion based screening, it may leave portfolios with significant residual exposure to a range of fossil fuel intensive industries, or sectors such as tobacco. An impact investing strategy, on the other hand, takes concrete action by investing in 'pureplay' investments focused on actionable positive environmental and social outcomes. Both strategies seek to improve outcomes, but impact investing allows investors to make more focused and measurable contributions. ESG is often seen as changing finance, but only impact investing is consciously financing change.

## IS PRIVATE EQUITY THE KEY TO IMPACT INVESTING?

ESG integration in large-cap listed equity and fixed income tends to focus on larger long-established businesses with significant inertia and long capex cycles. Although ESG data is becoming available, improvements in environmental and social performance may be slow, long-term projects. In contrast, private equity, unlike these other asset classes, is

the best approach for impact investing by giving exposure to 'pureplay' sustainable business models in technology and services. These offer transformational

// ESG IS OFTEN SEEN AS CHANGING FINANCE, BUT ONLY IMPACT INVESTING IS CONSCIOUSLY FINANCING CHANGE //

environmental and social impact from the outset, with fast moving business models and nimble market penetration.

## IMPACT MEASUREMENT IN PRIVATE EQUITY – THE STORY SO FAR

A successful impact strategy must include robust measurement, and to date, most private equity general partnerships (GPs) have evolved their own measurement methodologies, either entirely in-house or with the help of sustainability consultancies. Unfortunately, this wide range of bespoke methodologies is not helpful to capital markets, which seek standardisation. For both limited partnerships (LPs) and investee companies, significant time has to be invested in educating, explaining and implementing each GP's approach. Further impact measurement shortcomings can include unclear objectives, poor data collection and analysis, inconsistent reporting and a lack of clear standards for what qualifies as an impact investment.

The urgency to exploit the investment opportunities in impact investing means that confusion over standards must not be allowed to impede inflows of capital. The current wide number of bespoke

**FIGURE 1. IMPACT MEASUREMENT IN PRIVATE EQUITY – CUTTING THROUGH THE COMPLEXITY**

	<b>Deep dive vertical quantitative analysis</b>	<b>Horizontal scorecard analysis</b>
<b>Consistent (whole life) total impact parameters</b>	<p><b>Quant impact</b> Quantitative impact-driven analytic assessment across a range of impacts.</p> <p>Pros: Can provide rich analytic insight and describe linkage to financial performance.</p> <p>Cons: Requires data-rich, well-parameterised datasets more readily found for large-cap listed equities.</p>	<p><b>Whole life impact scorecard</b> Holistic measurement.</p> <p>Pros: Allows comparison across all investments in a portfolio and is not onerous to implement for management teams, avoids survey fatigue, consistency allows for aggregation at fund and fund manager level.</p> <p>Cons: Not intended to deliver a deep quantitative assessment but this can be completed where it is of value.</p>
<b>Selective choice of impact parameters</b>	<p><b>Impact return on investment</b> Quantification of impact in monetary terms such as an impact multiple of money invested.</p> <p>Pros: Neat parameterisation in monetary terms makes it easy to understand.</p> <p>Cons: May require changes in methodology for each investment. Limited ability to make comparisons across different investments. Can be laborious and hard to audit. Calculations are only as good as the data that feeds them. May not include 'whole life' impacts of a business other than local measures. There may be limited reporting on negative impacts.</p>	<p><b>Mission alignment and measurement</b> Selective bespoke KPIs are identified for each investment to align between mission and measurement.</p> <p>Pros: Straightforward to implement by choosing easy to measure KPIs for a given investment.</p> <p>Cons: Tendency not to choose the harder to measure metrics, and report only positive impact and not negative. May not include supply chain and end of life impacts. Limited ability to make comparisons across different investments as metrics may differ, hampering the ability to aggregate at fund and fund manager level.</p>

approaches now needs to coalesce rapidly around a small number of consistent and understandable impact measurement standards. This pressure is analogous to the development of accounting standards from the 1930s onwards in response to events such as the 1929 stock market crash. Although there may be longer-term improvements of impact standards in parallel, there is no time to wait for this to make investments.

We cannot let the 'perfect' be the enemy of the good. Time is pressing to make impact investments.

**CUTTING THROUGH THE COMPLEXITY IN PRIVATE EQUITY IMPACT MEASUREMENT**

We have reviewed the approaches currently used by private equity funds and have identified key themes that characterise different approaches taken. These are set out in Figure 1, 'Impact measurement in private equity – cutting through the complexity', which is defined by two key questions for an impact measurement approach in private equity.

- 1. Do you attempt to measure all investments with the same set of consistent whole life measures and data sets, or do you select bespoke sets for each situation?**
- 2. Do you do 'deep dive' 'vertical' quantitative analysis, or do you apply a shallower 'horizontal' scorecard approach?**

Although the 'quant impact' approach is normally only used for listed equity strategies, the other three methodologies are in current use in impact private equity.

Quantitative analysis such as the 'return on investment' can neatly parameterise in dollar terms, but it is only as good as the data it is fed, and can be complex to implement and hard to audit. If data is poorly parameterised or incomplete, its analysis risks becoming spurious. While the advent of blockchain or 'big data' approaches may assist in these, this remains a future development for private equity.

Selective 'self-certified' choices of KPIs bespoke to each investment are appealing from an ease of adoption

perspective but have significant drawbacks. These 'mission alignment and measurement' scorecards may choose only metrics that are easily measurable and look good. This can go hand in hand with a tendency to report only positive impact and avoid negative impact. It is especially vital to include supply chain and end of life impacts in measurement. The 2017 GIIN survey *The state of impact measurement and management practice* reveals that two-thirds of the impact investment sector only reports positive impact, and only 18% measure negative and/or net impact for all of their investments. Even if this is addressed, bespoke KPIs will limit the ability to make a comparison of impact across different investments or to consolidate at fund and fund manager level.

There are a number of further approaches used in impact investing.

- Social impact measurement often uses 'theory of change' models, however in a 'live' investment environment, the goal setting and measurement this involves is effectively the same as the mission alignment and measurement selective scorecard above, ie, identify KPIs bespoke to each investment, and then measure against them.
- Control groups are an academic approach to compare investment outcomes against a randomised control group. This can be challenging to implement in many real-world impact investment situations, as a duplicate potential investment has to be identified and then kept 'uninvested' and measured for the lifetime of the actual investment.
- Additionality is also studied in impact investing but its quantification in real investment situations has to be through either:
  - 'Full measurement' approaches which require control groups with the inherent difficulties explained above, or
  - a KPI scorecard 'low, medium or high' which is a subset of the KPIs in the 'mission alignment and measurement' discussed above.
- SDG based labelling of impact strategies can be used for high level sector mapping, but the SDGs do not lend themselves easily to quantitative holistic impact measurement. They can, nonetheless, help to define impact metrics for specific target areas.

At Earth Capital, we believe a ‘whole life’ scorecard is the approach that delivers consistent and robust impact measurement in private markets.

Key performance indicators are selected across ESG tests. The scorecard is easy to implement and is not onerous to complete with portfolio companies. Start of life and end of life impacts are included, and negative impacts are considered and measured. The ‘whole life’ scorecard allows portfolio company improvement to be measured over time,

comparisons can be made between investments, and it allows aggregation at both the fund and fund manager level.

**MARKET DEVELOPMENTS**

Impact investing methodologies will continue to evolve for many years to come, with ongoing improvements in the choice and range of metrics in impact scorecards. The IFC’s Impact Management Framework<sup>4</sup> and the Impact Management Project<sup>5</sup> are invaluable initiatives in this evolution process.

What is clear however, is that the global urgency of environmental and social needs means that impact investment must press ahead at speed. The simple measurement approaches set out in this paper provide the measurement framework to enable this. Private market asset owners and asset managers will benefit from quick and straightforward impact approaches across both existing portfolios and new investments.

**CONCLUSIONS**

Impact investing is growing rapidly in response to rising demand for strategies that go beyond ESG integration to produce measurable societal benefits and support a transition to low carbon and sustainable and just economy. Private equity is at the forefront of this transition. The ability to effectively measure and manage desired impacts is critical to ensuring that impact investments fulfil their stated objectives. Reliable metrics are needed to avoid the

**// THE GLOBAL URGENCY OF ENVIRONMENTAL AND SOCIAL NEEDS MEANS THAT IMPACT INVESTMENT MUST PRESS AHEAD AT SPEED //**

potential risk of ‘impact washing,’ and using the impact label primarily for marketing and asset gathering purposes. Impact measurement and management

should be embedded in all phases of the investment process, from initial due diligence and project selection to investee company performance management and reporting.

Quantitative analysis such as the return on investment can neatly parameterise in dollar terms; however, it is only as good as the data it is fed and can be complex to implement. Although this lends itself

to large cap public market securities where high quality market data might support robust ‘quant’ analysis, it will remain challenging to implement this in the private equity space.

Selective ‘self-certified’ ‘mission alignment and measurement’ choices of KPIs bespoke to each investment are appealing from an ease of adoption perspective but currently have a tendency to only report positive, not negative, impact and ignore whole life impacts. They limit the ability to make a comparison of impact across different investments or to consolidate at fund and fund manager level.

As a result, we believe a ‘whole life’ scorecard is the approach that delivers consistent and robust impact measurement in private markets. It is easy to implement, and allows comparison and aggregation across portfolios.

**ABOUT EARTH CAPITAL**



Jim Totty, managing partner, Earth Capital



Richard Burrett, chief sustainability officer, Earth Capital

Earth Capital, a pioneer in impact investing since 2008, is a growth capital private equity investment manager totally focused toward sustainability – investing capital into sustainable technologies for resource efficiencies and renewable clean energy infrastructure opportunities. It invests globally in companies and infrastructure which address the challenges of sustainable development, such as climate change, energy, food and water security. It focuses on the commercialisation and deployment of proven, sustainable technologies in various industries including agriculture, clean industry, energy generation, resource and energy efficiency, waste and water.

Its Earth Dividend™ impact measurement methodology is a ‘whole life’ scorecard developed for the private markets, based upon net environmental, social and governance (ESG) impacts

and benefits. The Earth Dividend™ provides an annual measure of an investment’s sustainable development impact. It has been developed by Earth Capital’s in-house sustainable development specialists following a review of international best practice approaches to the assessment, reporting and assurance of ESG issues and performance.

The Earth Dividend™ is established as part of the due diligence process and reported annually. The sustainability team works to identify improvements in each area where they add value and make commercial sense. The plan targets annual improvements in the investment’s contribution to sustainable development to enhance the underlying commercial performance of the asset and help to maximise value on exit. The Earth Dividend™ enables a holistic understanding of the risk and impact of sustainable development; an understanding of where investments make a positive or negative impact; identifies those areas where a business may be made more resilient and from where more value can be extracted; and is subject to external assurance annually.

[www.earthcapital.net/sustainability/earth-dividend](http://www.earthcapital.net/sustainability/earth-dividend)

<sup>4</sup>[https://www.ifc.org/wps/wcm/connect/Topics\\_Ext\\_Content/IFC\\_External\\_Corporate\\_Site/Impact-Investing](https://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/Impact-Investing)

<sup>5</sup><https://impactmanagementproject.com/>

# RATIONAL INCOME INVESTING IN A POST-QE ENVIRONMENT – LET THEM EAT CAKE

DOUG BRODIE AND COLLEAGUES FROM MASTER ADVISER TAKE A CLOSE LOOK AT THE INTRICACIES OF GENERATING INCOME FROM CASH POTS IN CHALLENGING TIMES

A major challenge in wealth management, financial planning and financial advice today is advising clients on how to generate retirement or other long-term income where the objective is reliability of income, not capital growth. Determination of the risk profile of clients is a particular challenge in an increasingly tightly-regulated market – a theme which has been developed by Keith Robertson, Chartered FCSI, in recent editions of *RoFM* (Q3 2018 and July 2019). Here, Doug Brodie CFP™ Chartered MCSI and colleagues tackle the subject from a different angle in an excerpt from a thought-provoking paper on “rethinking risk and techniques for income investors, pension drawdown and trust investment in today’s markets”.

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This paper considers the solutions available to income investors, chiefly trusts and those using self-invested personal pensions (SIPPs) in drawdown, to generate long-term income in 2019/20 – a post-QE environment with interest rates at record lows, UK gilt yields below 1% and more than US\$12tn in negative yield accounts. This is a unique investing environment requiring new thinking on suitable solutions. It cannot be just ‘unfortunate’ for 65-year-olds to be retiring with ultra-low yields, it is the adviser’s job to source current solutions for current investors applicable to trusts, drawdown pensions and investors.

This paper examines equity funds as bond proxies and naturally focuses on investment trusts due to their ability to support dividends with balance sheet reserves.

£0.5tn is a wall of purchase pension money in DC workplace schemes and in SIPPs that is peeling off each year. The expectation is that pensioners

themselves will convert the accrued lump sum into a monthly pay cheque. UK demographics show the problem is increasing every year, and the collapse in the UK annuity market means bond proxies are necessary: this means that suitable equity income funds should not be risk graded as high risk and therefore unsuitable for pensioners. We examine and analyse why today’s income seekers should not be steered away from equity solutions.

## VOLATILITY OF EQUITY CAPITAL HAS LITTLE CORRELATION WITH THAT OF EQUITY INCOME

It is clear that academic definitions of risk and how to reduce it in portfolios play an important role in determining how clients’ money is invested.

In an increasingly tightly regulated market, advisers must determine the risk profile of clients before they can handle their money. This leads to regulated advisers widely using computer-based risk-profiling programs to ascertain the level of risk to which a client’s portfolio should be exposed by attempting to quantify the client’s attitude to risk. However, the risk profiling software typically uses standard definitions of risk and diversification which may not coincide

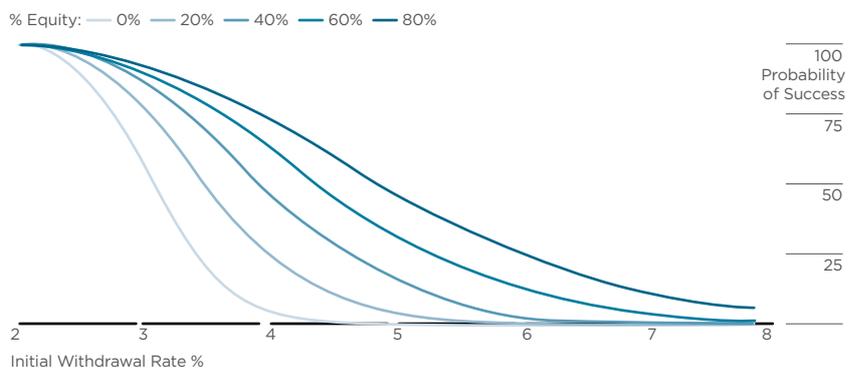
with people’s own view of risk, with the result that they may be often pushed in the wrong direction when it comes to seeking a long-term, secure income. If the output of the software is unchallenged, by an adviser perhaps, then the original software programmer’s interpretation of risk wins.

The software typically works by assessing the answers an investor gives to questions based on different scenarios where their money is subject to different levels of uncertainty. It then matches the answers to a risk score. This is meant to ascertain the investor’s mental attitude towards risk.

One mainstream profiling tool states, for instance, that it is developed by “an independent team of leading psychology academics”. The problem is that, however expert the developers of these programs, a standard set of questions cannot possibly extract the information necessary to meet the investment needs of very different individuals. That can only be done in a person-to-person discussion.

One standard question exemplifies the issue, asking investors if they prefer their money “safe from risk” without finding out what risk means to that person, or indeed if that person’s understanding is correct.

**GRAPH 1: SUCCESS RATES FOR VARIOUS INITIAL WITHDRAWAL RATES AND PORTFOLIOS (30-YEAR RETIREMENT PERIOD)**



Source: Morningstar

In isolation, everyone would like their money to be safe from risk, but if it was explained that this would still leave it subject to the vagaries of inflation or unable to provide an income for the rest of their likely life, that their income could stop in their 70s or 80s, many might give different answers to those currently being recorded. Investors would certainly seek more clarification.

In reality, those displaying a dislike of uncertainty are steered towards low volatility, cautious assets, and away from equity income, because the characteristics of the stock market make a heavily equity-based investment 'risky'. The truth, we would argue, is that the stability of an equity-based investment is often the income solution with the least risk. This is illustrated in research conducted by Morningstar, the data provider.<sup>1</sup> It examined mixed equity/bond portfolios, using differing proportions of equity ranging from 0% to 80%. Traditionally, the 0% equity portfolio would have been seen as the least risky and the 80% equity-heavy portfolio the higher risk, yet this is not borne out by the historical results.

Graph 1 is an extract from Morningstar's research. It shows the probability of success of meeting withdrawals over a 30-year period using different proportions of equity within a drawdown portfolio. It is striking that in every case shown, the highest equity allocations display the least risk of the money running out: in other words, the least risk to long-term income.

The 80% equity dark line has the highest probability of success with all withdrawal rates. This suggests that standard investment advice applied to reduce risk in equity income is incorrect. The attempts to reduce the risk to the capital simply increase the risk to the longevity of the income.

When investing for drawdown income, there is indeed a risk created by the equity part of a portfolio, but the risk is that there is too little equity in the portfolio, not too much.

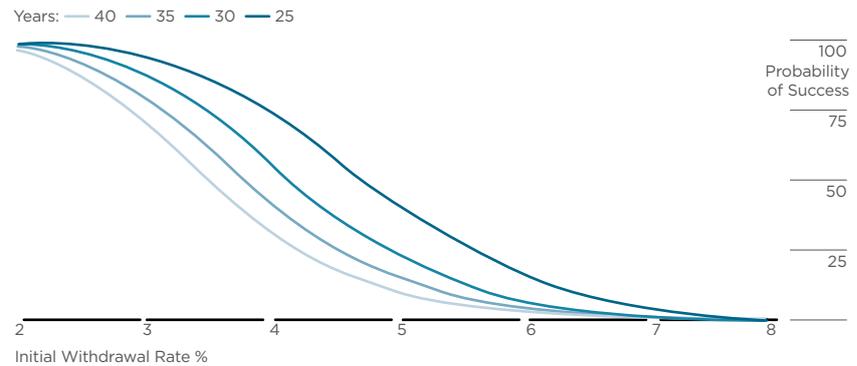
The issue goes back to our definition of risk – as advisers on regulated

<sup>1</sup> *Safe withdrawal rates for retirees in the United Kingdom, May 2016*

<sup>2</sup> *Barclays Gilt Equity Study 2019*

**How long before the investor dies? Would you like to select 25 or 30 years? It matters.**

**GRAPH 2: SUCCESS RATES FOR VARIOUS INITIAL WITHDRAWAL RATES AND RETIREMENT PERIODS (50% SHARES & 50% BONDS)**



Source: Morningstar

investments, we define risk as the likelihood that an investment will fail to do what an investor expects. It is only when the asset is sold that the loss is made permanent. The drawdown payments on which graph 2 above is based are achieved by combining income with capital realisations, that is, selling assets. The only way investors can mitigate the effects of those sales is by owning other 'risky' assets able to generate the returns needed to swim strongly against this outflow of funds. Typically, that means equities. It seems clear to us that – generally – the higher the proportion of equity in a portfolio, the higher the probability of success (for each given withdrawal rate) in generating long-term income using drawdown.

Morningstar runs the same scenario again but using a portfolio that is 50/50 shares and bonds and comparing not the different percentages of equity but the number of years of required income. One can see the jump where a 4% withdrawal for 30 years has a c.60% probability of success, whereas for just 25 years the probability jumps by 25% to a 75% success rate.

If one is to consciously reject crystal ball gazing when planning an investor portfolio for 20+ years, it would be wrong to ignore the evidence that over the past 119 years, UK equities have outperformed inflation by 4.9% per annum,<sup>2</sup> whereas gilts were at 1.9%. Finally, in that study Barclays uses its

**TABLE 1: EQUITY PERFORMANCE AND THE PROBABILITY OF EQUITY OUTPERFORMANCE**

	Number of consecutive years				
	2	3	4	5	10
<b>Equities v cash</b>					
outperform cash	81	83	85	87	100
underperform cash	37	34	31	28	10
total number of years	118	117	116	115	110
<b>Probability of equity outperformance</b>	<b>69%</b>	<b>71%</b>	<b>73%</b>	<b>76%</b>	<b>91%</b>
<b>Equities v gilts</b>					
outperform cash	80	87	87	83	85
underperform cash	38	30	29	32	25
total number of years	118	117	116	115	110
<b>Probability of equity outperformance</b>	<b>68%</b>	<b>74%</b>	<b>75%</b>	<b>72%</b>	<b>77%</b>

Source: Barclays gilt equity study 2019

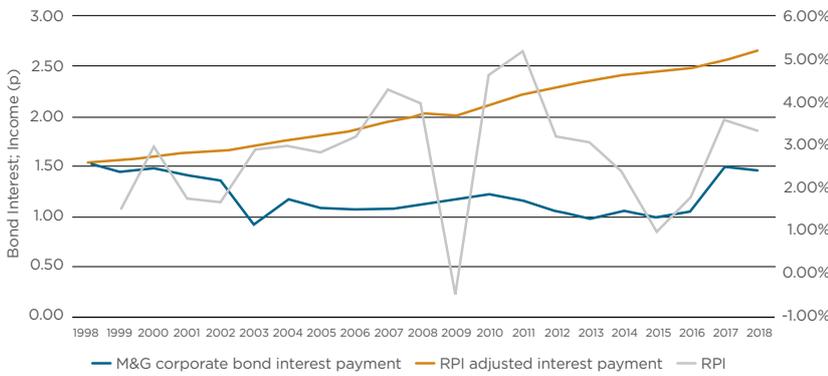
**‘NATURAL’ INCOME FROM A CORPORATE BOND FUND**

Inflation has fallen in recent years, but not enough to offset the fall in interest rates. To see how a real investor might have experienced this change in circumstances, we compared the natural income provided by M&G’s £3.5bn Corporate Bond fund over the past 20 years with inflation over that period. Note that is not to say that a combination of natural income and selling down units would have failed to deliver required income; however, that directly injects sequence risk into the portfolio, it increases the income seeker’s risk of an unwanted outcome.

We have included the cost of inflation in discrete years to match annual income, which is paid in pence, and only displayed as a % yield. Fund distributions are not calculated nor paid as a percentage of the fund.

It is clear that an income investor seeking safety in fixed income has not been well served over the past 20 years. While both bond income and rates of inflation have fluctuated, the latter has generally remained stubbornly higher in recent years, resulting in bond income not having kept up over all three periods we examined.

**GRAPH 3: M&G BOND INCOME VS M&G BOND INCOME X RPI 1998-2018 (CUMULATIVE)**



significant resources and human capabilities to calculate table 1.

**SEEKING NEW SOURCES OF SECURE AND SUSTAINABLE INCOME**

We can only invest in today’s assets with today’s returns – yesterday’s income is all gone. As we have said, the

Morningstar research assumes that a drawdown recipient will have to rely on both the annual income provided by their investment portfolio, as well as regular realisations of capital from it. There are clearly two elements to this: ‘natural’ income provided by interest from bonds and/or

dividends from equities, on the one hand, and capital provided by regular sales of the underlying asset, a bond and/or an equity portfolio, on the other. To assess the value of these two elements, we need to look at each in turn.

The box on the left shows how the natural income provided by M&G’s £3.5bn Corporate Bond Fund over the past 20 years compares unfavourably to inflation over that period.

How then would an equity portfolio measure up? For this, we chose 30 household-name investment trusts offering broad global equity diversification. The reason for selecting active trusts as the real-life equity proxy is evident in table 2:

Comparing the bond proxy to our equity proxy – a basket of investment trusts – a similar picture emerges, although, in graph 4, page 61, the rising nature of a managed dividend income is visible.

As we saw before, the bond fund income has tended to fluctuate, leaving a broadly flat trend. What is notable about the investment trust income is its remarkably smooth progression upwards. In fact, not only has this annual income growth beaten that from bonds, but it has also comfortably surpassed inflation in all three periods we examined, summarised in table 3 below.

We can also cherry-pick trusts with long histories of dividends that have focused on dealing with inflation over the long term (as opposed to selecting those with greatest annual increases or lowest income volatility). A simple example is the world’s oldest mutual fund, Foreign & Colonial (which commenced eight years before General

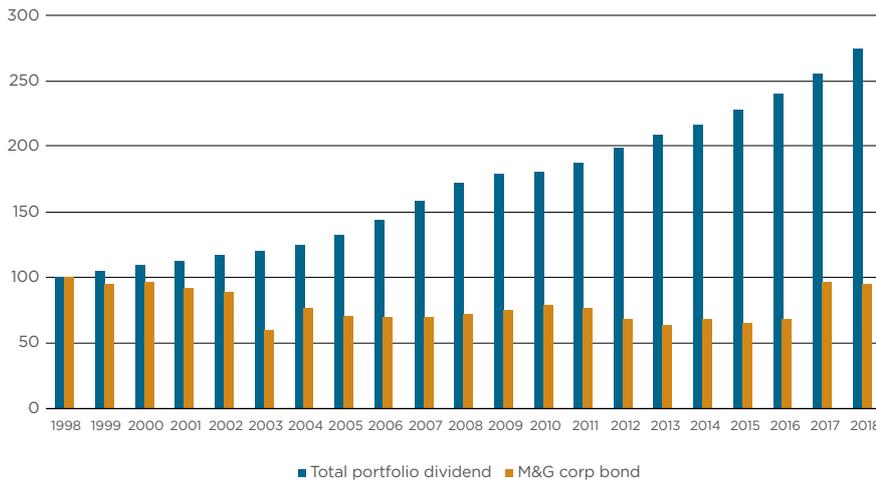
**TABLE 2: TOTAL RETURNS 1999-2018**

Total return, 1999 to 2018, inclusive of all fund charges	Charge: ocf	
Murray International	466.35%	0.69%
F&C	406.87%	0.65%
PIGIT	400.57%	0.72%
Temple Bar	351.21%	0.47%
City of London	243.29%	0.41%
Merchants	214.98%	0.58%
FTSE All-Share Index	167.80%	0.00%
FTSE 100 Index	128.47%	0.00%

**TABLE 3: AVERAGE ANNUAL INCREASES IN DIVIDEND INCOME FROM THE PORTFOLIO ACROSS THE DIFFERENT PERIODS, COMPARED TO THE AVERAGE ANNUAL INFLATION**

	Trusts	Inflation
1987-2018	32 years 6.47%	3.31%
1999-2018	20 years 4.21%	2.78%
2009-2018	10 years 5.31%	2.76%

**GRAPH 4: M&G CORPORATE BOND INCOME V PORTFOLIO DIVIDEND INCOME 1998-2018 (1998=100)**



**IN TRUSTS WE TRUST**

Our research looked at 30 mainstream investment trusts over the period since 1974, one of the most volatile periods in the equity and bond markets since 1929. Not all trusts have been in existence that long, and some that have do not have full records. In total, however, the research analysed 1,236 annual consecutive annual payments. (See Appendix C in the full paper for further information on how we selected our trusts.)

This analysis found that:

- A dividend payment was never missed by any trust.
- The payment was the same or higher than the prior year in 98% of cases.
- In 91% of cases it was increased.

The reasons for this consistency are not hard to find. Like the underlying company holdings, the dividends from investment trusts are set and controlled by the directors, and are based on actual cash receipts and liabilities. The directors have a legal responsibility to advise investors throughout the year how the profits and likely dividends are progressing via stock market announcements. Shares in the trusts tend to rise and fall in line with the value of the underlying holdings. However, analysis shows that dividend volatility has no correlation to share price volatility.

Investment trusts maintain revenue and capital reserves on their balance sheets and use these to support a smoothed dividend stream. As listed companies, the balance sheets are available to us for analysis and to monitor progression of items such as dividend/reserve cover.

By example, the City of London Investment Trust has increased its dividend every year for 52 years, with a further 15 trusts having increased their annual payments for longer than the 28-year life expectancy calculated by Aviva, the UK insurer, for a 60-year-old male.

It is therefore clear that the record of income increases from mainstream investment trusts has demonstrated the ability to far outstrip the likely number of years needed by a retiree in drawdown.

Custer fell out with Crazy Horse at the Battle of Little Big Horn). In graph 5, the blue line shows the annual dividends and the orange line takes the first dividend in 1972 and then grows it each year by RPI.

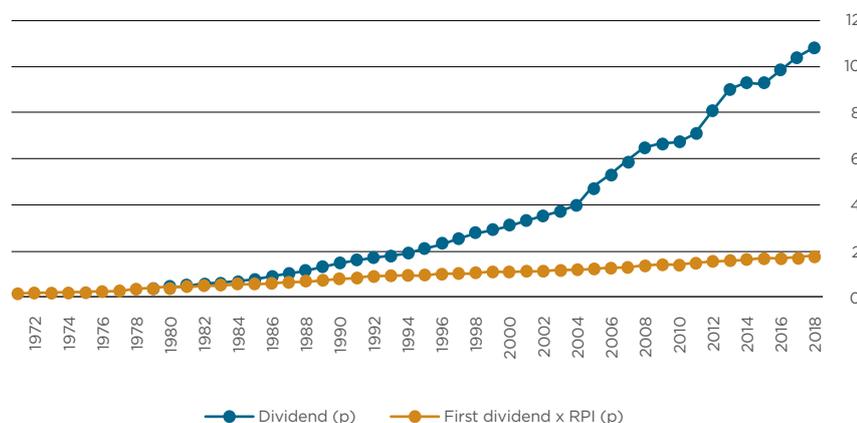
We look at income this way because this is precisely the scenario an investor will encounter when commencing drawdown of a pension from their early 60s.

Expanding the F&C example to build a portfolio of trusts, it becomes evident that a well-researched 'buy and hold' equity trust portfolio can produce a

pretty solid lifetime income that can outperform inflation. In fact, leaving aside the extreme inflation experienced in the 1970s, our core portfolio of investment trusts has defeated inflation by a factor of almost 2:1 since 1987. We comment in the box to the right about why investment trust income has become so reliable.

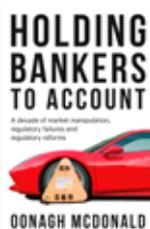
*Doug Brodie ran a masterclass for CISI Fellows and Chartered members on this theme in London in January 2020. For details please visit [cisi.org/events](http://cisi.org/events).*

**GRAPH 5: F&C INVESTMENT TRUST**



## HOLDING SENIOR MANAGERS IN FINANCE TO ACCOUNT

REGULATION GURU **DR OONAGH MCDONALD** CONSIDERS THE RECENT HISTORY OF SENIOR MANAGEMENT SUPERVISION, IN A NEW BOOK ANALYSING A DECADE OF REGULATORY REFORMS



As the Senior Managers & Certification Regime (SMCR) takes effect in the UK to bring much of the original Senior Managers Regime (SMR) into our sector, we take a

look at the background to SMR through the perceptive and wise eyes of Dr Oonagh McDonald CBE, an international financial regulatory expert and former British MP and frontbench Treasury minister, now resident in Washington, DC. In her latest book, *Holding bankers to account*, she provides probably the most comprehensive account yet written of the scandals that emerged from the 2007 to 2008 financial crisis. In this excerpt, she probes the background to SMR and its development, and considers the important roles of independent directors, particularly the chair of the board and of the audit and risk committees.



As the fines imposed on banks for their part in the manipulation of LIBOR, the foreign exchange market and the Gold and Silver Fixes have mounted up, the question posed by the public both in the UK and in the US is: why have so few senior bankers gone to jail? The public saw a handful of traders tried and jailed (and sometimes set free on appeal) and a few senior bankers resigned or were asked to resign, while retaining comfortable pensions and even bonuses. The UK and EU regulators considered that reforming the methods of provision of the benchmarks and reforming their governance were vital but insufficient on their own. The behaviour of banks and their senior management is crucial for the operation of the benchmarks and for the restoration of trust.

The UK Parliament, the government and the regulatory authorities sought ways of ensuring that senior bankers are accountable. The Financial Services and Markets Act 2000 was amended by the Financial Services (Banking Reform) Act 2013 and the Bank of England and Financial Services Act 2016. Both Bills were introduced by government after extensive discussions between Treasury civil servants, staff of the Financial Services Authority (FSA) and then the Financial Conduct Authority (FCA), and the Bank of England. These Acts, like their predecessors, provide the legislative framework for financial regulation, granting powers to the regulatory authorities to make all the necessary rules and regulations within the scope of the legislation. This excerpt explores the reasons for the new powers and for introducing the SMR. The conclusion is that the SMR [and its successors] will not only provide a means of holding senior bankers to account but may well also promote higher standards of diligence and responsible management.

Under the regulations available at the time, the FSA/FCA's fines on the banks were made on the basis of the banks breaking its 'Principles for Businesses' and for the US Commodity Futures Trading Commission on the basis of the US Commodities Exchange Act. The CEA specifically makes it unlawful to deliver false or misleading information, and to manipulate or attempt to manipulate the price of any commodity in interstate commerce. Sections 6(c), 6(d) and 9(a) of the CEA clearly prohibit acts of attempted manipulation. Two elements are required to prove an attempted manipulation: an intent to affect the market price and an overt act in furtherance of that intent. [In 2012] the CFTC was able to fine Barclays for collusion in attempted manipulation. Barclays was guilty of collusion under the CEA section 13(a). Liability as aider and abettor requires proof that the CEA was broken, that the aider and abettor knew about the wrongdoing underlying the

breach of the law, and that the aider and abettor intentionally assisted the primary wrongdoer. The CFTC had at its disposal not only the frequently amended Act but also considerable case law. The CFTC made Barclays pay a fine of US\$200m based on detailed legal considerations. The CFTC was also in a position to hold Barclays responsible for the activities of its agents under section 2(a) of the Act, and the Commission's own rules impose strict liability on principals for the actions of their agents. Lacking the legislation and regulations now in force in the UK and the EU, neither the FSA nor its successor the FCA had such grounds, but was able to rely on the 'Principles for Businesses', which provide the framework and the overarching principles from which detailed rules may be derived. There may be advantages in the latter approach, since the detailed and extensive laws and regulations which apply to financial institutions may not cover an actual situation and provide considerable scope for legal challenges. As the FCA Handbook notes:

"Since the Principles are also designed as a general statement of regulatory requirements applicable to new or unforeseen situations and in situations where there is no need for guidance, the FCA's other rules and guidance or EU regulations should not be viewed as exhausting the implications of the

Principles themselves." I begin by arguing that the huge fines imposed on banks failed both in terms of

### // THE FINES DID NOT PUNISH THE INDIVIDUALS RESPONSIBLE FOR THE OFFENCES //

justice and in terms of bringing about changes in culture and behaviour. Moreover, those fines did not punish the individuals responsible for the offences. The practice was roundly condemned by Judge Jed Rakoff in the US after the financial crisis, who described the whole process in the following terms:

"Just going after the company is also technically and morally suspect because,

under the law, you should not indict or threaten to indict a company unless you can prove beyond reasonable doubt that some managerial agent of the company committed the alleged crime; and if you can prove that, why not indict the manager? And from the moral standpoint, punishing a company and its many innocent employees and shareholders for the crimes committed by some unprosecuted individuals seems contrary to elementary notions of moral responsibility.”

It should be noted that ‘shareholders’ does not refer to a few wealthy individuals, but pension funds and mutual funds, investing on behalf of many small savers. The size of the fines and the reputational damage affect not only the share price with the knock-on effects on people’s investments, but threatens the viability of the bank itself, especially when a bank is faced with separate fines from multiple agencies.

With regard to the boards of banks, according to UK regulations the role of the chair is separate from that of the chief executive officer. The chair is subject to the ‘fit and proper’ requirements, as are all other members of the board. The non-executive chair’s responsibilities are set out in detail in the supervisory statement, but they include both chairing and overseeing the development of the board and leading the development of the firm’s culture by the board. In addition, the board has four committees – audit, risk, remuneration and nomination – each headed by a non-executive member of the board.

The chair of the audit committee is responsible for ensuring and overseeing the integrity and independence of the internal audit function, including the head of internal audit. The chair of the risk committee is responsible for overseeing the independence of the firm’s risk function, including the independence of the chief risk officer.

A bank’s finance, internal audit and compliance departments can discuss matters of concern with the chair of the audit committee, and the head of the risk management department can bring any such issues to the chair of the risk committee. The chair of the bank is in contact with all four committees of the

board and, through the chairs of these committees, together with any informal discussions with heads of departments, has the means to be fully informed about every aspect of the bank’s operations.

The role is a demanding one, taking up to three days a week, and is designed to enable the board to oversee the bank’s strategy on the basis of full information and agree the bank’s strategy, within its risk appetite and with a sustainable

## // PUNISHING A COMPANY SEEMS CONTRARY TO ELEMENTARY NOTIONS OF MORAL RESPONSIBILITY //

business model, to meet its regulatory objectives. Such a structure may have enabled senior managers to identify the risks involved in the behaviour of their traders and their managers, but it would not have been enough on its own.

How did the Senior Managers Regime in the UK evolve, following not only the financial crisis but the widespread manipulation of benchmarks? The new regime will help to ensure that senior management carelessness, negligence, or worse, is prevented by the implementation of a clear managerial structure and proper systems and controls. This is much more than setting ‘the tone at the top’, which involves

statements of management’s leadership, commitment to openness, honesty, integrity and ethical behaviour. The trouble is that public statements by CEOs, articulating the standards they want others to work by, are not regularly measured or evaluated and are often undermined by their own leadership teams’ behaviour. CEOs are not necessarily seen as role models. Setting the ‘tone at the top’ is not by any means enough on its own and may well be viewed with a certain degree of cynicism by staff. Much more than that is required to ensure proper standards of behaviour throughout the firm, and the advantage of the new structure for senior management is that it provides a managerial framework for that to be carried out. The new structure does provide a means of holding senior managers accountable, since they have to set out exactly what their responsibilities are in the bank.

This extract was taken from *Holding bankers to account: A decade of market manipulation, regulatory failures and regulatory reforms* by Oonagh McDonald (Manchester University Press, 2019). See [cisi.org/rofm-jan2020](http://cisi.org/rofm-jan2020) for a fuller extract. CISI members can get a 40% discount by using the code **bankers40** at [cisi.org/bookdiscount](http://cisi.org/bookdiscount)

## Operational risk

It’s not like credit risk, market risk or liquidity risk, it’s not a permissive risk, where you can say, ok, we will take an acceptable level of exposure, in pursuit of a quantifiable reward.

No, it’s a different risk, it’s related to inherent factors, factors you can’t control, measure or predict, like the risk a systems programmer misses a key stroke and curdles the coding of your Black and Scholes model, or someone doesn’t do the Know Your Counter-Party checks, or an invisible glitch in your website turns away customers, or like the time your most trusted employee met the competition in a Morrison’s car park and handed over confidential information for a brown paper bag of fifty pound notes.

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# WHAT IS GRESHAM'S LAW AND WHY DOES IT MATTER?<sup>1</sup>

ALDERMAN **MICHAEL MAINELLI**, CHARTERED FCSI(HON), ALDERMANIC SHERIFF OF THE CITY OF LONDON AND EMERITUS PROFESSOR OF COMMERCE AT GRESHAM COLLEGE

Alderman Professor Michael Mainelli, Chartered FCSI(Hon) has made a special study over many years of the life and work of Sir Thomas Gresham, founder of the eponymous college and subject of a vibrant new biography by Tudor historian John Guy.

In this masterly overview of the origins and development of Gresham's Law, he paints a vivid picture of the intellectual spirit and verve that has guided economics, the supposedly 'dismal' science, over the centuries.

Professor Mainelli has long been at the forefront of stimulating constructive debate around the City, not least in his role at Gresham College, and brings fresh and important present-day insights to conundrums of the past.

Colloquially expressed as 'bad money drives out good', Gresham's Law was attributed to Sir Thomas Gresham in 1858 by Scottish economist Henry Dunning Macleod. In Tudor times, governments sometimes issued silver coins adulterated with lead, so that people traded in these coins while hoarding the more valuable pure silver coins, saving them up for better times, or exporting them to get their full value. The Nobel economist Robert Mundell rephrased Gresham's Law more accurately as "cheap money drives out dear money only if they must be exchanged for the same price".

Gresham's Law applies in any situation where two or more goods of varying quality are being sold for the same price. People are shrewd. They try to get the better quality items first. So why the confusion? Some points on Gresham's Law: it (a) goes back to Aristophanes, (b) is incorrectly expressed by most people, and (c) is falsely attributed to Sir Thomas. *Encyclopaedia Britannica* helps a bit.

<sup>1</sup> <https://www.mainelli.org/?p=1431>

<sup>2</sup> <http://www.columbia.edu/~ram15/grash.html>

## Gresham's Law

Observation in economics that 'bad money drives out good'. More exactly, if coins containing metal of different value have the same value as legal tender, the coins composed of the cheaper metal will be used for payment, while those made of more expensive metal will be hoarded or exported and thus tend to disappear from circulation. Sir Thomas Gresham, financial agent of Queen Elizabeth I, was not the first to recognise this monetary principle, but his elucidation of it in 1558 prompted the economist HD Macleod to suggest the term Gresham's Law in the 19th century.

The elegiac poet Theognis, writing in the late 6th and early 5th century BC, wrote a few lines suggesting Gresham's Law: "Nor will anyone take in exchange worse when better is to be had." Aristophanes expresses the Law in his 405 BC play *The Frogs*. But these express more that 'good money drives out bad'.

From Robert Mundell's 'Uses and abuses of Gresham's Law in the history of money',<sup>2</sup> Columbia University, August 1998: "Cheap money drives out dear, if they exchange for the same price", rather than the misleading and overly terse, 'bad money drives out good'. Put more generally, 'a cheap measure drives out a valuable measure, if they exchange for the same price'.

## 'Good money drives out bad?' - excerpt from section 3 of Mundell's paper

The usual expression of the law, 'bad money drives out good' is a mistake. Schumpeter refers to this common definition as "not quite correct". But as the statement stands, it is not just "not quite correct"; it is quite false. The opposite is true!

Standing by itself, the general statement, 'good money drives out bad', is the more correct empirical proposition. Historically, it has been good, strong currencies that have driven out bad, weak currencies.

Over the span of several millennia, strong currencies have dominated and driven out weak in international competition. The Persian daric, the Greek tetradrachma, the Macedonian stater, and the Roman denarius did not become dominant currencies of the ancient world because they were 'bad' or 'weak'. The florins, ducats and sequins of the Italian city-states did not become the 'dollars of the Middle Ages' because they were bad coins; they were among the best coins ever made. The pound sterling in the 19th century and the dollar in the 20th century did not become the dominant currencies of their time because they were weak. Consistency, stability and high quality have been the attributes of great currencies that have won the competition for use as international money.

If Gresham's Law could be rendered coherently as 'bad money drives out good' it would have no claim to our attention as a serious proposition of economics. On the contrary, it is a completely false generalization, and an invalid rendering of Gresham's Law.

Perhaps the closest Gresham himself comes to expressing his eponymous law is in a letter to Queen Elizabeth around 1560:

Ytt may please your majesty to understande, thatt the firste occasion off the fall of the exchange did growe by the Kinges majesty, your latte ffather, in abasinge his quoyne ffrome vi ounces fine too iii ounces fine. Wheruppon the exchange fell ffrome xxvi\*. viiirf. to xiii\*. ivrf. which was the occasion thatt all your ffine goold was conveyd ought of this your realme.

In an 1857 essay, Henry Dunning Macleod touches on Sir Thomas:

At last, Sir Thomas Gresham explained to Queen Elizabeth that allowing base and degraded coin to circulate along with good coin caused it to disappear;

that bad coin and good coin cannot circulate together; but that the bad coin invariably and necessarily drives out good coin from circulation, and alone remains current.

Macleod starts the statement problem when he tries in 1860 to express things more completely in his *Theory and practice of banking*, p.216, where he appears to contradict himself a bit:

These considerations lead us to a fundamental and universal law in Political Economy, which has been found to be true in all countries and ages – that bad money drives out good money from circulation; or, as it is expressed in an anonymous pamphlet *A reply to the defence of the bank*, setting forth the unreasonableness of their slow payments, London, 1696, “When two sorts of coin are current in the same nation of like value by denomination, but not intrinsically, that which has the least value will be current, and the other as much as possible will be hoarded,” or exported, we may add. The fact of the disappearance of good coin in the presence of bad, was noticed by Aristophanes; and was long the puzzle of financiers and statesmen, who continued to issue good coin from the Mint, and were greatly perplexed by its immediate disappearance, till Sir Thomas Gresham explained the cause, whence we have called it Gresham’s Law of the Currency.

Macleod is clearly aware that Aristophanes mentions the law in *The Frogs* (405 BC):

This law is of such fundamental importance in Political Economy, viz., That good and bad coin cannot circulate together, but the bad coin will drive out the good, that it may be interesting to quote the passage which contains the earliest notice, that we are aware of, of the phenomenon. Aristophanes, *Frogs*, 765, says: “The State has very often appeared to us to be placed in the same position towards the good and noble citizens as it is with regard to the old currency and the new gold; for we make no use at all, either at home or abroad, of those which are not adulterated, but the most beautiful of



all money, as it would seem, which are alone well coined and ring properly, but of this base copper, struck only yesterday, and recently of a most villainous stamp. And such of the citizens as we know to be well-born and prudent and honorable gentlemen, and educated in the palaestra, and chorus, and liberal knowledge, we insult. But the impudent and foreigners, and the base born, and the rascals, and the sons of rascals, and those most recently come, we employ.” This law, thus first noticed by Aristophanes, has been found to be true in every age and country. It is also from the same principle that a paper currency is invariably found to expel a metallic currency of the same denomination from circulation. And to show the generality of the principle, it was found in America that when a depreciated paper currency had driven coin out of circulation, and a still more depreciated paper currency was issued, the more depreciated drove out the less appreciated from circulation.

Gresham would never have said baldly, “bad money drives out good”. Macleod provides a number of explanations in close proximity, any of which could be his Gresham’s Law – “bad money drives out good”, “when two sorts of coin are current in the same nation of like value by denomination, but not intrinsically, that which has the least value will be current, and the other as much as possible will be hoarded”, “disappearance of good coin in the presence of bad”, “good and bad coin cannot circulate together, but the bad coin will drive out the good”. The last, rather ambiguous one, seems

to be the explanation driving the subsequent century and a half of schoolyard trivia. If only Macleod had said “good and bad coin cannot be forced to circulate together, but the bad coin will drive out the good”, we would have had a useful statement for everyday use.

As Mundell concludes: “Schumpeter’s comment points up a paradox: the law is trivially easy to understand, but then why does everybody get it wrong?”

So this year, Z/Yen has struck a coin that pokes fun at Gresham’s Law reversibility by having one phrase on the obverse and the other on the reverse. Perhaps the 500th anniversary of Sir Thomas Gresham’s birth will help return attention to this 2,500-year-old law, and reverse 160 years of recent confusion brought on by Macleod. Hopefully over time “good law drives out bad” as “good money drives out bad”.



**Professor Michael Mainelli, Chartered FCSI(Hon), is executive chair of Z/Yen Group. Z/Yen is the renowned creator of the Global**

**Financial Centres Index among other things. Michael’s book, *The price of fish: a new approach to wicked economics and better decisions*, written with Ian Harris, won the 2012 Independent Publisher Book Awards Finance, Investment & Economics Gold Prize.**

**Read his profile at [cisi.org/polymath](http://cisi.org/polymath)**



Andrew Davis

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## LAST WORD

# Dangers lurk for income investors

DIVIDEND-PAYING COMPANIES HAVE FILLED THE HOLE IN INVESTORS' CASH FLOW SINCE THE FINANCIAL CRISIS, BUT THAT COULD SOON DRY UP

“The best things in life may well be free, but the world remembers Motown Records' first hit song, from summer 1960, for what comes next: “But you can give them to the birds and bees. I want money.” Sixty years later, little has changed – the bills keep coming and the only answer is still cash in the bank.

But where to get it from? Over the past decade, this has become an increasingly tricky problem for those who look to the financial markets to provide their income. Safe, steady cash flows from bonds have slowed to a trickle and many have turned to dividends from equity income funds to keep the money rolling in.

There's nothing like a steadily rising income to keep investors smiling, and dividend-paying companies have done their best to oblige since the financial crisis. In 2009, UK companies paid out around £52bn in regular dividends (ignoring ad hoc special payments). Last year, Link Asset Services' *UK dividend monitor Q3 2019* estimated the equivalent figure will be £99.1bn. That's an annual growth rate of more than 6% – not bad for an 11-year period during which inflation has stayed well below that level (and during most of 2015 was close to zero) and economic growth has rarely been above 2%.

### Milking the portfolio

In many ways, dividends are the main point of investing. Academic research has shown that a large proportion of the long-term total return that equity owners receive is accounted for by reinvesting dividend income to buy more shares, expanding their stock of capital from which to reap dividend income. Among equity income investors, the idea is different: they aim to milk the portfolio judiciously for regular income. Companies that aim to increase their

dividend pay-out annually, ideally above the rate of inflation, are particularly sought after as other sources of income dry up.

But as the post-crisis yield drought has dragged on, the risks for equity income investors have increased. Their implicit assumption – that a small group of large, mature companies can carry on indefinitely increasing their dividend payments above the rate of both inflation and GDP growth – has become steadily less safe. The current, yawning gap between the 'risk-free' yield on ten-year gilts, at around 0.75%, and the prospective 4.5% yield on the FTSE 100 Index, highlights the dangers building up.

“As the post-crisis yield drought has dragged on, the risks for equity income investors have increased”

Bullish investors will argue that the huge difference between gilt and dividend yields must indicate that bonds are outrageously expensive and shares excessively cheap. As this anomaly corrects, rising share prices will cause their dividend yields to fall, bringing the gap with gilts back towards its long-term average. That's perfectly possible, but for share prices to rise, investors need to believe companies' dividends are sustainable and their growth prospects solid.

### Financially stretched firms

This is open to question. As companies have attempted to meet investor expectations of relentlessly increasing dividend pay-outs, they have become financially stretched. UK companies' dividend cover (the extent to which their earnings exceed their dividend

payments) fell to 1.6x in 2019 – the third lowest ratio globally and far below the global average of 2.2x, itself a ten-year low, according to the asset manager Henderson. As UK companies have paid out a bigger percentage of their net profits as dividends, some have seen their cover ratio sink below 1x. With their margin of safety gone, many have taken on debt to help meet their payments. In 'Avoiding dividend risk – Imperial Brands', an opinion piece on fund manager Liontrust's website, its global equity team head, Robin Geffen, says, “The average yield across the [equity income funds] sector is 4.4%, which appears attractive, but 25% of that yield is powered by companies that have uncovered dividends.”

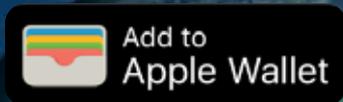
The 14% collapse in the pound after the Brexit referendum helped underpin the corporate world's sterling dividend payments by increasing the relative value of their foreign earnings. This gave a final push to the dividend bandwagon, supporting increases in headline payments even as the underlying picture grew weaker. In Q3, says Link, regular dividends fell 0.2% year-on-year to £32.2bn, but it adds, “Even this total was inflated by £850m of exchange effects” thanks to the weak pound. For 2019 as a whole, Link predicted regular dividends would rise 3.3%, “almost nine-tenths of which is down to exchange-rate gains”.

The dangers are clear, whatever happens from here. If the economy goes into a downturn, many of these companies' earnings will suffer and they will have to cut their dividends. And even if we escape a downturn, a boost to sterling will wipe out the currency gains that dividend payers have come to rely on.

This year looks like a tricky one for equity income funds and their investors. ”

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firm directly.

For more information visit  
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