Financial Services Council Speech -- September 2, 2011
Future Directions for Financial Services
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I was a little apprehensive about talking today. I received emails from a few friends noting the FSC email invitation was titled “Last Chance to hear Jeremy Duffield speak.” *The last chance to hear me speak!* That sounded pretty ominous. I mean it may be the last time you want to hear me speak, but I’m looking forward to hearing myself at least a few more times!

That John Brogden is a pretty clever guy. He pulled the oldest trick in the book to get a speaker to say “yes.” By asking me six months in advance, long enough that it’s going to be hard to say “no” based on my forward calendar.

At the time, world stock markets were well on the rise and it looked as though we were going to be in for solid economic growth and stable financial markets – with the worst of the GFC well behind us. As I envisioned it, I’d be able to be my usually optimistic self and talk about the nature of future growth in the funds and super industry.

But a couple of months later, our “winter of discontent” had set in. We should have all followed the famous Wall Street adage of “sell in May, go away.” Since early May, we’ve seen remarkable downward volatility and events (not the least of which, the S&P downgrading of US Treasury debt). And economic hopes have dimmed across the US, through Europe, Australia and even China. The ugly moods have set in. The pundits have raised their estimates of a second recession in the developed economies and there’s been a broad loss in investor confidence.

An industry friend described the environment for fund managers as analogous to being a “farmer four years into a harsh drought.” Good analogy. Doing it tough is standard stuff for the Australian farming sector but very unusual for us. Not only have our fund asset values suffered a pummeling but our investors’ confidence levels have hit such depths that fund net sales have gone negative. Distress on the land must be worse but

[1]Although I have a number of associations -- past and present-- one of the nice thing about being “retired” with a portfolio is that I no longer speak for anyone but myself and my remarks today should be taken in that context.

nevertheless this drought for fundies is no fun either.

When John first asked me to speak, I mistook the audience as the graduates of the FSC-Deloittes Future Leaders program, a great program aimed at developing our next generation of leaders. In thinking that I was going to be giving a "graduation" speech, I'd thought I might call it "The Future is What You Make Of It. Or is it?" I've decided to stick with that theme.

When I joined Vanguard in the US at the ripe ol' age of 25 back in 1980, I did feel that the "future could be what we made of it." I came in after doing research at the Federal Reserve on **the one** hot area of the mutual fund business, money market funds (or cash management trusts). The rest of the mutual fund business was a backwater of the financial services industry and virtually dead. Indeed Vanguard had just emerged from a period of 78 months of consecutive negative fund cash flows.

But in the tumultuous high interest rate period of 1980/81, Money Funds were breathing new life into a very modest industry. Mutual Funds were only owned by 8% of US households. Equity prices were depressed; gold prices soaring. The Dow Jones Average had made no net progress over the past 13 years.

We were so down, there seemed like nothing but upside. And the rules were pretty straightforward – having been laid out in the Investment Company Act of 1940. All we had to do was keep the customer in mind and compete to earn his or her business. For a variety of reasons – some pathbreaking retirement savings legislation and a turnaround in the equity market -- the industry took off and Vanguard took off at about twice the industry rate. We were "bull market babies" as Jack Brennan, the leader of my generation of Vanguard execs called us.

When I came back to Australia in 1996, in the early days of compulsory super, it also seemed like all blue-sky opportunity.

However, in 2011 Australia, in the fund industry, it's much less clear that "the future is what we make of it." It seems that our influence is moderated by two forces way beyond our control.

The Economic Environment Makes Our Future
The first force, the economic environment -- was never under our control. Today, increasingly it feels as though it's beyond anyone's control and will not be tamed. Rather, like a fever, it has to run its course, or kill the patient.

I mentioned that the problems of the late 1970s and early '80s seemed to tower over us. High inflation and interest rates were at the root of a stagflationary environment with stubbornly high unemployment levels and weak stock prices. But those problems proved to be curable with a strong dose of monetary medicine administered by the world's central banks led by Paul Volcker's Fed. That monetary discipline lasted some twenty years and brought core inflation and interest rates down to healthy levels, and let world economies grow and equity markets take off.

Today's worldwide economic problems are likely not to be so easy to cure. The known policy remedies have been tried and found wanting. And so many developed governments have run up such stockpiles of debt that the degrees of freedom for policy may not be there. Many governments are caught in a Catch 22. *We can't get out of our economic blues without more government stimulus. But we can't do more government stimulus because we have borrowed to the hilt already and unless we grow, more borrowing will not be tolerated. In fact, we must cut our deficits and our debt.*

Sounds like the definition of "stuck" to me and perhaps the recipe for an enduring sluggish economic environment for years to come, at least in the developed world.

My usual optimistic mindframe in past cycles has led me to count on "muddling through." Will we muddle through this time? Probably, but I'm not so convinced that we'll work our way back into robust growth anytime soon.

The good news is that stock prices are depressed with lower P/Es and very attractive yields – higher than govt bond yields – and with decent earnings growth albeit with uncertain long-term growth prospects. The bad news on the world stage is that the Western economies have a huge debt stockpile that will take years and years to return to a satisfactory position. On the Australian stage it's that we have a particularly undiversified economy and stock market and when the Lucky Country's luck runs out at the end of this commodity cycle (whenever that may be), it may be truly ugly!

Government Policies Make Our Future

The other force that Fund executives don't control is government policy with respect to our business. As economist Nick Gruen points out, financial services are a "joint product" between government and the financial services industry. You can't think about financial services without thinking first and foremost about the rules that govern financial services and how they might change. In effect, we have a joint venture going with the government.

Now, I'm often thankful that financial services are a joint product. Without compulsory superannuation, I'm not sure I would have found the justification to come back to Australia. And I think we're all proud of the bold birth of super 20 years ago under the Keating Labor Government. We think it's fundamentally good policy for Australians and Australia. The Global Pension Index developed by Mercer and the Australian Centre for Financial Studies confirms we have one of the best retirement systems in the world. And we're squarely behind Bill Shorten's big push to take super contributions up to 12%.

And no one denies the strength of the Australian regulatory system as being a key part of our relative success in surviving the GFC. We had good prudential controls; we'd learnt from previous mistakes; and both Coalition and Labour Governments have taken a thoughtful and collaborative approach to policy development.

But is the balance in the joint venture shifting a little too far?

If you step back and consider the policies just about to emanate from the various reviews, most notably, Stronger Super and FoFA, I think you'd have to say we may be at a watershed moment in this "public private partnership." The government is expanding its impact by stepping into the areas of product design (ie the default fund), definition of distribution practices and the regulation of elements of pricing, and deeply into delivery mechanisms as well through the SuperStream recommendations.

I certainly don't fault the sentiments of the policies; they are clearly trying to do the best for Australian super investors. And I thought the way Jeremy

Cooper and team and their successors have worked with the industry has been first rate; a great example of collaborative enterprise.

But I am concerned about the Government trying to take hold of the reins of industry innovation to quite such an extent. I worry about the rise of social engineering at the expense of free markets.

Much political thinking these days seems to be following in the footsteps of the behavioural finance researchers. The developing philosophy is that consumers should be allowed choice but a sort of "bounded choice," where they're encouraged to make smarter choices by default.

In Super, the strength of the behavioural economics pitch for reform is the recognition that a large group of super members simply doesn't have any interest or the capability to invest well. Fair enough. Good observation.

However, the argument leaps from there to an assertion that the current system is built on the premise that super members are rational, motivated participants and provides too much unbounded choice. And so it fails to optimally meet the disengaged group's needs. Further, competition isn't doing its job because current default options are differentiated over too many dimensions; so we need to modify the playing field to homogenize the default offer and encourage greater price competition.

The most articulate advocacy of this movement to turn behavioural finance learnings into policy is in the popular book Nudge by Dick Thaler and Cass Sunstein, both noted professors. The book suggests that just by tweaking certain policies you can get desirable outcomes for consumers without them even being aware they're being manipulated. They argue for a new movement based on what they call "Libertarian Paternalism."

Under Libertarian Paternalism, you steer consumers to good choices, while allowing a full range of choices to ensure no-one is denied a different choice if they prefer. Generally, I'm sympathetic to this thinking.

However, it's one thing to say consumers should have bounded choice but another step to say that industry competitors can only compete in a certain way – ie. You can only compete for default monies in this way….you can only sell your products in this way…you must operate in this way. At this point of industry-defining policies, I think perhaps we've moved from Nudge to Shove…and I start to get a little toey and concerned about collateral damage.

Look, despite these concerns, I generally support the recommendations from the Cooper review and FoFA. But I am uncomfortable with where we might be going, if we're presaging a more and more prescribed social engineering approach to industry competition.

I worry that there will be unintended consequences…..e.g., I wonder if default options – which are in fact already a very important element of today's superannuation funds -- won't in fact become devalued. I wonder if the government ever considered that FoFA might precipitate a wave of financial planner consolidation. Is that a good thing, the decline of independents?

I am concerned whether the government appreciates what taking two years plus to debate and implement "improvements" to the superannuation system does to the innovation efforts of private sector players? To what extent does Government innovation "crowd out" industry innovation? Industry cannot move forward with certainty while future rules and requirements are debated. There are drawbacks to government-imposed innovation.

To make change with impact, what we really need over time is disruptive competition focused on offering high value to clients. Is that most likely to emerge in an environment of constrained competition?

At the same time as these massive policy changes are being contemplated, fund executives face the huge uncontrollable risk of government change. We clearly have an unstable political environment, with a minority government and a deeply divisive opposition. Who knows when the next election will be, or what impacts it will have on our industry! It makes planning for the future very difficult. As with the economy, I'd say we face higher-than-usual political risk.

What Can We Make of Our Future?

Having bemoaned the cyclical nature of the economy and the strong hand of government, I must say there's still plenty for Fundies to be excited about as we move forward in terms of what we can control. It's rare indeed for an industry to be assured as we are of a long-term growth rate through compulsory purchases of our products. It's a cyclical business in a long-term growth market. Within the bounds set by government, we have the opportunity to compete vigorously to serve members.

I like to think about opportunities in the framework written up by Deloitte's Mehrdad Baghai in his terrific book, The Alchemy of Growth.[2] In this approach, you break down strategies and actions into three horizons, the first horizon being defending and growing core businesses, the second being growing emerging businesses or business lines, the third horizon being creating viable options for future growth. The key thing is that you are working to some extent on all three horizons and not just the current. You are in effect building a staircase to growth.

It's pretty clear to you what has to be done in Horizon One: competing for the day-to-day business, serving and attracting more clients through excellence in investment performance and service, seeking cost competitiveness through efficiency gains and/or consolidation, complying with changing regulatory requirements, building the quality of the team.

Horizon Two will depend on your own vision of the future and how you see your own company growing its staircase. For some it will be building out the financial planning capability, for others building out the retirement incomes product, for others enhancing the online offer, scalable advice or an international distribution effort.

But we should also always be investing some effort in Horizon Three enterprise activities, which are about creating options for the future and preparing for potentially dramatic changes in our industry. Watching what recent change there has been in other industries, particularly as the result of technological change, makes me wonder about the potential for much more rapid and disruptive change in our industry. What can the mobile phone, the Ipad, the Cloud, Social Networking and the App do to our business models?

Working As One

I've tried to describe the future as a mix of things that we don't control and things we have more control over. In these tough conditions, I think we need to muster our psychological and emotional resources. The sentiments

[2] Written (while at McKinsey) with Stephen Coley and David White

behind the Serenity Prayer seem appropriate for us:
Lord, give us grace to accept with serenity the things that cannot be changed, Courage to change the things which should be changed, and the Wisdom to distinguish the one from the other.

In a nutshell, the lessons are:
We can't change the economy; live with the cycles. Help our investors understand and live with them. Reconsider whether we've exposed them to too much risk. Help them tolerate them to the extent possible as well-chosen risks are likely to pay off in the long run.

The Government is crossing a bridge into a different definition of the strange "public private partnership" that is financial services. While we have activist government, we should recognize that and play a full role in negotiating outcomes. But always with the touchstone of what is likely to be good for consumers, competition and the country. If we're to live in this beneficent social compact where we benefit from a private delivery of what is seen as a social outcome, we must focus on meeting the government's objectives, as well as our consumers' and our own.

And we must accept compromise to maintain the integrity and cohesiveness of the effort. We cannot afford the hard-edged political divisions and failures to act that are hurting the US and Japan so badly.

But further recognizing our partnership, we should expect the government to help us to grow and improve our businesses. We should work assertively with them to help set the agenda. Our agenda needs to be developed over a multiple horizon view. A lot of things are in Horizon One. But we must also be working on Horizon Three. Helping us build capabilities to sell our wares offshore is a perfect such example. The FSC has been a leader in working with government on that and together we are making significant progress. There are others but building the payout phase of super has got to be a high priority. And that will take building out the Australian corporate bond market, which should become another priority.

And as for the things you control directly, I know that the Australian funds management and super industry has lodes of capability. And more than that, a good will, generosity, and a genuine concern for our clients. You will come through the current "unpleasantness" with honours.

I thought I might close with a benediction that sounds religious but isn't:

Every individual goes through periods when he does a lot of the right things and gets no immediate, tangible results. This the point where successful people bring to bear the powers of faith, patience, persistence and will. Faith is the ability to believe without any tangible evidence.[3]

Have faith. It's Spring, the Finals are about to start; we should look forward with optimism, even if it's a tempered optimism.

[3] Dr Bob Rotella, Golf is a Game of Confidence