

In the Grip of Complexity

BY RHEA WESSEL

“The opportunity set is stretched, and this makes ‘normal’ choices risky,” says Roger Urwin



ECONOMIC UNCERTAINTY and prevailing market conditions have caused Roger Urwin to invert his customary view of markets and managers. Normally, he would trust markets over managers. However, “the markets, based on today’s valuations, don’t look very trustworthy,” he says. Active managers now seem to have an advantage.

Needless to say, much has changed in the past two years. In this exclusive interview with *CFA Magazine*, the global head of investment content at Towers Watson shares his perspective on the investing landscape, including the challenges of “re-regulation,” how the investment industry is likely to evolve, and the need to distinguish between the global financial crisis “narrowly defined,” which has already ended, and the global financial crisis “broadly defined,” which continues. He also discusses his views on “the increasing grip of complexity” and how it affects markets and regulation, the best investment strategies for the current environment, and trends among investment companies. Finally, as a member of the CFA Institute Board of Governors, Urwin shares his views on the role of CFA Institute in today’s market environment.

What are your observations of the regulatory efforts that are under way?

Governments are confronting a very difficult political landscape. The market fundamentalism that we relied on has not served the world particularly well of late. People have a creeping realization that we were papering over some of the fault lines that had developed through weak regulation. New and stronger regulation is the government response. People support this because the lighter version of regulation has been seen to fail around the world. For once, governments have a mandate from their electorates that regulation is warranted. It’s absolutely clear that we’ll have a multiyear resetting of regulation.

Which type of regulation would you welcome the most and why?

Regulation should definitely improve transparency. The investment industry and the finance industry will

always have agency issues or conflicts of interest. Therefore, improved transparency is actually a very critical component of a better industry. Another area is over-the-counter markets. They have not been as secure as they should be. I would welcome a CDS [credit default swaps] clearinghouse and proper market. Finally, and more arguably, we need regulation designed to stop the secular drift toward more obsessive short-termism and support enlightened decisions made on a sustainable basis.

How could regulation promote long-term thinking?

The investment industry definitely stands to be criticized on its short-term perspective. It’s not just the investment industry, of course. It is corporations as well and the public sector through its political cycles. In the investment arena, you could see long-term incentives introduced through the tax system, but that

would take global governance to be effective. And that is a stretch, as you know. People do agree on the problem, but they don't agree on the best approaches to the problem.

There has not really been any move to cooperate at the global level.

Leading countries collaborated effectively in 2009 against the acute global financial crisis. Now, that cooperation has faded away as we face a fiscal crisis that is less acute. As a result, the consensus for making changes or for implementing regulations is much weaker. If you study global politics through the lens of game theory, you learn quite quickly that reaching optimal solutions is not likely. You reach compromise solutions to world problems. Economists speak of "the law of second best" to illustrate some of those compromises, but often we are actually talking about the law of the fifth or sixth best. There are so many parameters to solve for.

And would you go so far as to say that the opportunity for fundamental change has been lost?

No, no, I wouldn't go that far. We've not exploited the crisis that well because it seemed like it was over quickly when it wasn't. The "bandwidth" for change since then has been completely taken up with addressing the problems at banks and the macroeconomic systemic issues. The Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States has been substantive and hit quite a few high notes but left some gaps where issues are too difficult. Its scale and complexity is a sign of the times to come.

What is really going on in financial markets, and why can't regulation keep up?

The speed at which knowledge is moved around the system is increasing dramatically. Knowledge moved slower 10 years ago. People now get a new perspective on a problem very, very quickly. And it changes their view of the best solution. All of this takes place in a supercharged atmos-

phere in which people are always second guessing.

The result of all the new information and reflection on it is more problems. We can no longer anticipate change and manage change effectively because of so much global connectedness.

It all comes back to the increasing grip of complexity. Just as knowledge is moved around faster than before, the pace of change is getting faster. This impacts three areas of the investment industry. The first is the institutions, which include funds and managers and the people in the industry. The second is the market and marketplace, which sets prices and quantities for securities and products sold. The third—and this is the bit that has been changing most—is the instruments and technology through which things get produced, such as theories, processes, systems, risk models, intellectual capital, and governance arrangements.

Are investors doomed to navigate a system that is essentially out of control?

The global financial crisis—narrowly defined—finished about April 2009; the global financial crisis—broadly defined—is still raging. We swapped one set of symptoms of the crisis for another. We solved the financial crisis symptoms, but we are paying the price with a fiscal crisis. And it feels like this is the way we will be managing for a while—moving from one crisis to the next. Leaders are left to pick through a whole heap of problems to find solutions that might be robust over time. In this setting, the risk of serious policy errors is heightened.

And you don't see any way out of that vicious circle?

The most promising way out of the vicious circle is fundamental, strong growth for the world economy so that some of the imbalances are diminished. To get this, we need a much more virtuous mix of savings, investment, sustainable development, technology, and growth. That is the perfect combination that is critically needed. But this isn't so likely.

For the various reasons discussed, you have said you don't have a short-term outlook. What is your outlook on growth for the long term?

With the structural deficits and the significant fiscal indebtedness of a large number of Western countries, growth will be slow. The problem is being exaggerated by demographics. A number of Western countries in this situation are trying their hardest to deal with a very adverse set of conditions. They're now putting together rather optimistic assumptions about how quickly they can resume their old, normal growth levels and regain a more sensible fiscal position.

Which countries are being overly optimistic?

In the United Kingdom, we had a government that had been making its projections on the basis of "old growth" GDP. One of the first things the new government actually did was set up a neutral and independent Office for Budget Responsibility. It came forward with projections that were half to three-quarters of a percent less.

Most of the developed world is risking a double-dip recession by addressing fiscal deficits with cuts in the public sector. It looks like the risk of nightmare sovereign spreads has the upper hand, with the exception of the United States. It's a very difficult balancing act. Governments are trying to support growth, and in particular sustainable growth, while producing the conditions for people's savings to be productively invested over a period of time.

Where do you think savings can be productively invested right now?

The opportunities in the emerging-wealth countries, in the BRICs, and elsewhere in Asia continue to rank right up there. They are in local equities but also in foreign companies with exposures to these countries. I see even more opportunity with debt and the currencies in these areas. Some of the best equity and private equity areas are energy efficiency and renewable energy. Governments could work much harder to make these a bigger part of our economy.

You have said you are worried about the raging populist sentiment. What is your concern?

Our politicians face very tough decisions. They will be subject to many pressures, some of which are rather unhealthy pressures. We have to be braced for populism or backlashes in which people start shouting, "It's not fair!" Greece is only the curtain raiser. They say you get the politicians you deserve. This worries me at the moment.

You have written about responsibility continuing to shift back to the individual and away from paternalistic government systems, particularly regarding pensions. Is this the cause of the backlash?

In the pension system, obviously, we're seeing the move from defined-benefit arrangements that allowed people to have predictable incomes at retirement. For a generation, this was a superb pension system. But in the last 10 or 20 years, it's become no longer fit for purpose now that people no longer stay in one job for life, and companies and governments cannot be trusted with intergenerational equity.

As a result, the pension system has had to be moved to a defined-contribution arrangement in most countries. This means more individual responsibility and more risk to the individual. The system in the past was a collective system. Now, we have collective investment but individual risk. People believe that the state shouldn't necessarily come to the rescue of someone who under-saves but they may think differently about someone whose investment decisions let them down.

And do you think the population in Europe has internalized this message? In the United States, people never expected much from the Social Security system. But in Europe, people may be slow in realizing the state's diminished role.

That's very interesting. In large parts of Europe, such as Greece, they've had a long period of improved paternalism and support. Large numbers of the Greek public sector have been

retiring early on full pay. That's an extraordinarily generous and unsustainable type of support blanket. People got used to it, and they grew to expect it, unfortunately. That's a profligate system, so there's going to be a change. I don't want to single out the Greeks, but I think we will look back on their profligacy as the high-water mark of public and private excess.

What do you make of some analysts' talk about de-globalization?

De-globalization is a strong version of what I believe, which is that the forces of globalization were arrested by the problems of the global financial crisis. De-globalization captures ideas of protectionism, but I don't see much evidence that that is actually taking place yet. So, what I would say is that globalization may have been slowed by the global financial crisis, but it's not been reversed.

class in Asia. This means an enormous change in the marketplace, and it will support a lot of growth in those markets. That growth will find its way through to revaluations of currencies.

China currently has a managed currency that it has used to keep its export sector in better shape than it would be otherwise. Therefore, there are expectations that China's currency will be released from its shackles and find higher levels at some point in the future.

You have been known to say that you should trust managers more than markets. What does that mean?

The markets, based on today's valuations, don't look very trustworthy. They're not valued fairly when allowing for risk. Good managers can find the pockets of value and manage risk. Therefore, I put choice of managers ahead of choice of markets at the

I am not that supportive of the hedge fund industry in normal times because it's an extremely expensive way to get wealth managed. ... But temporarily, my view is the other way around.

So, where are the investing opportunities?

The opportunity set is stretched, and this makes "normal" choices risky. It's difficult to find undervalued assets at the moment. We saw a significant, liquidity-induced run-up in asset prices. They are supported by inordinately low interest rates across the world. At the moment, I'd place my faith in active investment choices and thematic opportunities like emerging country currencies and clean technologies.

And why are you keen on emerging country currencies?

The economic opportunities in the emerging-wealth countries are much higher than in developed countries because of substantial consumption-led growth. About 2 billion people are on the verge of becoming middle

moment. This is not my usual point of view. Quite honestly, I am not that supportive of the hedge fund industry in normal times because it's an extremely expensive way to get wealth managed. Most of the time, I'm more inclined to place my trust in markets and diversification. But temporarily, my view is the other way around.

Given your recent fondness for investment managers, what trends do you observe among them?

When you talk about traditional investment managers, such as those that are independent, bank-based, or owned by an insurance company, most of the firms have grown up with the ability to manage many different types of mandates and serve a very large marketplace. There are gazillions of these firms. While other industries, such as pharmaceuticals,

have concentrated, you can't say there are six or seven global leaders among the traditional investment managers. There are 60 or 70.

These firms will struggle if they don't stop trying to be all things to all people and begin to serve the marketplace in more specialized forms that play to their particular strengths, such as boutiques do.

Some investment firms can be "manufacturers" in the sense that they use ideas to produce the right portfolios. Others are "distributors" with very strong marketing and a sales force that uses others' manufacturing. And the new part is that investment firms can become "aggregators." They can piece together other people's work and produce end products. Fund-of-funds would be one example of that, as well as the new field of fiduciary management. They take parts of the investment chain and put together a particular package, which solves a problem for a client. It's sometimes called the solutions business, but I'd call it being an aggregator.

I think the investment firms that will be the most successful will be disciplined in working in one of these three models. These are the specialist business models that are emerging.

If you look back at the investment industry over the past decade, what do you see?

No one in the finance industry should look back on the last 10 years with much of a sense of pride. They may see some progress, but it's not been that consistent or produced the value that it should have. Paul Volcker has said the biggest financial innovation in the last 20 years was the ATM. That is an interesting data point for an industry that has so many creative people in it.

Looking back at the financial crisis, could CFA Institute have done more?

Let's start with whether investment professionals could have done more. I don't think that they could have done much more. Investment professionals are providing a really important long-term function to make sure that people can grow their wealth

ROGER URWIN is the global head of investment content at Towers Watson, a global professional services company. Previously, he served as the global head of the firm's investment practice. Urwin joined Watson Wyatt (which merged with Towers Perrin to create Towers Watson in January 2010) in 1989 to start the company's investment consulting division. Before that, he led the business development and quantitative investment functions at Gartmore Investment Management. Urwin is also advisory director to MSCI, the index and risk company.

He also serves as a member of the CFA Institute Board of Governors. "My professional qualification is as an actuary," he says, noting that, unlike other Board of Governors members, he doesn't hold the CFA designation. "After I had given up prime years sweating through those exams, it didn't work for me to sit for the CFA charter. But I've been involved with CFA Institute in various forms for most of my working life. I particularly like its mission and culture."



and manage their finances satisfactorily over time. The investment industry is critical for making sure that the savings of today become a productive pension for tomorrow. Investment professionals are serving society in their role, and they are by and large ethical and professional and have not abused that position.

They have lost some of the trust that was bestowed upon them through this period, but I think that reflects the abnormally bad results we've experienced. I think that when everyone looks back at the global financial crisis, they can demonstrate that there was no single cause, no individual or group of individuals that was centered in the middle of the crisis and tipped the system into a crisis.

What you can say is that the banking industry stands to be most criticized as a result of the activities, particularly the investment banking industry, as opposed to the retail banking industry. Although the investment banking industry doesn't carry all the blame, there's no question that some of the activities in investment banking were based on short-term principles and were unsustainable and lacked ethics.

And under-regulation was a contributor to this. So, we haven't been paying enough in the investment industry for regulation, really. And in

that sense, one of the aspects of the failure that led to the financial crisis was actually a failure of thinking. People believed too strongly that markets would right themselves, but this isn't a reasonable assumption at all.

It's difficult for any person or any organization to stay up to date in an industry that is changing at all times. Theory is being rewritten on a daily basis. CFA Institute struggles valiantly in these sorts of conditions with its charterholder program and its continuing education of members. Maybe it didn't influence people away from free-market fundamentalist theory enough. But one of the things that CFA Institute does very well is get people talking about these things. It sets an agenda for discussion, and the discussion it's leading is definitely moving the dial in the right direction here.

CFA Institute has continued to emphasize ethics. It has sponsored working groups that have been examining the global financial crisis. It has mobilized a lot of time and attention to that agenda, and I believe it will make a difference there. Lifelong learning is also critical. CFA Institute facilitates this lifelong learning particularly well through technology-based opportunities. ▀

Rhea Wessel is a financial journalist based in Frankfurt, Germany.