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Business comment

Real wealth creation benefits society as well as investors

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The active investment management industry is widely derided for producing little added value for clients. Active managers don't on average beat market indices, and indices can be mechanically replicated at minimal cost. So why pay more?

Let's return to first principles. What actually is "investment"? It's the productive deployment of capital in the expectation that over time it will create additional wealth for the investor. Where does this wealth creation come from?

It comes from using fewer resources to produce the same output, or the creation of a better-quality product than the incumbent, or a combination of the two. Additional wealth can accrue to society generally or to the individual, and for that reason is not always easy to measure.

The intangible can become tangible: an increasingly common line of thinking is that companies create wealth by operating responsibly and sustainably, and over time this benefits their owners as governments and consumers support them rather than confront them for their social and environmental shortcomings.

Similarly, why do we reference "the average" investment manager? The average manager works in a company that has external shareholders pushing them to hit ever-rising profit targets, which generally means trying to gain ever more assets under management.

As investment managers get bigger, it becomes more difficult to invest those assets productively (but no one worries much about it because senior management mostly get their bonuses based on increasing revenues and short-term profitability, not client outcomes).

The problem is that productive investment is a very different and more involved activity than simply trading in the stock market in anticipation of being smarter then the next person. Wealth creation takes a long time and requires patience, creativity, ideas and imagination.

It can't be measured by short-term share price volatility in a market dominated by speculators. Speculating in the market, on the other hand, takes no time at all and simply transfers existing wealth around the system based on the wild mood swings of its participants.

The average manager is far more focused on the stock market and on other investors than on actual investment. They spend a lot more time trying to anticipate what other investors are going to do than analysing how their capital is being put to work. Squabbling over returns rather than creating them. No wonder productivity growth is so lacklustre, and the average manager doesn't outperform. So why would anyone want to hire the average manager?

We in the "investment" industry need to ask ourselves what it is we're trying to do. Are we locked in a zero-sum game of trying to slightly more effectively free-ride on the creativity of others, or are we in the business of trying to create wealth in the first place?

Those of us who are actually investing need to describe what we do in entirely different terms than those we currently adopt. Sure, we should be able to outperform the average passive fund in the long run because the creator of wealth is always going to get more of it than the late-arriving free-rider. But that largely misses the point. What we should be talking about is how we are playing a key role in the stewardship of capital on behalf of investors who want to do something useful and productive with it, thereby benefiting society and in the process generating investment returns.

Actual investors think about real investment opportunities. For example, how do we respond to the coalescence of technologies – artificial intelligence, processing power, communications and digital miniaturisation, gene sequencing and editing, and robotics – that is overturning everything we think we know about healthcare? The robotic and gene-based technologies that can be used to hugely reduce the need for harmful pesticides in farming? The facial recognition software and network management skills that are completely bypassing the need for consumer banking in China? These days the vast majority of productive capital investment sits within a small number of companies who look far into their own future and are happy to embrace risk and experimentation, even sometimes in defiance of short-term external shareholders.

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Investment managers with a sensible investment horizon should pay a lot of attention to working constructively with management at those few companies, not trading in and out of their stocks and ticking governance boxes. The point is that a lot of wealth creation happens within the best existing companies, and sensibly encouraging this is a big part of the investment opportunity set. It's not just about making investments and hoping for the best, it's also about trying to help the best outcomes.

The excitement of creating something valuable is what investing is really about. Done well, it not only improves living standards now, but can do so in a way that increases living standards for people in the future through environmental and social progress. It is not about the analysis of patterns in stock markets, positions relative to index, or bogus arithmetical constructs that are simply complicated projections of the market's trading history. It's time to remember our original purpose.

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