Why Phi?

A NEW REPORT IDENTIFIES MOTIVATION AS THE HIDDEN VARIABLE OF PERFORMANCE

By Lori Pizzani

The goal of any good investment professional is to generate great performance. But what if there were a secret weapon that, if deployed, could potentially further boost performance? That secret weapon has now been identified and dubbed *phi*—a name which, besides referring to the 21st letter of the Greek alphabet, is an acronym representing the combined motivational forces of three key ingredients: purpose, habits, and incentives.

KEY POINTS

Phi focuses on aligning the motivation of an investment professional with the long-term goals of clients rather than short-term outperformance.

A one-point increase in phi has been linked to a 28% increase in organizational performance, a 57% increase in employee engagement, and a 55% increase in client satisfaction.

Only 17% of investment professionals score high in phi, while 53% score low or have no phi at all.

That's the premise behind an October 2016 report ("Discovering Phi: Motivation as the Hidden Variable of Performance") released by CFA Institute in collaboration with State Street Center for Applied Research (the independent think tank of State Street Corporation). The report is the result of an 18-month study based on in-depth interviews with 200 global industry leaders and government officials, qualitative statements from more than 3,300 investment professionals, and survey results from 3,600 individual investors across 20 countries.

Phi's impact can greatly up the performance ante. Analysis shows that just a one-point increase in phi can be associated with a 28% increase in the odds of excellent organizational performance, a 57% increase in the odds of excellent employee engagement, and a 55% increase in the odds of outstanding client satisfaction. That can translate into a significantly better investment firm, more motivated employees, and happier clients.

Yet, according to the report, only 17% of investment professionals score high in phi, while 53% score low or have no phi whatsoever.

ADDING TO THE GREEK ALPHABET SOUP

Phi has been called the "hidden variable" of performance. By understanding and using the components of phi, the investment management industry as we've long known it could evolve into a better, more robust industry that purposefully puts investors' needs first.

Phi joins a trio of other Greek letters frequently used by investment professionals to quantify performance. Alpha refers to the excess return that financial advisers can generate, either by luck or skill. Beta is defined as the systematic exposure to risk of a portfolio, often achieved through asset allocation. In 2013, David Blanchett, CFA, head of retirement research at Morningstar Investment Management, and Paul Kaplan, CFA, director of research at Morningstar Canada, further defined gamma—up to that point used mainly in derivatives trading and risk management—as the value add achieved by making intelligent financial planning decisions.

Phi is intended to represent a "more sustainable and valuable motivation," explains the report. It's a mind-set "driven by purpose and embedded by habits and incentives."

THE HIDDEN VARIABLE

Unlike concepts that measure the value added by investment professionals according to how they outperform an external benchmark, a recognizable index, or even their peers, phi allows for much more introspection and less focus on competition. It turns the lens inward, focusing on the motivation and purpose that underpins the investment firm and its staff members and shifting the motivational core from that of outperformance to providing long-term achievement of clients' objectives.

"Motivation is the engine that drives behavior and performance," says Rebecca Fender, CFA, head of Future of Finance at CFA Institute. "Phi is something—a hidden variable—that most didn't even know was missing. As an industry, we tend to focus on the tangible."

According to the report, 53% of asset managers and other intermediaries say that although they originally pursued their career because they were passionate about financial markets, they feel that the industry has disconnected from its true purpose.

The motivation and purpose factors that embody phi are vastly different from the typical motivation to achieve short-term outperformance versus a chosen index or benchmark. Phi takes a longer-term view, with a focus on aligning the motivation of an investment professional and an investment firm's employees with the long-term goals of clients. This alignment puts the interests of clients above all else.

"You can't understand motivation in isolation," says Suzanne L. Duncan, senior vice president and global head of research at State Street's Center for Applied Research. "Motivation—why we do something—is not static, but it's dynamic. Individuals with a high degree of phi are committed to a purpose." She acknowledged that her firm is currently developing what she calls a "phi-agnostic" that will help identify the presence and magnitude of phi by virtue of a phi score. Culture is becoming important, and we simply don't get to a better culture through regulations alone, she adds.

The report doesn't just single out the misaligned motivation of investment professionals. Retail investors can be just as mistakenly motivated by the desire to beat the investment performance of a friend, family member, or neighbor. This motivation can lead to moves that prove detrimental to individuals' financial goals over the long term.

What's more, 54% of retail investors believe that financial institutions are most likely to offer products and services that are in the best interest of financial firms—not necessarily clients. Consequently, only one in three retail investors (32%) attributed their long-term financial planning success to an investment adviser or provider. More than half (55%) credited themselves with their success, whereas 38% credited family members or friends (respondents were allowed to choose more than one option, making the low score for retail investors even more alarming).

In addition, institutional investors apparently aren't immune to performance envy. The report points to an independent study showing that university endowment allocations specific to alternative assets are linked to the allocations of their competitors, especially to those of their closest rival.

BREAKING BAD HABITS

So, what is making it so difficult for investment professionals to fix their motivation and put the long-term financial objectives of clients ahead of all else? According to the report, the investment management industry has developed several habits that not only should be questioned but also should be changed.

The current environment misdirects investment professionals' passion for beating markets toward behaviors that inhibit performance and call into question the "legitimacy and credibility of the industry," the report points out.

Among the characteristics of their firms, the majority of employee respondents to the survey gave their employers low marks for articulating a compelling vision of the future, being prepared to challenge assumptions and adapt their vision over time, discussing with employees their most critically important values and beliefs, and investing time teaching and coaching employees.

In addition, 36% of asset managers and wealth managers and 52% of asset owners expressed concerns about "career risk." Managers fear that shorter-term performance assessments (including short-term losses) will judge them harshly despite their longer-term focus, which might lead to their being fired by the client.

Furthermore, compensation, which is largely viewed as an effective motivational tool and as a factor used to prevent dissatisfaction among employees, has been shown in studies to create additional pressures. This pressure can lead to employee difficulties in processing information and making decisions. The report suggests that a firm's compensation structure should be fair, transparent, and controllable.

Articulated mission statements—such as those publicly presented on company websites—can also be troublesome if they are vague, empty, or difficult to interpret and implement.

PHI IN THE SKY

Through the forces of corporate culture and leadership, the workplace culture can be altered to increase phi, the report notes. Individuals who exhibit high levels of phi view their profession as a "calling" rather than just a job or even a career. Moreover, the report states that phi is a mind-set that fully embraces performance driven by a motivation to work in the service of something greater than themselves. Top executives at investment firms should remind managers of their fiduciary duty and encourage better understanding of client goals beyond performance.

"Only a sense of purpose beyond comparison, competition, and contingent rewards will deliver strong, sustainable performance over the long term," the report counsels.

Neither Fender nor Duncan is expecting a phi revolution. But they do expect that recognition of phi will foster an industry evolution, a migration toward better acceptance of its underlying principles, and a greater understanding of each company's motivation, purpose, and culture. "The concept of phi is useful for the industry, because it gives us new language to describe and build effective organizational cultures," says Fender. "That is an important way firms can differentiate themselves."

"Human beings are resistant to change," says Duncan. "You can't control markets or regulations, but you can control phi." Millennials coming into the workforce will likely also drive this trend, Duncan adds, because they want to contribute to something bigger than themselves.

Lori Pizzani is an independent journalist specializing in business and financial services.

Eight Ways Firms Can Increase Their Phi

1. Reconsider your firm's vision, goals, values, and purpose, and make sure they align with those of clients.
2. Rethink your true motivations.
3. Re-examine critical assumptions, and be ready to challenge or even change them.
4. Create an environment that fosters a clear vision and supports ownership and autonomy.
5. Choose leaders who share the firm's values and beliefs.
6. Invest the time to teach and coach employees.
7. Create opportunities to understand how actions impact clients' lives.
8. Restructure monetary incentives to be fair, transparent, controllable, and aligned with longer-term goals.

KEEP GOING

"Discovering Phi: Motivation as the Hidden Variable of Performance": http://cfa.is/2fmnWcr