ADVISOR PERSPECTIVES

What "Value" Does Investing Create?

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by Michael Edesess

I attended the CFA Institute annual conference in Hong Kong May 13-16. I was pleasantly surprised to find it interesting, thoughtful, and stimulating. The theme of the conference was "Measure Up." It was posted everywhere and written on conference materials. When I asked Paul Smith, the CFA Institute's CEO, how they came up with that theme, his answer was, simply, "Ogilvy & Mather" (the advertising, marketing and public relations firm). I took this to mean that it was a consequence of the finding, in a CFA Institute survey (most likely conducted or commissioned by Ogilvy & Mather), that like so many institutions and professions these days, financial advisors and asset managers are – as a group – held in low esteem. The conference theme's implicit message was that this needs to improve. There may be a subtle reform movement afoot, with the CFA Institute trying to lead it.

Back to basics

How would it improve? This was not explicitly – or even implicitly – identified at the conference. But I believe there was a nascent theme. It can be gleaned from a few of the events at the conference, together with some peripheral developments. That theme is: the financial industry can measure up by conveying capital to improve the future of humankind; in short, by creating value.

What kind of a platitude is that, you may ask? Well, it's a platitude that has been forgotten. Most people's definition of what investing is about is getting the best possible return on investment. Indeed, much of the CFA training program supposedly aims at that goal (more about that later).

Getting the best possible return on investment is not the same as conveying capital to improve the future of humankind. In fact, getting the best possible return on investment is a goal that may be impossible, teleologically. Those who misinterpret Adam Smith may argue that if everybody pursues that self-serving goal, the invisible hand guarantees that the optimal future of humankind will result. But those who see beyond the mythical version of Adam Smith will find that hard to believe.

Creating value requires something more – something a little more realistically goal-oriented – than getting the best return on investment. The invisible hand might even work backward. Creating value – value for humankind in general, and for the natural world too – may itself result in the best possible return on investment. And why not, given that we don't actually know how to generate the best possible return on investment – we only pretend to?

Two of the major topics at the conference were investing in Asia and environmental, social, and governance (ESG) reporting. Let's look at how those might relate to the concept of creating value. Then, let's glimpse a new way of going about it, which the CFA Institute, among others, has recently embraced.

Investing in Asia

The keynote speech on Asia was delivered by Haiyan Wang, managing partner of the China India Institute. It was an excellent talk. She encapsulated the shift in China and India and other developing Asian nations in one exhibit:

EMERGING MARKETS GROWTH DRIVERS

State	⇨	Market
Bureaucrats	⇨	Entrepreneurs
Isolation	⇨	Global Integration
Illiterate	⇨	More Literate
Ignorant	⇨	Informed/Connected
Rural	⇨	Urban
Agriculture	⇨	Industry/Services

This exhibit shows concisely the transition that has taken place in China and is in the process of taking place in other developing and emerging countries of the world over roughly the last two decades.

One of the other talks, delivered by Andreas Vogelanger, CEO of Asia Frontier Capital (Vietnam) Ltd., highlighted opportunities in Vietnam, a country whose workforce is fast replacing China's as a low-cost, but highly competent substitute for higher-priced labor. Vogelganger's statistics were surprising. Vietnam is a populous nation, with 92 million people. Its minimum hourly wage is only a fourth of China's and about half that of the Philippines or Indonesia. Its average score on the widely-cited Programme for International Student Assessment (PISA) test is nearly equal to Germany's or Switzerland's and higher than that of the United States, while its GDP per capita is about one-eighth of those countries'. Clearly there is immense scope to beneficially lift the wealth level of the Vietnamese, and increase global value by exploiting the Vietnamese comparative labor advantage.

All of these shifts suggest vast possibilities for innovation and interconnection, which will need huge inflows of capital.

The challenge that was addressed by many talks at the conference is how to provide this capital in such a way that it will be applied usefully and not wasted – and of course, so that it will offer an attractive payback to investors. These methods were labelled variously as venture capital or private equity, with substantial overlap between them.

Numerous international non-profit organizations try to create value for poor people with their anti-poverty programs. A few are at least partially successful; many, perhaps most, are not. And some – too many – have a detrimental effect. Many observers such as the Nobel Prize winning economist Angus Deaton, and travel writer Paul Theroux in his book Dark Star Safari, have pointed out that some poor countries are doing worse than they were 30 years ago and blame aid agencies. But global trade and the exploitation of temporary and ever-changing differences in wage rates and other factors will certainly help lift people out of poverty – and they have done so. If there is a universal definition of creating value, this would surely be included.

Even from that, however, there are dissenters. Some object to "exploitation." But exploitation is in the eye of the beholder. Many of those who are "exploited" are grateful – at least their families are. Others, of course, object to the "destruction" part of creative destruction. For this, there may be remedies, but there often are not.

ESG reporting

A strong trend toward corporate ESG reporting – reporting of environmental and social impacts and corporate governance – has taken a firm hold in both regulatory institutions and corporations. In the city where the CFA Institute conference was held, Hong Kong, the stock exchange requires listed firms to produce an ESG report annually. The report includes environmental information on a company's uses of resources such as water and energy and its emissions into the environment; employment and labor practices; health and safety in the workplace; supply chain management to manage environmental and social risks of the supply chain; product responsibility as to health and safety, advertising, labelling, and quality assurance; anti-corruption; and investment in the community.

The ESG principle is that financial reporting is not enough; the corporation has a responsibility to control its "externalities" – the economist's term for impacts of its activities on the world outside. In contradiction to Milton Friedman's claim that the corporation has no "social responsibility," it has become the consensus belief that it does in fact have a responsibility – not only to its own shareholders, but to its employees, its consumers, its community, society at large and the natural environment.

The conference's emphasis on social and environmental responsibility could be regarded as part of the admonition to "Measure Up," even if not explicitly stated. The fact that "Measure Up" was the CFA Institute conference's theme tends to imply sympathy toward the importance of ESG reporting.

ESG reporting, however, has been criticized as a side show and a vehicle for corporate "greenwashing." Conventional financial reporting remains the main event. ESG reporting can be regarded as a Mickey Mouse job performed to comply with less-than-serious regulations; something that can be gamed, or satisfied with boilerplate. Conventional financial reporting is a discipline, backed up by auditors and other enforcers. Nevertheless, auditing of ESG reports has become a major activity of the Big Four accounting firms. College students majoring in fields with names including the words environment, sustainability or corporate social responsibility are at least as likely to be snapped up by accounting firms as any other firms.

However seriously it is taken, ESG reporting is separate from financial reporting. Hence, it is inevitable that it will be regarded as less serious and central than financial reporting itself. But there may be a better way.

Integrated reporting

While I was at the conference, a man named Richard Howitt sent a message asking to see me. He was the chief executive officer of the International Integrated Reporting Council (IIRC). He said that the CFA Institute had a new strategic partnership with the IIRC. I had not heard of the IIRC, but the sound of it was mildly intriguing.

When I met with Richard and then followed up by requesting information from his assistant, Juliet Markham, I was enlightened. The International IR Framework document, found here, provides full information about the IIRC's integrated reporting mission and framework. Its goal is to integrate financial reporting with ESG reporting, but in a way that simplifies and enhances both.

The key phrase, repeated in different forms several times in the framework document, is "An integrated report explains how an organization creates value over time." Crucially, it acknowledges that the world outside the corporation's sphere of financial interest – or, shall we say, its narrow-minded sphere of financial interest – is not something that can be put out of sight, out of mind. There are constant interactions and feedback loops, some of them very long-term, between the corporation's financial interest and the interests of the world at large, including the natural environment. What affects those outside worlds ultimately affects the corporation, and vice versa.

Hence, the Integrated Reporting framework suggests focusing on the creation (or destruction) of value in six types of capital: financial, manufactured, intellectual, human, social and relationship, and natural capital (i.e., all renewable and non-renewable environmental resources). Note that although the reporting is specific to the firm's activities, the impacts may not be specific to the firm in the immediate or mid-range future; they are impacts also on capital in the external world.

No math

I recently read a thoughtful essay by Dylan Grice, who works at a Bermuda-based company called Edelweiss Holdings Ltd. It included the figure shown below, labelled as "Figure 1 – Scientism in finance."[1]

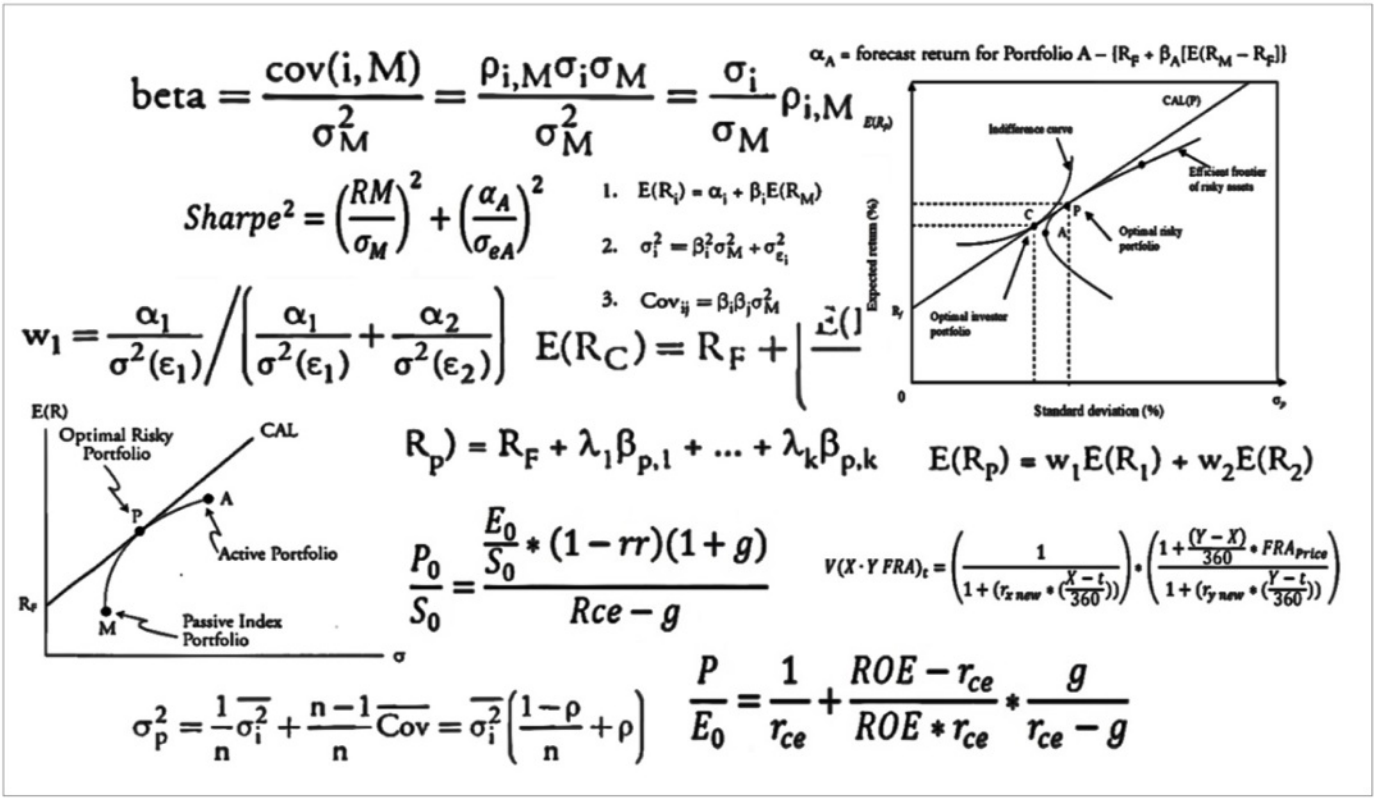

Figure 1 - Scientism in finance

The essay says that, "In Figure 1 you see excerpts from the CFA curriculum, a worldwide training program for financial analysts." The essay goes on to argue a number of points, with which I mostly agree.

But, in spite of the conference theme's double-entendre, "Measure Up," if this is how Certified Financial Analysts (CFAs) are certified, there was no sign of that at the conference. Comparing Figure 1 with the conference, one might wonder why CFAs need to learn these formulas – unless it is just to prove that they can understand textbook mathematics.

These formulas are, or should become, dinosaurs, remnants of the old way of doing things. The field of investment finance is still clinging to these old ways, hoping that it can staunch the tide of dissatisfaction with them; and it has been doing so for a while, with concepts like smart beta. But it needs to shift away from the marketing implication that with formulas like these, and ever more complicated ones – much of which, as I have repeatedly pointed out, are wrong or wrongly interpreted – it can enhance an investor's returns or reduce risks.

Let's hope there is a new wave of investment philosophy in the making, one in which the objective of investing is to provide capital to help improve the future of the world – and all investors have a chance to participate in the benefits. Although it is couched in a vague language, perhaps so as not to sound too revolutionary, a new publication of the CFA Institute to which Mr. Howitt drew my attention, "Investment Firm of the Future," is trying to pave that path.

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[1] I am grateful to Bob Huebscher for passing this essay on to me.