CFA Institute

APRIL 2017

FUTURE STATE OF THE INVESTMENT PROFESSION

PURSUING BETTER OUTCOMES—FOR THE END INVESTOR, THE INDUSTRY, AND SOCIETY

Executive Summary

PREPARING NOW FOR A DIFFERENT FUTURE

The future of the investment industry is important for the functioning of the global economy, for the approximately 2 million workers it employs, and for the clients and end investors that depend on it to manage around $100 trillion in assets.

This report, which includes findings from a survey of 1,145 industry leaders, addresses the issues that keep investment management executives up at night; they are the same issues that matter for CFA Institute as the largest association of investment professionals. Major shifts are underway that will likely result in significant change, and leaders need a better way to think through the implications of these shifts in various combinations—for their clients, the health of the industry overall, and the ongoing sustainability of their own firms.

Relevant megatrends include technological advances, redefined client preferences, new macroeconomic conditions, different regulatory regimes reflecting geopolitical changes, and demographic shifts. The industry's potential future state is further complicated by important issues that are very specific to investment organizations, such as trends in digitization and commoditization, downward pressure on fees, pressures from sustainability, new tech-centric business models, and other investment innovations. The scenarios and analysis in the pages that follow offer a road map for leaders in their strategic decision making as they seek to chart a course for the future of their firms.

This report also provides insights for professionals interested in becoming future industry leaders by identifying the traits and abilities that will be prized by future investment management organizations. Finally, it suggests ways that the *possible future states* of the investment industry could be influenced so that the *actual future state* provides the best possible outcomes, by fulfilling client objectives, serving end investors, and contributing to societal wealth and well-being.

Business Model Faces Pressure

84% of investment leaders expect consolidation of the industry

70% expect investors will increase their allocations to passive investment vehicles

52% of CFA charterholders surveyed expect substantial or moderate contraction of profit margins for asset management firms

57% expect institutional investors will look to reduce costs by insourcing more investment management activities

Changing Client Profiles

73% of investment leaders expect environmental, social and governance factors will become more influential

70% of investment leaders expect Asian financial centers will become more influential

Opportunities on the Horizon

55% of investment leaders expect globalization will offer new opportunities for investment professionals

48% of investment leaders expect technology will offer new opportunities for investment

UNDERSTANDING THE INDUSTRY'S PURPOSE THROUGH ITS MANY MOVING PARTS

The fundamental purpose of finance is to contribute to society through increases in societal wealth and well-being. Looking at finance as an ecosystem reveals important interconnections and points of friction in how finance currently works in relation to this purpose. The financial ecosystem is:

- **Connected:** It reflects the multiple diverse participants, people and organizations and their connections with each other and with the wider landscape. While the system is served by many specialists, there is a need to understand the bigger picture.
- **Reflexive:** It incorporates the two-way nature of those connections and dependencies. Specifically, it allows for reflexivity, where landscape changes affect and are affected by participants' beliefs and actions.
- **Non-linear:** It allows for the jumps, or tipping points, that characterize some of the properties of the system and are difficult to explain with traditional theory. Simply put, crises happen.

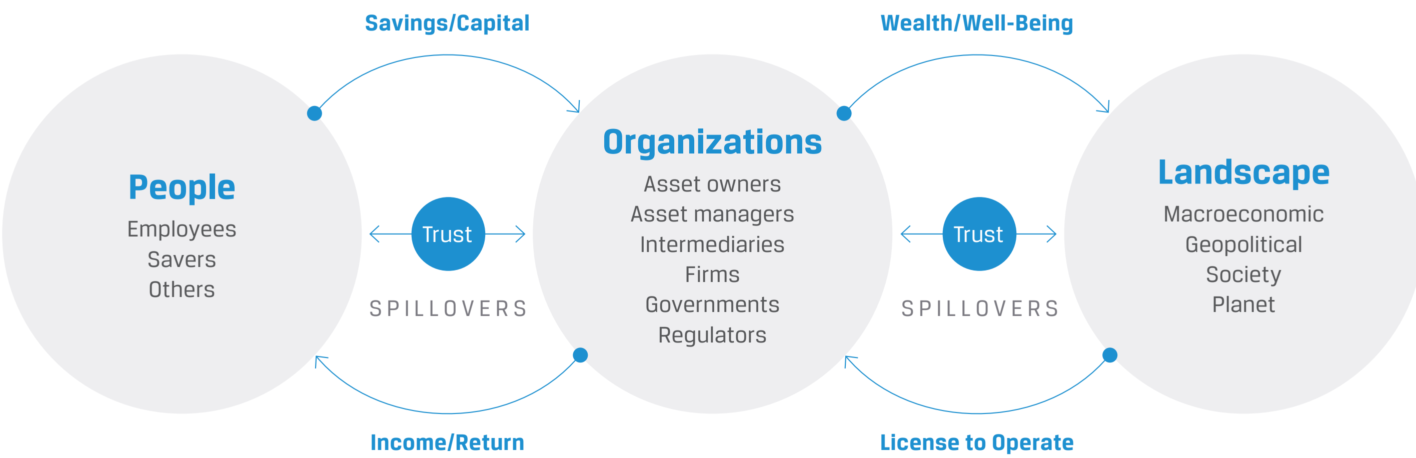
The financial ecosystem rests on a singular fundamental transaction: those with a surplus of capital but a deficit of ideas (investors) provide capital to those with a deficit of capital but a surplus of ideas (inventors, entrepreneurs, businesses, firms, etc.). When those ideas are successful, then both the providers and users of capital benefit by earning investment returns. CFA Institute argues that an investment industry of enormous value to society has grown from this kernel; but its sustainability is dependent on the nature of the value delivered and the quality of trust between the end investor and the organizations involved.

Uncontrollable forces consistently exert influence (sometimes extreme influence) in the financial ecosystem, just as they do in the natural world. The challenges the investment industry will face in the future are currently being shaped by a number of megatrends that already have significant momentum: people are living longer and demographic structure is altering markedly, technology is empowering individuals and organizations, economic imbalances continue to grow in markets and society, the regulatory pendulum is swinging faster, and natural resources are under stress.

Our focus here is on the investment function of finance, which lies alongside the payment, lending, and insurance functions. More specifically, the core purposes of the investment industry lie in two overlapping areas:

- **Wealth creation:** Mobilizing capital for jobs and growth; the capital managed in this chain creates wealth and well-being.
- **Savings and investments:** Deploying investment services for wealth and risk management; the savings and investments managed in this chain allow inter-temporal (over time) risk management and increases in wealth.

THE FINANCIAL ECOSYSTEM



THE ART AND SCIENCE OF SCENARIO PLANNING

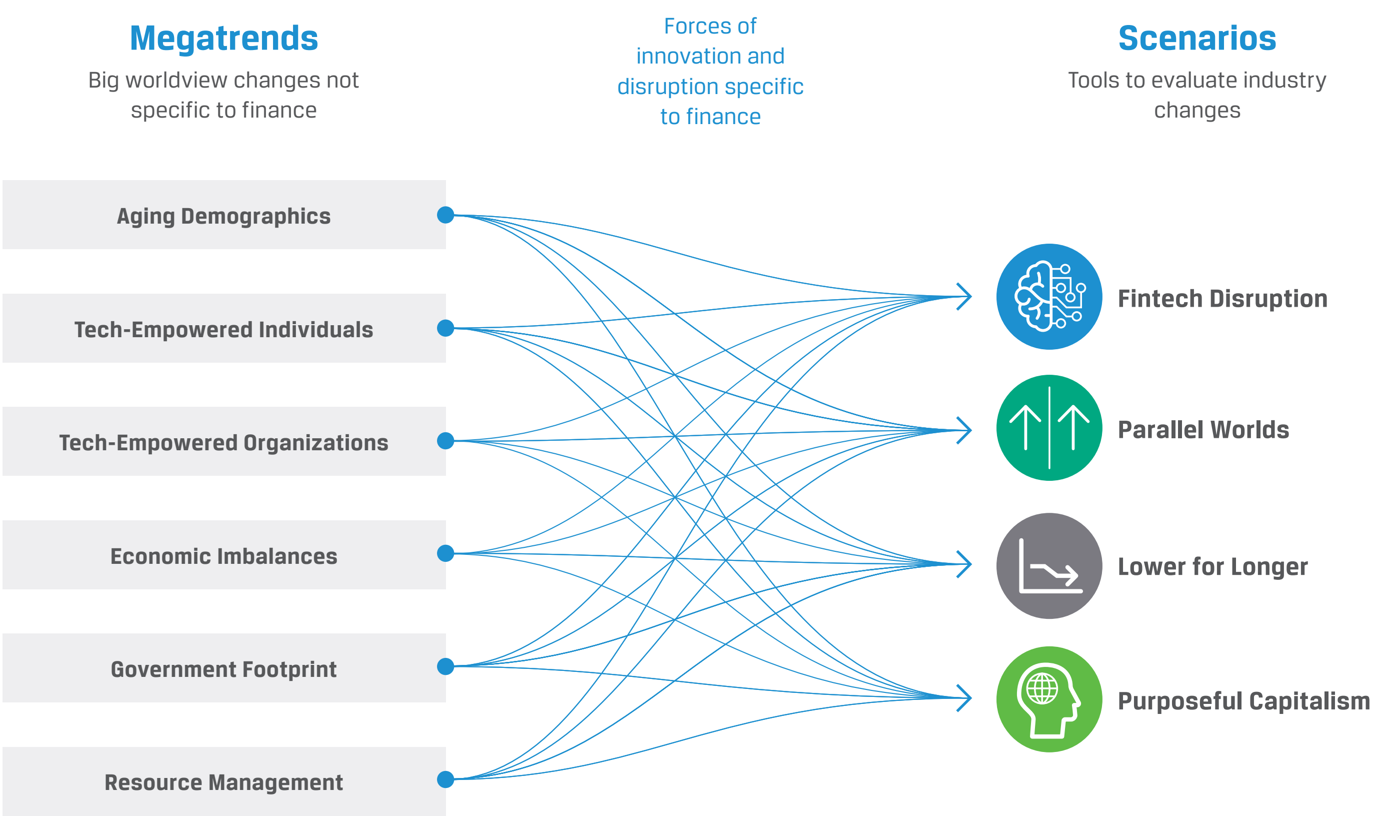
Even when forecasts are directionally correct in finance, they are usually specifically wrong. That is because the future of finance is created by a combination of many moving parts and legions of complex interactions; the result is inherently impossible to predict. Consequently, we use scenario planning to reveal insights about the future state of the investment profession, regardless of what future unfolds.

Our scenarios draw on a number of megatrends—large scale changes in circumstances that are omnipresent in all facets of our world—that are identified as virtually certain to disrupt the ecosystem regardless of how the future unfolds.

The megatrends are mixed with finance-specific forces in different combinations to create unique scenarios in the form of narratives about the future. These narratives are not forecasts; instead, each narrative strives to tell a unique story. With these stories in mind, decision makers are equipped to recognize the narratives as the future unfolds and act early.

Our time frame is 5–10 years, which is long enough to allow business models to substantively change in response to the disruptive megatrends and forces we identify, but not so long as to be overly futuristic.

MEGATRENDS COMBINE FOR POSSIBLE FUTURES



FOUR SCENARIOS FOR FUTURE STRATEGY

These scenarios represent four ways in which the future of investment management could unfold.

Fintech Disruption

New technologies promote new business models; disruption and creative destruction are endemic; challengers do better than incumbents; major disruptions to the world of work

Major Elements

- Quickening flow of disruptions from technological innovation in digitization and digitalization
- Fintech develops globally with a particularly strong Asia-Pacific element
- Regulatory infrastructure in finance gradually integrates technology-driven models
- Disruptions to investment organization business models; success with technological advancement is critical
- Traditional active management shrinks; some growth in alternatives, smart betas, and outcome-oriented solutions
- Smart machines and systems, data analysis, and inference play a disruptive role in finance's evolution
- Financial services becomes highly personalized and digitalized everywhere
- Robo-advice and its "cyborg" variants become preferred style or tool for delivering investment advice

Parallel Worlds

Different segments—by geography, generation and social group—engage in society differently; a higher baseline for financial services participation with wider dispersion; product preferences for personalization, simplicity and speed

Major Elements

- Better worldwide education, healthcare and telecoms increase societal engagement
- Social media carries potency to bring people together and to divide, legitimately and illegitimately
- Potential for mass disaffection; consequences in anti-globalization, populism, and authoritarian nationalism
- New-style financial institutions enabling personalized, simple, and speedy engagement; trust is also needed
- Big data serves customiza-tion of investment products to specific segments; more reflection of personal values
- Improvement in financial literacy and empowerment produce better financial participation
- The "have-nots" act on their disillusionment with the system
- The trustworthiness of the tech model with tangible products and immediate gratification is tested in investment contexts

Lower for Longer

New normal low interest rates and returns become embedded for the foreseeable future (5–10 years), accentuated by lower levels of global growth and higher levels of political instability

Major Elements

- Limited success with interest rate normalization; natural interest rates stay low
- Growth challenges: indebtedness, adverse demography, excess savings, China/EM, companies hoard cash
- Large gaps in pension coverage with longevity; pension poverty
- Moves to lower-cost, higher-tech investment solutions; premium on innovation; industry consolidates
- Private markets carry growing weight in capital raising; issues with opaque-ness, liquidity, agency, overcrowding
- Corporate and public pension costs rise to pay for increased longevity and reduced returns
- Disappointment with outcomes rubs off on trust; investment skill under pressure to demonstrate its value
- Geopolitical instability connects with social instability; inequality fissures; negative feelings deepen; job fears; immigration challenges

Purposeful Capitalism

Capitalism's way of working evolves; the investment industry raises its game with more professional, ethical, and client-centric organizations acting in aligned-to-purpose, lower-cost, and efficient ways

Major Elements

- Governments and firms work toward a more positive direction of travel for capitalism with more respect for wider stakeholders
- Markets for publicly listed equity and private equity are more fair, efficient, and deep over time and grow as a result
- Firms and investment organizations integrate their wider purpose alongside their profit motivations
- Asset owners are more influential; they add focus to longer-term value creation and sustainability
- There is an increased attention to fiduciary responsibility in investment with better alignment
- Fierce competition for leadership talent among investment organizations; diversity and culture are draws
- Investment providers need to have a "clean license to operate" including ESG principles

ORGANIZATIONAL GAME CHANGERS

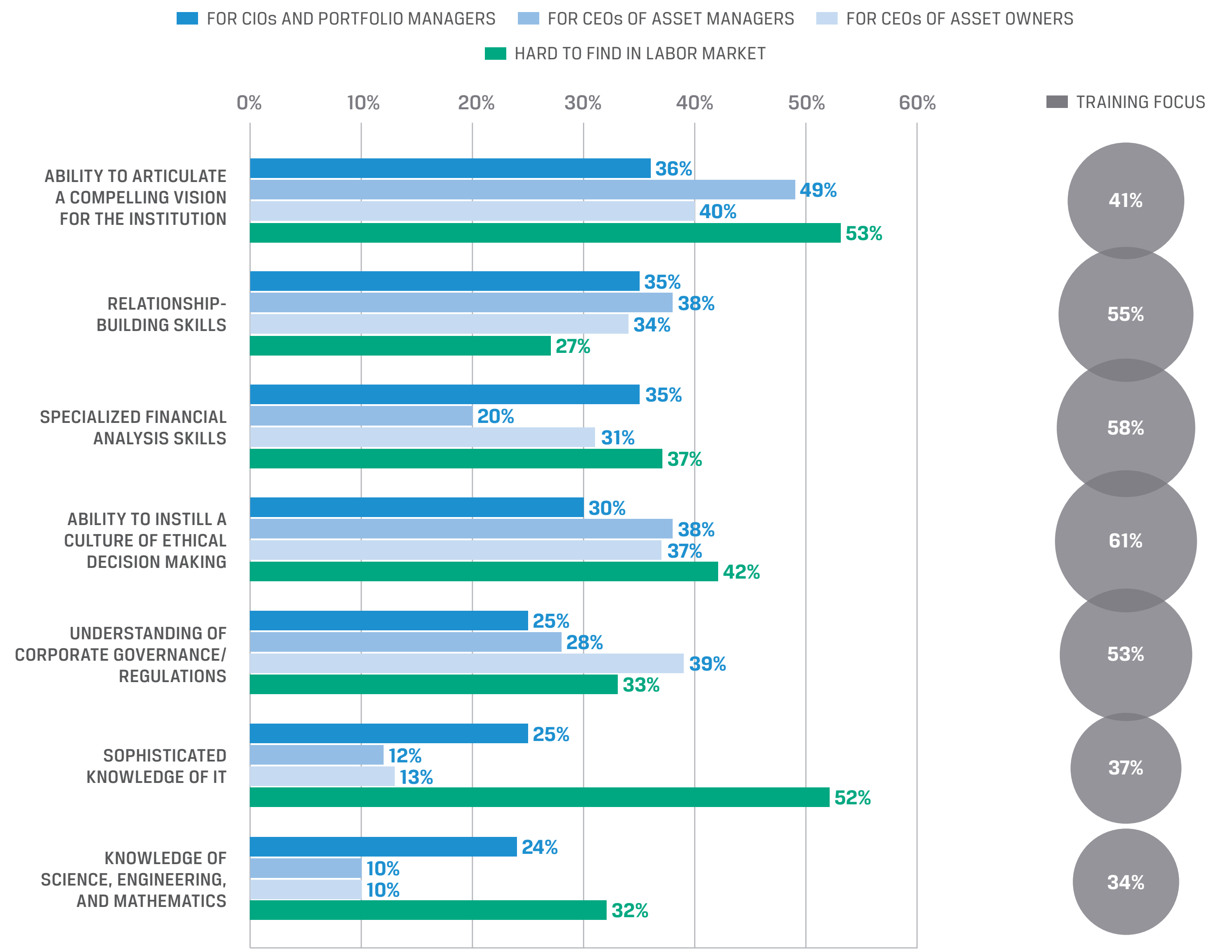
Investment organizations can be divided into asset owners, asset managers, and investment intermediaries. These are all "people businesses," dependent on talented leaders and staff to move forward. Our survey asked about the most important skills for leaders in the future, and the results indicate that investment organizations need to recruit and develop employees along new dimensions.

Investment organizations looking to retool for the future face some challenges. It is particularly difficult to find people with the ability to articulate a compelling vision for the institution and to instill an ethical culture—the two most-valued skills. But financial analysis skills and ethics rank at the top of the list for training.

Game Changer 1: New Skills for New Circumstances

- Increasing need for soft skills, like creative intelligence and influencing skills, given that technology will replace many straightforward human processes
- Adaptiveness to change is needed for increasingly disrupted situations, but this skill is in short supply
- Training requires attention to ethical and professional orientation
- Organizations need to increase their understanding of the interaction of skills in group settings
- There is a critical need for increased diversity both for a business case and improved cultural strength

MOST IMPORTANT SKILLS FOR THE FUTURE

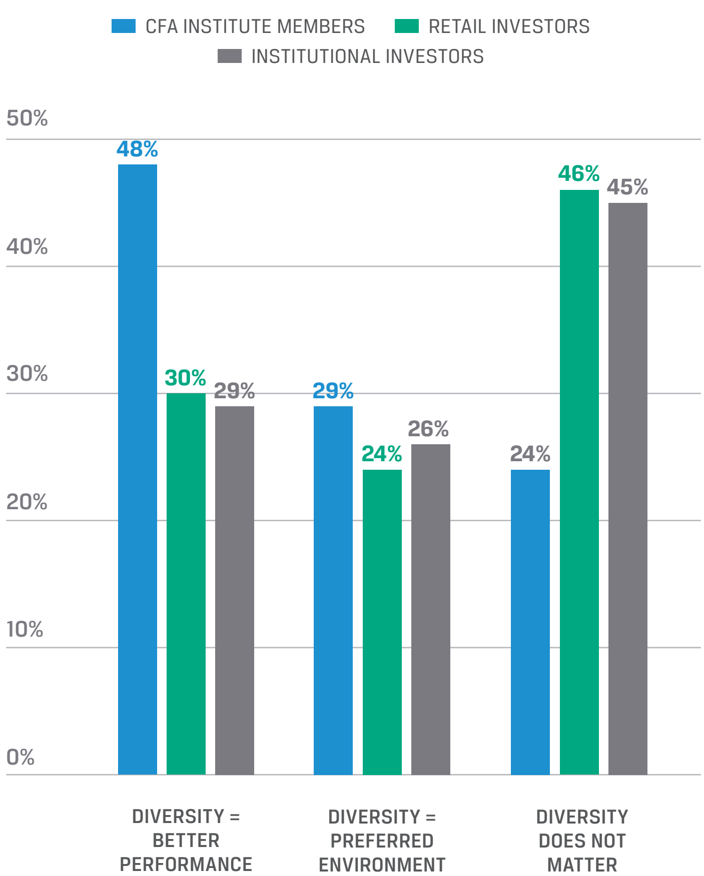


The Role of Diversity

The other major dimension of workforce capabilities will be the contribution of improved diversity. Diverse people are most often identified through surface characteristics (gender, race, national culture, education, sexual orientation, age, etc.), but the business case for diversity is linked to intrinsic individual characteristics, such as values, perspectives, experiences, knowledge, and way of thinking.

Diverse groups benefit from more and different ways of seeing complex problems and, thus, better ways of solving them. A growing body of research has shown the link to better performance and better culture that a gender diverse industry could have. There are opportunities to benefit from cognitive diversity and overcome the risks of groupthink.

WHEN IT COMES TO THE GENDER DIVERSITY OF A TEAM OF INVESTMENT PROFESSIONALS, WHICH ONE OF THE FOLLOWING BEST DESCRIBES YOUR VIEW?



The benefits of gender diversity to improve outcomes are beginning to be understood by the investment community, as indicated by the accompanying chart from earlier CFA Institute research.

These issues warrant increasing leadership attention given that the materiality of behavioral factors to decision outcomes has become clearer, and is in synch with the thinking and methodologies to make progress on this front.

Game Changer 2: New Pensions and Lifetime Savings Models

- Private pension markets are barbelled—adapting the mature markets and developing the immature ones
- Best practice is usually found where there are "win-win" alignments between far-sighted sponsoring firms and well-governed pension funds
- Pension engagement and advice is ripe for disruption—it needs new models that use technology more efficiently
- Increasingly, private pensions will follow the Defined Contribution (DC) model with a flexible investment platform and behaviorally smart design
- Low levels of contributions and low returns produce inadequate retirement income; working later in life is necessary

Game Changer 3: Evolving States of Trust

- Trust is mediated by the values, competencies, and transparency of our investment organizations
- Trust reflects a particular type of communication model: communicate early, fully, and often and to fill gaps in understanding
- To build trust, show some societal responsibility; deliver to expectations in competency and ethical practice; add consistent value
- Trust will rise in the industry if selection of future talent emphasizes strong values
- Trust will be influenced in future by innovation in technology—for example, blockchain technology distributes trust

THE TRUST EQUATION

Trust from an end investor is the *dependency on a service provider in a situation of risk over a prolonged period.*

The type of trust expected by an end investor is far more complex and tacit than the trust expected by the end user of most any other product, regardless of its type or business sector of origin. Its importance grows with the size of risks taken and the length of the term of the relationship—making it core to investment service delivery.

Trust and value in investment are interconnected. For the end investor, value will relate to perceptions of outcome relative to expectations. (In other words, do not think first of performance versus benchmarks as these do not represent particularly relevant expectations for most investors.) Value and trust are developed by an individual or an organization by building **credibility** and demonstrating **professionalism** as captured in the **"Trust Equation."**

CREDIBILITY

License to operate: End investors need assurance that their investment professional or organization is professionally accredited to provide the service needed to succeed.

Track record and experience: Can this individual or organization add value? Performance track records are important but there are other ancillary elements mostly concerned with quality assurances

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PROFESSIONALISM

Competency: The mix of competency attributes needed for an investment role varies. Subject matter knowledge, client listening skills, and problem-solving skills are very critical.

Values: Strong ethics and client-centric focus, where empathy and loyalty in putting clients first are critical; the values of a fiduciary are relevant, prudence and loyalty in particular.

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TRUST AND VALUE

The Trust Checklist for Organizations

At a simplistic level, a highly professional firm is filled with many highly professional individuals. To achieve this across an entire organization, however, a complex coordination challenge must be met, and its solutions require good culture and an appropriate business model to secure alignment to the necessary attributes of credibility and professionalism. Trust in the context of the investment organization spans a spectrum of critical attributes.

Transparency

Organizations should display "glass door transparency" of all things, including business processes, limitations of the investment process, risks, performance reporting, fees and their impact on portfolios, and potential conflicts of interest. They should be candid about the mistakes they have made and explain what steps they are taking to correct them.

Realistic Measures

Firms and their employees need to be realistically measured in relation to financial and non-financial goals over relevant time horizons. End investors are concerned with outcomes.

United Values

Alignment of values between firms and all of their stakeholders is critical. Organizations build their strongest trust by being aligned in their purpose, objectives, and way of working with those they serve.

Sustainable and Fair Rewards

Fees and rewards need to be fair and reflect the value clients receive. Trust will best be secured when there are incentives for agents to do their absolute best for their clients.

Time-Tested Relationships

Good relationships develop over time and allow the client to develop confidence. Research shows that people are much more trusting when working with consistent partners—a situation which offers a chance to build a good reputation through repeated interactions.

TOWARD GREATER SOCIETAL BENEFITS

Aspirations Align with Need

Making a consistent and determined contribution to societal wealth and well-being is not just a nice goal for the investment management profession—it is quite possibly a matter of existential importance. The good news: the research shows that investment professionals aspire to a more positive social contribution.

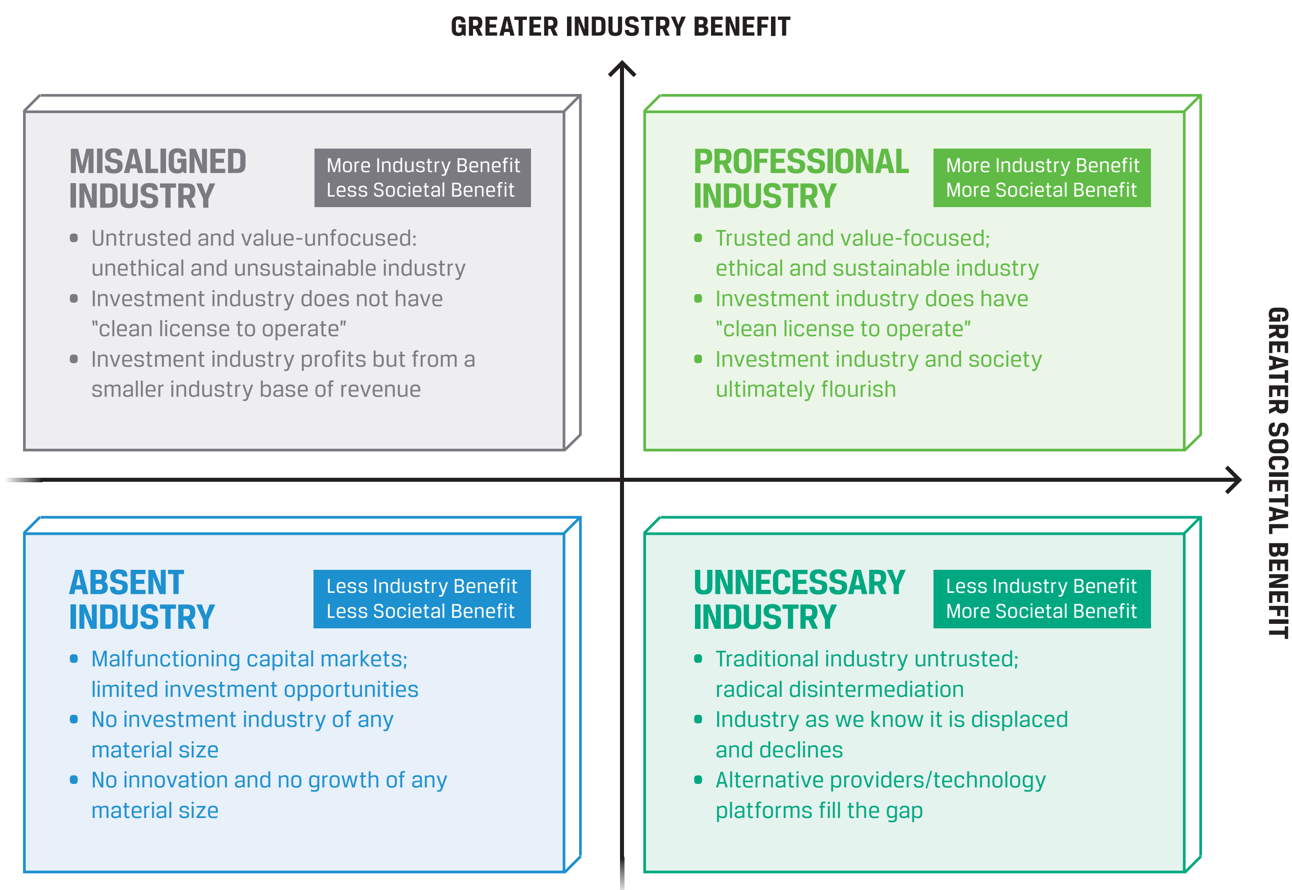
We offer below a model for creating a healthy investment industry by looking at the potential outcomes from the interaction of differing levels of industry versus societal benefit.

Potential for the Industry

11% **of investment leaders describe the impact of the investment industry as very positive for society today**

51% **of investment leaders expect the impact of the investment industry to be very positive for society *contingent on stronger principles***

FOUR STATES FOR THE RELATIONSHIP BETWEEN INVESTMENT MANAGEMENT AND SOCIETY



IDEAS TO MOVE THE NEEDLE TO A BETTER INDUSTRY

The research that underpins this report tells us that change is coming. We have anticipated how that change might play out in planning scenarios, and what state the industry could end up in depending on how well it adapts to change and to what degree it earns (or does not earn) widespread public trust.

We believe the following "to-do" list and a road map derived from it can be the first steps in the journey toward a future where a healthy investment management profession benefits societal wealth and well-being.

Professional Transformation: Identify What Is Needed to Go from Industry to Profession

An "industry" is defined by the circumstances of producing something of value to a consumer. A "profession" is different; it extends a license to operate to individuals and organizations that is granted and maintained by containing requirements for entry, standards of fair practice, disciplinary procedures, and continuing education for its professionals in conditions of an ongoing relationship. In doing this, the profession combines value and trust. The trust in this arrangement is of considerable value, not least because it creates the conditions for growth in wealth and well-being. The open questions are: How can the investment industry evolve so that it shares identifiable and key characteristics in the manner of medicine, law, and accounting? What is the current gap? What benefits could arise from filling this gap?

Fiduciary Implementation: Master the Meaning of "Fiduciary" in a Way That Can Be Effectively Implemented Even with Inherent Conflicts

Fiduciary responsibility in most jurisdictions means putting the interests of beneficiaries first when determining investment strategy, limiting conflicts of interest, and investing to the standard of care of a prudent expert. All investment organizations face the practical issue of balancing these requirements within the context of their own viability. CFA Institute will be conducting further engagement on how organizations should be dealing with fiduciary responsibilities and other issues where legal and regulatory frameworks are at potential conflict with the ambiguities and uncertainties endemic to the investment field.

Stronger Standards: Specify and Influence Culture and Practice with Regard to Values and Costs

CFA Institute successfully introduced standards for presentation of performance records in the form of the GIPS® standards. There may be other areas of practice that could benefit from such an approach. We cite standards for the structure and size of fees and costs as one possible idea. We also believe that the testing of new types of investment products could be the subject of standards in ways that draw on practices in other industries and professions.

Work toward Better Diversity

Diversity is desirable for a combination of cultural and financial values. Research suggests that diverse teams are better at complex decision making and that surface-level diversity issues, such as gender, have a first-level impact, but that cognitive diversity is more deeply impactful. CFA Institute is developing a mix of research, advocacy, and standards to support this developing field.

Leverage the Ecosystem

CFA Institute has more than 146,000 members worldwide, and this vast group is sometimes tapped to achieve a global view on a wide spectrum of issues. We are struck by the potential of networks empowered by new technologies to focus political and social capital in particular areas. Our membership can speak more powerfully for society's benefit through such a mechanism, particularly if it speaks with one bold voice.

A WAY FORWARD

We have put forward a number of steps and ideas by which the investment industry can realize its fullest potential, and we now encourage our members and industry leaders to act to make this a reality.

CFA Institute is committed to further consultation with leading industry figures on the following:

- Creating a road map for moving our industry to higher standards of professionalism, with its implications for fiduciary responsibility and for attaining the status of a profession
- How we can work together on the most pressing industry issues, particularly business models that capture purpose, trust, and value; cultural values that are inclusive; and technological competencies that streamline our industry
- How the CFA Program can maintain its edge in fast-moving industry conditions

The future is a choice to be taken by you applying foresight and coherent actions…not an outcome given to you reflecting uncertainty and compelled reactions

About the Report

In 2016, CFA Institute commissioned the Institutional Investor Thought Leadership Studio to survey members of the investment management profession for an overview of the current and future state of the profession. A questionnaire was distributed to two lists, one drawn from Institutional Investor's database, the other from CFA Institute. There were 1,145 responses (644 from CFA Institute) collected from 8–22 December 2016, with a margin of error of 2.9%. In addition, Institutional Investor conducted interviews with 19 executives in the investment management profession to obtain context and further details about the collected data.

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CALL-TO-ACTION FOR THE INDUSTRY

Start with Purpose
Enlightened self-interest

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Build the Talent
Values critical

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Plan for Disruption
Foresee the scenarios

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Produce the Value
Outcomes versus expectations

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Make Trust Happen
The biggest edge of all

CFA Institute

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials.

The organization is a champion for ethical behavior in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow.

CFA Institute has more than 146,000 members in 160 countries and territories, including 140,000 CFA charterholders and 147 member societies.

The CFA Institute Future of Finance initiative is a long-term, global effort to shape a trustworthy, forward-thinking investment profession that better serves society.

For more information, visit **www.cfainstitute.org/futurefinance** or contact us at **FutureFinance@cfainstitute.org** to offer your ideas about how to shape the industry for the future. We encourage you to cite this report using the link **www.cfainstitute.org/futurestate**

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