SPEECH BY DANIEL GODFREY AT THE "CMU ACTION PLAN – ONE YEAR ON" CONFERENCE BY BETTER FINANCE

27 September 2016 –Daniel Godfrey, Founder of The Investor Forum & former head of the UK Investment Association

Good afternoon Ladies and Gentlemen and Thank you for that very generous introduction Guillaume.

I was honoured to be invited to make this keynote address to Better Finance's Conference because of the very high regard in which I hold Guillaume and his team.

They are making a real difference for the better and there are not many people who can say that these days.

And I have to say that as an Englishman, I felt even more honoured to be retained as a speaker after the terrible UK referendum result on June 23rd.

The failure of the UK's mainstream political parties to secure a remain vote in the referendum represents the failure of capitalism over the last ten years to improve people's lives. With UK unemployment below 5% you might ask yourself how can this be?

But since the Global Financial Crisis, citizens across Europe, including in the UK have had to run faster, with less security just to stand still. Now people are willing to tolerate this kind of hardship - if they can see that they are building a better future for their children. But they don't. Instead they see a very small group of super-elites becoming ever wealthier. And the largest group by far in this elite class are in financial services.

The failure of capitalism in the recent past to benefit the majority is the key driver behind the growth in the populism, nationalism and xenophobia that is an increasing phenomenon today. And heaven help us all if they take power.

The populist, isolationist slogans of "take back control" and "make America great again" if in power would only lead to even greater poverty, inequality and conflict. A better alternative needs to be offered, Capitalism needs a reset. Capitalism 2.0 needs to be built and soon.

And the foundations of Capitalism 2.0 in Europe ladies and gentlemen could be built on the foundations of the Capital Markets Union project.

That's why CMU and its potential to drive change is perhaps the most important project there can be in Europe today.

To succeed, two key objectives will have to be delivered.

Growth is the most important factor and good growth stems from good investment, which means the efficient deployment of capital. In other words, better capital markets structured for the users of financial markets – that is the providers and the users of capital - and NOT the intermediaries.

Secondly, the elites are going to have to get used to being a little less elite. Of course, these two objectives are highly correlated because more efficient capital markets would reduce the earnings potential of financial intermediaries.

As Professor John Kay said in his speech to the Bank of International Settlements: "*High salaries and bonuses are awarded not for fine appreciation of the needs of users of financial services, but for outwitting competing market participants*". In the most extreme manifestation of a sector which has lost sight of its purposes, some of the finest mathematical and scientific minds on the planet are employed to devise algorithms for computerised trading in securities which exploit the weaknesses of other algorithms for computerised trading in securities."

We all know that if Europe is to be restored to health it needs growth. If it is to grow, it needs not just better capital markets but more capital to drive long-term investment.

That's why CMU must be about so much more than the plumbing of market infrastructure. It needs to give confidence to the citizens of Europe that their hard-earned savings will be deployed with integrity, for their benefit, into productive activity that creates wealth sustainably for the long term.

Does anyone believe that a German auto worker will say: well they've fixed CCP recovery and resolution over in Brussels so I think I'll move my savings into equities?

Because I don't!

For the Citizens of Europe who hold trillions of Euros of long term savings on deposit earning zero interest, it is investment itself that needs to be made safer, better and cheaper.

And where better to start than with the greatest cause of consumer detriment in Europe? The captive distribution models of banc assurers.

Of course, the clue is in the name. Captive distribution models treat customers like prisoners. And the captors decide what prisoners will get, how they'll get it and how much they'll pay for it. And like prison food, it often leaves a sour taste in the mouth too.

Like when German Savings Banks who persuaded customers to sell equities at the bottom of the Global Financial Crisis bear market so that the proceeds could go back on deposit to restore their capital ratios, only to then put them back into equities when the market had risen and so that they could take another slice of commission pie.

Or Like when Spanish banks forced their own bonds onto retail customers that promptly fell in value. Or when Italian banks sell the same fund that's on offer to a UK retail customer at 0.65% to their own customers at 4% plus a performance fee!

And of course, when UK Banks sold product protection insurance that could never be claimed to their customers with a compensation bill of nearly 30 billion Euros and still rising.

If the EU is serious about building consumer confidence then the captive distribution model needs to be broken.

I know that's hard. Bank and insurers are two of the most powerful lobby groups in Europe. If all we're willing to do is to talk about change without being willing to do the difficult things, then nothing will change. But real change is absolutely imperative if we really want consumers to bring more money to the capital markets.

Genuinely cross-border fund platforms would allow European citizens to shop around for the best price on funds. That would be capital markets union for a consumer. From a local perspective, a European Digital I.D. that would allow an individual to prove their identity in any country and buy financial services in any Member State would create conditions for more competition.

Digital IDs would help; I have an Estonian e-Residency already to experiment with.

But although this would be a step in the right direction, it will not suffice. Many captive consumers are suffering from Stockholm Syndrome. This means that some institutions are so powerfully positioned with their customers that they must be required by regulation to provide open-architecture platforms to their clients. Their revenues would come from fees charged directly to clients for the provision of the platform and the investment selections would be chosen on the basis of their quality, value for money and ability to meet client long-term needs.

DG FISMA and DG Comp may need to work together to bring this about and they will need support from Member states to resist the lobbying that would come from the industry to prevent it.

Just as CMU needs to bring about change to the way consumers access investment, if CMU is going to "*boost retail investments into capital markets and enhance individual confidence*" as recognised in the CMA Action Plan, investment management itself needs to evolve.

Firstly, fund objectives need to become much more specific. Today, they are far too vague. Objectives should be set so that they can be judged on the same "how much? by when" standards that any good key performance indicator can be measured.

Without this how can consumers know whether to be pleased or disappointed? And what kind of market is that? Certainly not a market that is likely to build confidence and boost investment. Investment managers wouldn't buy shares in a company that didn't disclose Key Performance Indicators why should consumers buy funds that don't.

Secondly, all of the ongoing costs of funds, including research, should be wrapped into a single charge, made by the authorised fund manager, who would then pay all other suppliers out of their own revenues. This would make it easy for consumers to see and compare the costs of funds and make better informed choices.

Thirdly, there needs to be far greater transparency over fees and charges as was also proposed in the CMU action plan. Here, great credit is due to Better Finance, who played a key role in persuading the European Parliament to send back the train wreck of a disclosure regime that was being proposed for the PRIPs KID.

The pause on PRIPS disclosure provides an opportunity for a reset on cost disclosure. The European Commission and Parliament need to take it.

You shouldn't knock one regime without a constructive alternative. Here is mine:

We need one disclosure regime for estimating future costs and another for accountability to investors for past costs and performance.

There cannot be one regime that covers both the past and the future because there are costs which are known in advance and others that cannot be known in advance. Performance cannot be known in advance either. There are explicit costs, when customers' money is deducted form a fund and there are also implicit costs, such as spread, where no money changes hands, but nonetheless a drag on performance definitely occurs.

To start with a regime for the past that delivers accountability for costs that have been taken we should require disclosure of all ongoing explicit costs per unit with every published unit price. These costs are accrued every time a price is calculated or managers would be unable to calculate a price. So the data exists and is readily available.

These costs should be made available as a total cost per unit.

With that Information, the adviser or platform could apply these costs factors to the number of units held at each pricing point, then add advice and platform charges as applicable to produce a comprehensive, accurate and simple-to-understand cost statement for the client on a periodic basis.

The impact of implicit transaction costs should also be disclosed so that consumers can understand a very important element of how performance is generated and the friction they cause on performance. This can be done by establishing a common methodology for calculation of portfolio turnover and portfolio spread.

When it comes to giving consumers a simple, comprehensive and high-quality estimate of future costs and charges, a different regime is required. The best solution would be to build on a UCITS-type ongoing charges figure that could easily be standardised across Europe, especially if the single, all-inclusive charge that I proposed is introduced. Advisers and platforms could add their own ongoing costs to provide consumers with a comprehensive total cost estimate.

The impact of likely implicit transaction costs should be explained separately and presented either as the average of the last three years or estimated by the manager with harsh penalties later for underestimation.

Einstein is reputed to have said that you should make things as simple as possible… but no simpler. I believe that this proposed transparency regime, is as simple as possible, but no simpler!

Even though integrity in distribution and transparency is a necessary condition for increased capital market participation by consumers – it is not sufficient.

The practice of investment itself needs to evolve so that it fulfils its potential not only to help people provide for their futures, but also to have a positive impact on the economy and society.

The practice of investment management today rarely reflects the time horizons of the individuals whose money is being managed

This is evident in the fact that two of the most prized so-called qualities in asset management are control of volatility and liquidity.

But if your time horizon is ten, twenty or even forty years into the future, short term volatility and liquidity are irrelevant. Liquidity is only a risk if you need liquidity. Warren Buffet says that you should be fearful when others are greedy and greedy when others are fearful. You might say that you should provide liquidity when liquidity dries up because it's a great chance to buy assets cheaply.

The move over the last thirty years of active management towards index benchmarking has been negative for clients and the economy. It has led to short-term perspectives and incentives that lead to short term stewardship of companies. It leads to underweight:overweight portfolio construction techniques. And I have to say I have never been able to explain to anyone why they should want to pay an active investment manager to be underweight – to buy and hold shares in companies that they think are going to do badly.

This is more about risk management for investment managers, (because it's easy not to underperform a benchmark by very much), than it is about risk management for clients. No wonder that passive funds and ETFs are capturing ever greater market share.

Active investment managers need to communicate to clients that as their agents, they can deliver better long term performance by a high conviction, long-term, high engagement, low-turnover approach than they can by hugging benchmarks in the hope that they can outperform an index consistently.

Passive funds are quite understandably winning that war.

Investment managers need to sell better, not just more. Why is it that despite the very long term needs of consumers and constant warnings that investment is for five years plus, the best-selling funds are ones that promise to control short term volatility? Effectively, we are selling expensive insurance that clients don't need by abusing their human behavioural biases to loss aversion.

Instead, investment managers should be using their skills to convince consumers that they will be better off if they entrust their money to long-term investment and, as the saying goes, keep calm and carry on during periods of market turbulence.

A move of active management towards long-termism, where investment managers seek to be judged over periods greater than five years is not only important for investors, it's vital for the economy and society too.

It is the only way that investment managers will be able to exercise the stewardship that is needed to support long-term thinking at companies. If an investment manager is buying a share because they think it's cheap and selling it a few months later, just how important do you think governance and responsibility will ever be?

But if an investment manager buys a share because they believe that the company has the potential to create wealth sustainably over the long term, then responsibility issues are absolutely core.

Short term investment and incentives throughout the capital market chain and then into companies themselves are the core reasons for the productivity puzzle.

A long term investor cares about human capital development, research and development, new products, new markets, employee engagement, environmental footprint, fair payment of taxes, lobbying with integrity and reducing pay inequality.

Through short termism and liquidity obsession; consumers, advisers, investment managers, companies and even regulators have constructed a model in which the users of capital are incentivised to chop down the orchard to sell the wood and not to plant new trees from which we can harvest fruit in the future.

Long-term investment is better for consumers, better for companies and better for society. Through CMU, we must focus on rewriting the terms of engagement so that investment is no longer locked into a destructive cycle of short term focus.

You may have noticed that I have not mentioned the word trust. That's because I fundamentally believe that it has been an error to talk and talk about the "need to rebuild trust" We've been talking about it a long time and it hasn't happened.

This is because trust is not an objective. It's a consequence. It's a consequence of doing the right thing and being seen to do the right thing consistently so that people come to believe we'll do the right thing even when they're not looking. We can't build trust. Others will decide whether or not to give us their trust. All we can do is behave in a trustworthy way.

In the UK I tried and failed to introduce a Statement of Principles to set out what the responsibility of managing other people's money means in practice. Well now it's up to the industry and maybe regulators to find another way, because without another way, things will not change and the biggest goals for CMU will fail

Ladies and Gentlemen, this is a big agenda but there is a big prize. Europe is not lost; the present generation of young people of Europe need not be lost either. The key is the integrity of long term investment and the remodelling of the investment chain and investor attitudes to achieve it.

Success will require real courage in taking on vested interests who are doing very well out of the current structure, but if CMU ends up only resulting in a few improvements to regulation of the infrastructure and a lot of words then I think we should all fear for the long term future of liberal democracies.

If on the other hand The CMU project addresses the issues that prevent consumers from having the confidence to participate in capital markets and actually makes investment better through long-termism, then together we really can start to change the world for the better.

Ladies and Gentlemen – thank you for your engagement. I wish all you an excellent afternoon.

Daniel Godfrey, Founder of The Investor Forum & former head of the UK Investment Association