The New Frontier Investors

Jagdeep Singh Bachher • Adam D. Dixon • Ashby H.B. Monk

The New Frontier Investors

How Pension Funds, Sovereign Funds, and
Endowments are Changing the Business of
Investment Management and Long-Term Investing

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For
Harbhajan, Kuldip, Aradhana, Jaspreet, Meher and Prabhnoor—JSB
Olga, Fay and Juno—ADD
Courtney, Henry and Bea—AHBM

Preface

The global financial services industry has been the subject of criticism since the 2008–2009 financial crisis. From social movements such as Occupy Wall Street to the economic elites at the World Economic Forum, there is widespread concern that the leading edge of the financial services industry has lost sight of its objective function: to facilitate the efficient allocation of economic resources over space and time under conditions of risk and uncertainty. Instead, the investment houses of the leading international financial centres (IFCs) often seem to be working in their own interests, even destroying rather than creating value for clients, shareholders, and the real economy. For some, parts of the financial world have become socially dysfunctional.¹ Simultaneously, short-termism appears pervasive, driven by structural changes such as mark-to-market accounting coupled with cognitive constraints to long-term decision making and herd behaviour. Consequently, existential socioeconomic challenges that are material to the generation of value over the long term, such as demographic ageing and climate change, are secondary concerns for many in the financial community, if they are a concern at all.

There are, however, two important yet understudied and unmapped developments challenging the global geography of finance and investment. First, large institutional investors with long time horizons are appearing in cities outside of the IFCs that have little or no history as purveyors of flows of global finance. This is due in large part to the dramatic growth and emergence of sovereign wealth funds in places such as Abu Dhabi, Auckland, Beijing, Edmonton, Juneau, Moscow and Oslo. Indeed, more sovereign funds have

¹ See, Adair Turner, 'What banks do, what should they do and what public policies are needed to ensure best result for the real economy?' (Cass Business School, 2010).

been set up in the past decade than in all the years before.² Second, a community of long time horizon institutional investors, which includes sovereign funds but also public pension funds, family offices, foundations and endowments, is pushing back against the misaligned incentives, high fees, poor returns and short-termism embedded in the for-profit asset management industry, which the financial crisis brought to the fore.

This growing group of long-term beneficiary institutions, which we define as *frontier investors*, is taking back responsibility for the end-to-end management of their investment portfolios by insourcing some asset management and reconceptualizing the investment decision-making process to bypass for-profit service providers and, in some cases, IFCs, altogether. Our work in the industry and our academic research covering sovereign funds, public pension funds, foundations, family offices and endowments from North America, Europe, the Middle East, Africa, Australasia and East Asia, suggests that frontier investors are developing ways of overcoming their geographic constraints. They have begun to harness network economies where financial services agglomeration economies are not present, and are leveraging their locational and organizational attributes to meet their human resources needs. This shift in practice and organizational form has potentially significant implications for the global geography of finance and the allocation of capital across time and space.

Our findings do not, however, suggest the demise of IFCs and the for-profit financial service providers. Financial centres produce a range of agglomeration economies in addition to offering complementary services that many frontier investors in financial outposts cannot. Attracting and retaining talented and specialized workers, and accessing sufficient and attractive deal flows, are easier to achieve in an urban agglomeration. Hence, at this juncture, there is an insufficient critical mass of organizations that are successfully and efficiently overcoming the organizational and geographical constraints necessary to threaten the dominance of the IFCs and the for-profit service providers. But we'd like to see that change. If *frontier finance*, the term we give to this innovation in asset management, represents a window of locational opportunity, it is in its infancy. And even if frontier finance is unable to unseat the dominance of IFCs, it may over time come to represent a viable (if small in comparison) parallel, decentralized system of global finance that provides a better alignment between the owners and users of capital, as the rents that would normally accrue to intermediaries and other market participants (e.g. short-term speculators) are removed.

² For an extended treatment of sovereign funds see, G.L. Clark, et al., *SOVEREIGN WEALTH FUNDS: LEGITIMACY, GOVERNANCE, AND GLOBAL POWER* (Princeton University Press, 2013).

At the core, we are interested in studying frontier finance and understanding frontier investors because they are constrained by their geographies and, as a result, forced to be innovative to operate effectively. Within the long-term investor community, innovation can be an overwhelming challenge, stymied by prudent person rules, peer risk and governance rules. Indeed, for these institutional investors to find a more aligned access point to the financial services industry, they have had to develop capabilities and resources that are not standard among other asset owners. How and why they have done this is of critical importance to this book. If we are to reconstruct the long-term investment community for long-term success, it starts by adopting innovative and creative techniques that are rarely recognised as being innovative or creative. How many public pension funds would you, the reader, describe as innovative? And yet, these long-term investors form the base of our capitalist system, setting the incentives for all the other agents operating in the global economy. In our view, the base of capitalism should be more capitalist, and that will require doing things differently in the future.

The nine chapters that follow are critical as well as constructive. In Chap. 1 we provide an outline the contemporary geography of investment management to help explain why most beneficiary financial institutions are dependent on third-party service providers. While this chapter has an academic tone, it is important for understanding the constraints that large beneficiary institutions face in becoming more independent and resourceful organizations. We argue that these constraints are partly a function of geography. But an organization's history and geography are no excuse for complacency. Yes, place matters. Yet, as we show in subsequent chapters, there are innovations that minimize, and in some cases eliminate, the limitations that many large beneficiary institutions face. We firmly believe that there is a wealth of opportunity for action, whether at a public pension fund in the middle of the United States or a sovereign fund in central Asia, to unleash their structural advantage and long time horizons in support of sustainable economic growth and shared prosperity.

Investment management is all about producing returns. Organizations receive money to which processes, people and informational advantages are added. These three factors of production are supposed to produce returns. In Chaps. 2 and 3 we outline what beneficiary investors can do to improve the investment process and attract the compelling and diverse set of people necessary for producing returns in an uncertain and globalized world economy. Improving process—or rather investment governance—begins by understanding the constraints and capabilities of an organization; establishing investment beliefs to guide decision-making; and providing the investment

process with the resources of time and attention that it needs. Frontier investors are often in the hinterlands of global financial markets where the talent pool is limited, even though they may actually be on the immediate environs of cities such as New York and London. Yet, as we have discovered, some beneficiary institutions have figured out how to attract best and brightest no matter where they are located.

Chapters 4 and 5 focus on the benefits of collaboration with like-minded beneficiary institutions and the possibilities for geographic expansion—or rather the establishment of satellite offices in major financial centres or important commercial cities. In both cases it is about unleashing structural advantage, whether that means bringing together investors that are spread across the globe to take advantage of each one's unique organizational and place-based attributes, or placing teams in the heart of the market to monitor investments and build more aligned partnerships with the financial services industry. In Chap. 6 we further the discussion on collaboration, providing insight on collaboration among long-term investors with venture capitalists.

In Chap. 7, we turn our attention to transparency. For many long-term investors full transparency is a legal requirement and not a choice. Although we believe in the moral and democratic imperatives underlying transparency and in the economic efficiency that should result, being transparent for the long-term investor can be problematic. Transparency may, unfortunately, drive short-term behaviour and myopic decision-making, at the expense of long-term performance. Furthermore, transparency may hinder a move towards a more capable and innovative investment organization. It is easier to follow the herd than to seek out new frontiers. But we think transparency is multi-faceted. It is much more than simply short-term performance metrics. Using the context of the crisis of international legitimacy that beset sovereign wealth funds in the last decade, we offer a nuanced perspective of the different forms of transparency and how such an understanding can help long-term investors explain how they invest and how they operate as an innovative and capable investment organization.

In the penultimate chapter, we take a slightly different turn in our narrative to consider sovereign development funds, particularly for developing countries. Indeed, the world has become too interconnected and interdependent for us to limit our discussion to large beneficiary institutions in rich countries. Not only are developing countries an important investment destination, many are turning to state-sponsored investment funds to encourage economic growth and development. We think these investment funds have the potential to become frontier investors. Some of these sovereign funds in resource-rich countries are basic stabilization funds invested in low-risk assets

abroad. Others have established funds with specific mandates to generate economic capabilities at home. Although we are sympathetic of this new class of frontier investor, we also recognize the challenges and risks that can impede their success. As such, we outline principles and policies that support success. And although the thrust of the chapter concerns developing countries, these same principles apply to any institutional investor that takes seriously the development of the real economy.

In place of a conventional conclusion, the final chapter presents the 10 pillars of centennial performance that we are using to guide the University of California's Office of the Chief Investment Officer. These principles and policies emerged from the same material that informs the chapters of this book. We take the opportunity with this chapter to demonstrate how seriously we take the lessons learned from our research and experience engaging with other frontier investors. We are putting our words into action.

Oakland, Bristol and Stanford

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