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Disruption, Innovation, and Investing for the Future

In the early 1960s, Charles Feeney and Robert Warren Miller revolutionized international travel purchases, establishing the first duty-free shop in Hawaii, catering to Japanese tourists. Today, Duty Free Shoppers is one of the world's largest duty-free networks—and innovation and disruption are everywhere, from medical advances changing lives to sports equipment revolutionizing athletic performance. Investing is no exception. In this paper, we examine why the ability to generate consistent alpha is essential to survival in the asset-management industry amid increasing disruption and explain that success in this environment necessitates strong leadership, continuous process improvement, and an unwavering client focus.

The Forces of Disruption

No discussion of disruption in investing would be complete without reference to regulation. Compliance requirements have increased. Tax laws and accounting methodologies are changing, incentivizing various forms of saving. For instance, in the United States the emphasis has moved from defined-benefit plans to defined-contribution plans in order to reduce the volatility of financial statements and decrease risk. The superannuation scheme in Australia is another example of how regulation has shaped the industry through forced savings of the population, while MiFID II in Europe will clearly change business models of sell-side and buy-side investors alike.

Just as the rise of the "style box" disrupted balanced funds, alternative strategies and players are disrupting investing. Hedge funds have been in existence for 66 years and now have nearly $3 trillion in assets, but the recent rise of hedge fund mutual funds has increased transparency, potentially disrupting the fee structures of traditional hedge funds. Exchange-traded funds (ETFs), which have been in existence for 25 years and have $3 trillion in assets, have also grown substantially in the past several years, supplanting other index funds and active managers alike. Will we see the rise of innovation outside of traditional asset management? It is not too far-fetched to think of a company such as Google or Tencent launching an asset-management platform, just as Amazon disrupted traditional retailers.

Buying-power shifts are also disrupting asset management. According to BCG, global private wealth totaled approximately $91 trillion in 2005, with approximately 85% of it in developed markets (primarily North America and Europe). In 2014 global private wealth had grown to $164 trillion, but only 66% was in developed markets. Emerging-markets-based wealth is thus growing at a significantly faster pace. Who are these new investors and how are their objectives different than investors in developed markets? How do we reach them effectively and, more importantly, keep them?

The millennials bear the scars of the global financial crisis and that has changed their risk tolerance (as it has for investors of any age). Younger generations are also more focused on experience and charitable giving, which affects how much they save and the structure of their investments. We also observe changing objectives institutionally through the aforementioned shift from defined-benefit to defined-contribution plans, affecting investment strategies, fee structures, and distribution models.

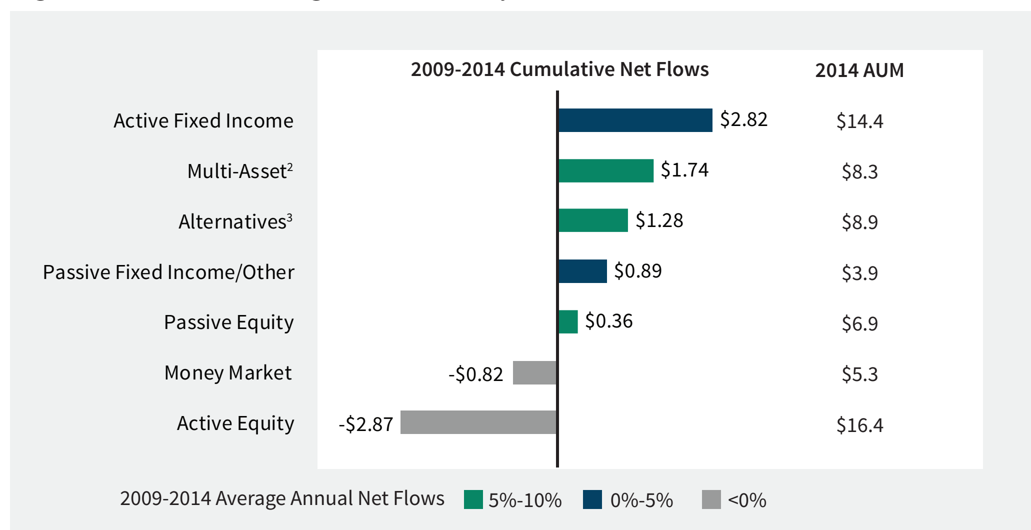
Changing structures within institutional and high-net-worth asset allocations have increased the emphasis on index strategies with more focused, actively managed strategies around them.

Quantifying the Disruption

One way to quantify the disruption in investing is to evaluate global asset-management flows over the past five years. Active fixed-income, multi-asset, alternative, and passive strategies have garnered significant inflows at the expense of active equities.

Part of this trend is cyclical: after the global financial crisis, investors were skittish about equities and therefore invested more heavily in multi-asset and fixed-income strategies. However, there are structural trends embedded in these flows as well. Defined-benefit plans begin to "de-risk" when attaining fully funded status, increasing their fixed-income allocations at the expense of equities; this is a secular trend rather than cyclical. Meanwhile, multi-asset flows have been bolstered by the rise of target-date funds, which have increasingly become the qualified default investment alternative for defined-contribution plans. At the same time, index funds have gained popularity given their outperformance of active strategies. But just as the industry declared that "active management is dead," active managers began outperforming again. While this is a cyclical phenomenon, changing structures within institutional and high-net-worth asset allocations have increased the emphasis on index strategies with more focused, actively managed strategies around them.

Fig. 1: Global Asset Management Industry Flows and AUM (in Trillions)[1]



[1]Includes 20 largest asset-management countries, accounting for ~95% of the global market.
[2]Includes actively managed target-date funds.
[3]Includes retail alternatives.

Source: McKinsey & Company.

Is investing being disrupted? Of course it is. The question is, what can investors focus on to not only combat these disruptive forces, but also capitalize on them?

The Importance of a Framework

Change can be both intoxicating and disruptive. Our job as investors is to analyze the impact of innovation on the companies we own and on industries as a whole, being ever mindful of evolving competitive dynamics. Investors look for growth created by radical innovations, but we must understand the nature of the growth and how long it will continue.

Having a framework to assess the changing nature of growth and its impact on corporate returns is important because value creation follows a cycle of innovation and changing returns. While many individuals get mired in the day-to-day news, as long-term investors, we know that the sources of growth and returns change, but the methodology of identifying them endures. This framework is applicable to companies, industries, and even countries.

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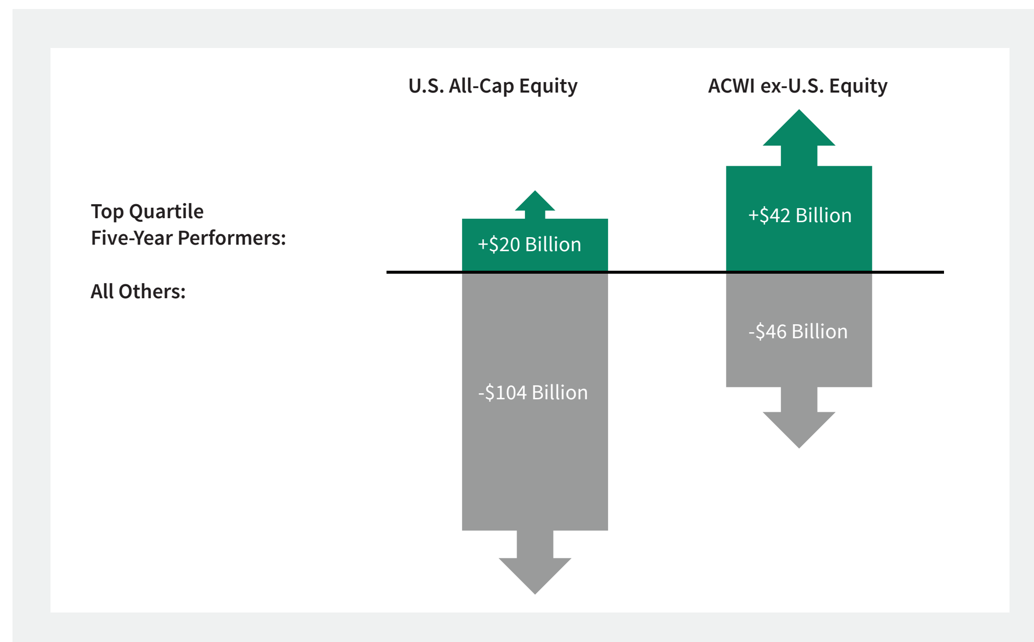
Alpha Generation Is Paramount

Consistent alpha generation is paramount. According to eVestment Alliance, actively managed, U.S. all-cap equity strategies that performed in the top peer group quartile over a five-year period have seen $20 billion in net inflows over the past three years, a significant contrast to the $104 billion lost over the same period by the active strategies in the bottom three quartiles. International equity managers in the top quartile have enjoyed $42 billion in net inflows, while those in the bottom three quartiles lost $46 billion in assets.

Fig. 2: Three-Year Net Flows of Actively Managed Equity Strategies



Source: eVestment Alliance, as of third-quarter 2015.

How do investment firms generate consistent alpha and garner these positive inflows? Alpha generation requires innovation at every level of the firm, from the investment process to the fundamental business model and distribution.

From an investment perspective, it is important to have a core philosophy. What do we believe are the key drivers of company and stock returns? Only if we have strong investment beliefs that are part of the very fabric of our teams can innovation occur. To paraphrase one of my former colleagues, the key to long-term investment success is to combine a sound, unwavering philosophy within a dynamic, flexible approach. This requires continuous introspection that leads to innovation and process evolution. Not only is change good, it is required to remain relevant.

Unlike in virtually any other industry, change is frowned upon in the investment world. Thirty years ago access to information was the competitive edge; now information is ubiquitous. The key differentiator today is how investors cut through the data and the noise and understand the short- and long-term drivers of both companies and stocks. Innovation in the process and in the tools is paramount. As investors, we look at disruption within industries; likewise, we need to disrupt our own processes and innovate.

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It is important to innovate in terms of business models as well. Business models and distribution/delivery models are driven by the historical constructs of industry structure, but companies also adjust their business models given their competitive strengths and weaknesses. Investment firms need to reassess their business models and distribution/delivery models and ask questions. What are the core strengths of the firm and how should we capitalize on them? How do our teams interact with each other, and is there a better way? How do we deliver consistent alpha in strategies that clients need? How are client objectives compatible or in contrast with the firm's strategies? Where are our target clients, and how do they make decisions? It is important to think about global shifts, shifts in wealth creation, and shifts in industry structure in deciding upon innovative solutions to address these needs.

Above all else, client focus is also important. How do clients communicate? How can we as investors partner with them?

Alpha Generation Requires Leadership

In short, having a strong core combined with continuous innovation should lead to consistent alpha generation, client retention, and growth. But ultimately, long-term success in the investment industry is dependent upon effective leadership.

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Leadership is needed in the culture of the organization, which must be one that fosters curiosity, innovation, engagement, and results-oriented collaboration. Only in this way can we promote an environment in which consistent alpha generation can flourish. That means letting people innovate and move out of boxes. It means letting new products develop organically. It means maintaining a cohesive strategy that reflects the strengths of the firm while recognizing both cyclical and secular trends. Investment leadership understands industry trends but is not afraid of them.

While there may be headwinds to growth due to evolving demand for strategies, as highlighted previously, leaders are not afraid of how these headwinds may passively affect the firm. Leaders try to understand the cyclical versus structural nature of these headwinds and capitalize on them. Sometimes these headwinds—these disruptions—stimulate innovation. Investment leaders need to foster this innovation, develop a long-term strategy, and have the ability to execute to that end.

Leadership is also required in terms of technology. Technology includes the tools used in the investment process, but also in communicating with external constituencies via formal written and verbal communications, interactive discussions, and, of course, social media.

Lastly, alpha generation requires leadership in human capital. Investment firms must attract and retain curious, driven, high-quality, team-oriented investment professionals to generate consistent performance. To do that, we must expand the opportunity set. Numerous industry studies have shown that diversity in backgrounds, in life experiences, and in gender and race contribute to better investment decisions. According to a McKinsey & Company study, for instance, the likelihood of good financial performance (as represented by earnings before interest and taxes) improves as gender and ethnic diversity increases. Similarly, a Credit Suisse study found that since 2006, among companies with more than $10 billion in revenue globally, those that had at least one woman on their boards

had 3.1% annualized outperformance versus those with no women on their boards. Women are also making more decisions relating to investment portfolios, both institutionally and in the high-net-worth arena.

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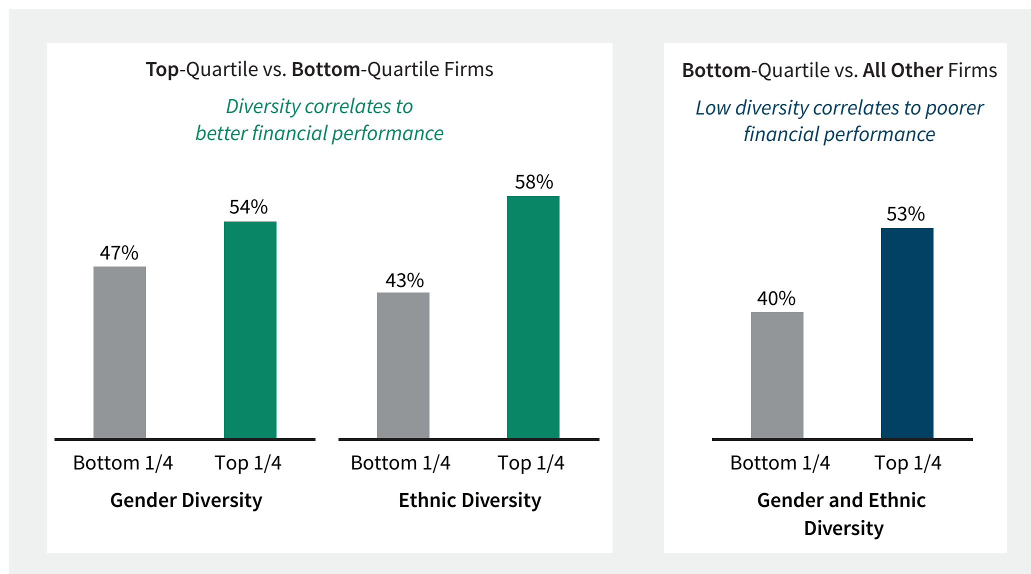
Fig. 3: Likelihood of Financial Outperformance (vs. Industry Median) by Diversity Quartile[1]



[1]Financial performance is measured as average EBIT from 2010 to 2013.

Sources: Diversity Matter, McKinsey & Company 2015; Greenwich Associates.

The imperative for diverse teams must be initiated by an organization's leadership, but must be implemented organically from the bottom up, with each team internalizing these initiatives and searching for candidates with varied backgrounds. Of course, each team member must fit within the culture, but not everyone within a strong culture looks the same, attended the same schools, or lives in the same place. We all need to do better, and I am confident we will do better. The integrity of our investment process, the continuous search for alpha, and our client outcomes demand it.

I am optimistic about the outlook for investment management with the broadening of world wealth, the innovation occurring within our industry, and the addition of a new investment generation. The future is bright for those investors who are curious, actively innovate, and have client best interests in mind. As American philosopher Eric Hoffer said, "In a world of change, the learners shall inherit the earth, while the learned shall find themselves perfectly suited for a world that no longer exists."

About the Author

Stephanie Braming, CFA, partner, is a portfolio manager for the International Small Cap Growth and International Growth strategies. Joining the firm in 2004 as an international and global equity specialist, she has been instrumental in portfolio construction and portfolio design, and has had a leadership role in the enhancement of the firm's systematic research tools. She has also led the design and launch of several strategies, including China A-Share and Japan. Stephanie also served as portfolio manager for the Japan strategy from inception in 2013 to close in 2015. Before joining the firm, Stephanie was a principal at Mercer Investment Consulting, where she was responsible for the strategic investment direction of her institutional clients. Before her role at Mercer, Stephanie worked at the Federal Reserve Bank of Chicago. She is a member of the CFA Institute and the CFA Society of Chicago where she served on the Society's Board of Directors. Education: B.A., DePauw University; M.B.A., University of Chicago Booth School of Business.

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