

Innovation in Institutional Investment: Catalysts and Methods

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Innovation is very rare in our industry... with good reason.

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Prudent Person Rule → Herding, Peer Risk

Monopoly over Assets → Guaranteed Survival

Poor Compensation → Career Risk, Capability

Poor Governance → Bureaucracy, Resourcing

Consultant Businesses → Misaligned Advice

Focus on Efficiency → Tension with Innovation



So what!?

Do we really even need
innovation?



Theoretically, Plenty of Long-Term Capital

\$70,000,000,000,000

(Note: That's actually a conservative estimate. Seriously.)



Short termism is endemic

1 Investors' Focus Has Become Short-Term



Source: LPL Financial, NYSE 08/06/12



Lack of Investment Dollars for Critical 'Projects'



Financial services is capturing too much value...



... while distorting incentives.



Challenge of Traditional Model of Institutional Investment:

The tables are tilted too far in favor of the third party asset managers:

- Where manager transparency is difficult to achieve, institutional investors will almost certainly be “gamed” on fees (Foster and Young, 2010).
- Phalippou (2009) argues that the confusing nature of management contracts allows GPs to charge high fees for low average performance.
- Robinson and Berk (2013) show that managers with higher fees do in fact generate higher returns, but the additional returns are not shared with LPs.
- Lots of papers show the incentives that standard compensation contracts give managers allow them to manipulate returns (see Starks 1987; Carpenter 2000; Bebchuck and Fried, 2004).



Let me sum up ...

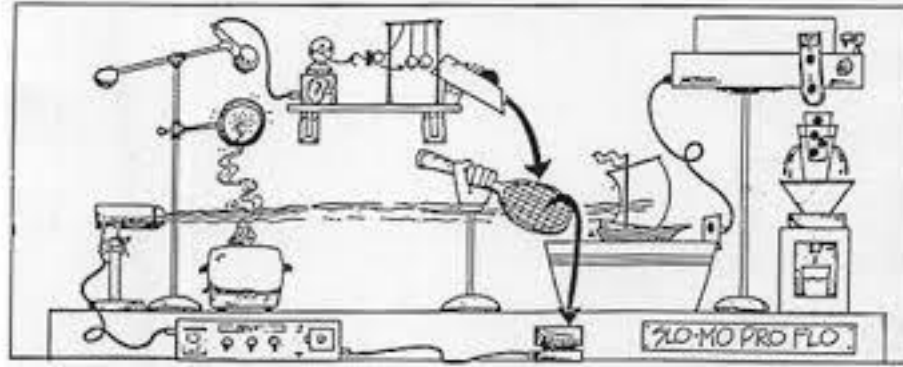
- ❑ There is A LOT of theoretically long-term capital in the world in pensions, sovereign funds, endowments, foundations, family offices, insurance companies, and so on
- ❑ But these long-term investors are investing over shorter and shorter time horizons
- ❑ This behavior is odd, as it rejects some of the key advantages of a long-term investor (time and scale) and plays into the hands of financial intermediaries (hence the high fees earned)
- ❑ And this leaves critical projects for the future of humans un-funded
- ❑ So... yes... we do need innovation in institutional investment.



Back to basics: The production function of returns...

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Looking outside-in a pension fund....

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Living inside a pension fund....

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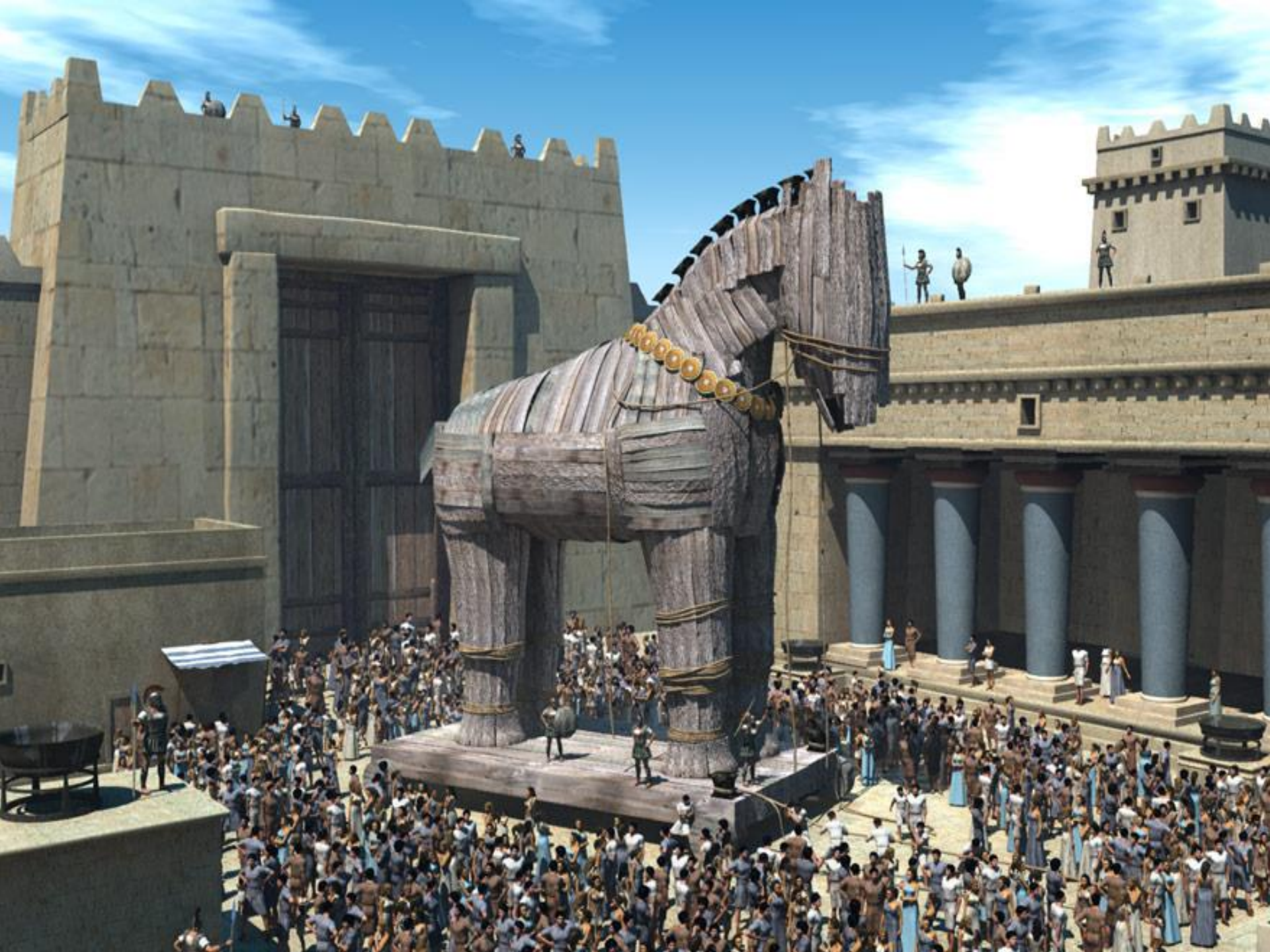
Our research at Stanford is focused on improving the production function of investment for long-term investors, which, we hope, will better align long-term capital with critical long-term projects.

Our focus is on institutional-investment innovation that can re-root long-term institutional investors in the *real economy*:

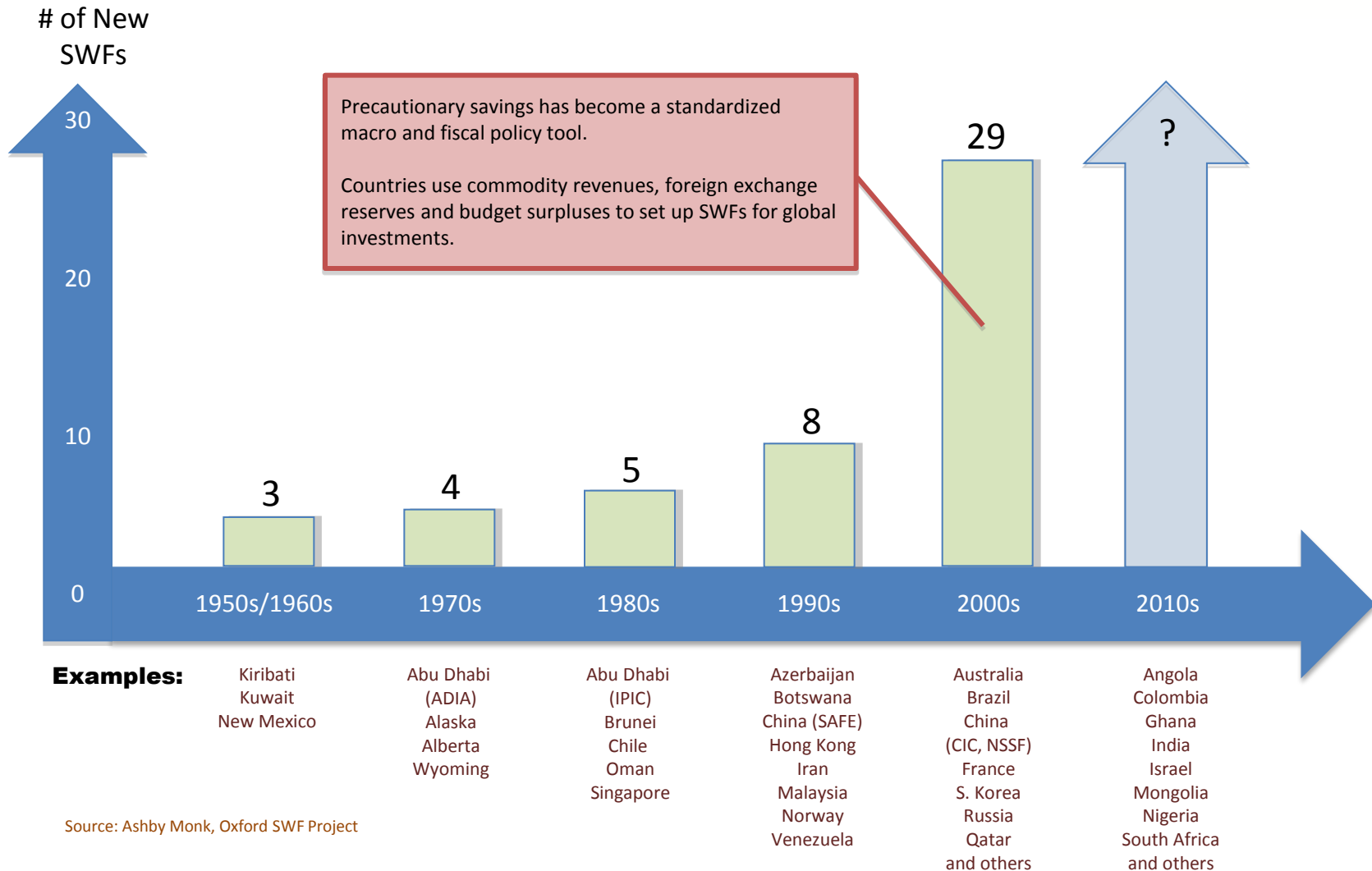
Specifically, this leads us to four categories of research, which we believe will help improve the return production:

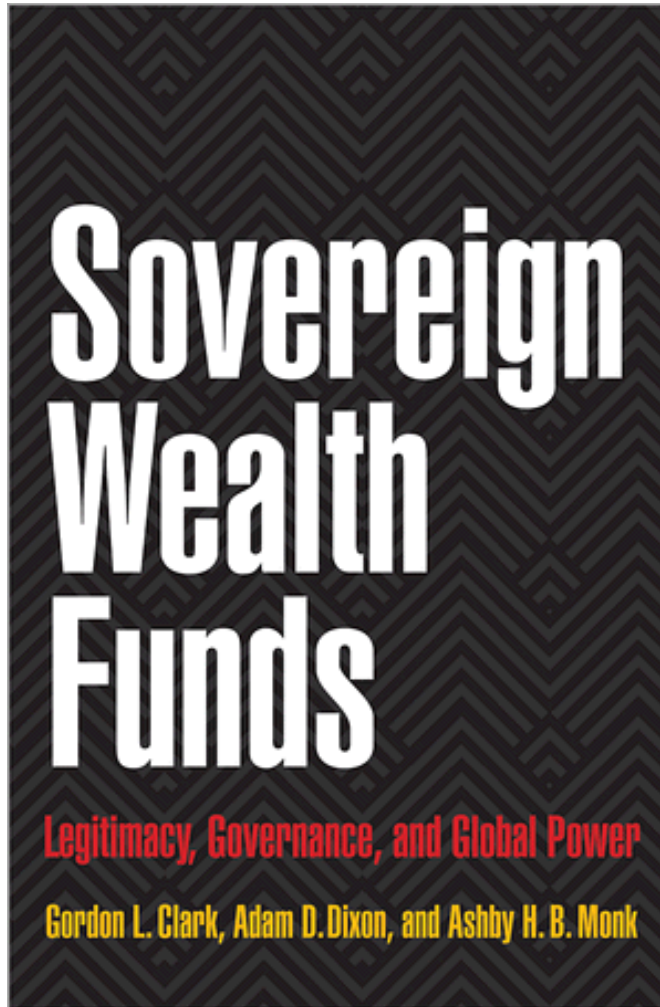
- ☐ Professionalization of AOs
- ☐ Re-Intermediation of AMs
- ☐ Conceptual Innovations
- ☐ Technological Adoption





A large, and growing, blank canvas...





*“This is the best book
I’ve ever read in my
life.... a real page
turner!”*

said nobody.



Blank canvas, yes. Agent for change? Not necessarily...

The FCA fined State Street £22.9 million in relation to the overcharging of six clients, including the [National Treasury Management Agency](#), for whom the NPRF manages assets. State Street fined the NTMA following the discovery

Goldman Sachs Group Inc. (GS) made about \$500 million arranging three bond sales in the past year for 1Malaysia Development Bhd., the state investment fund led by Prime Minister Najib Razak, said a person

Now, three years after the rise of the Libyan Revolution, a London court is reviewing documents, seen by *Forbes*, in a case brought by the Libyan

Investment Authority (LIA) claiming that Goldman Sachs abused their financial services as the Libyans were

“F—k your mother,” Mustafa Zarti, Chairman of the LIA, screamed at two of Goldman Sachs’ bankers in Tripoli in mid-2008, after he came to believe he had been taken for a fool. “F—k you and get out of my country,” he yelled at the Western bankers, after telling them he could “come after their families,”





2.0

Fees and Costs



Dis- and Re-Intermediation



A new paradigm; pensions actually care about fees? Really?

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N.Y. / REGION

Wall Street Fees Wipe Out \$2.5 Billion in New York City Pension Gains

By PATRICK MCGEEHAN APRIL 8, 2015

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Share

Tweet

The Lenape tribe got a better deal on the sale of New York City's pension funds have been getting according to a new analysis by the city comptroller.

The analysis concluded that, over the past 10 years, the city has paid more than \$2 billion in fees to money managers who have received virtually nothing in return. Comptroller

Public Funds Take Control of Assets, Dodging Wall Street

By NATHANIEL POPPER AUGUST 18, 2013 2:11 PM 65 Comments

Investors responsible for more than \$2 trillion recently gathered at a resort in the Canadian Rockies, far from the news media and, more important, far from Wall Street.



Last updated: March 4, 2015 3:41 pm

Fees matter more than asset allocation

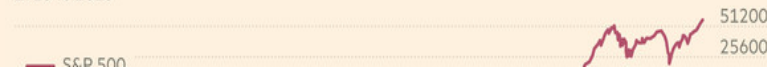


John Authers

Investment strategy study confirms importance of cost control

Real Returns

1913 to 2013



LATEST

Next week

Bank of

S&P 500

S&P 500

**New focus on fees is not only affecting asset managers operations...
It's affecting asset owners operations!**



A better understanding of the fees and costs is akin to a better understanding of the ingredients in your food... we need investors focused on “organic finance”!

Try Organic Food

***...or as your
grandparents
called it,
“Food”***



Key drivers of innovative behavior today and into future ...

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Fees and Costs



Dis- and Re-Intermediation

High Return Targets

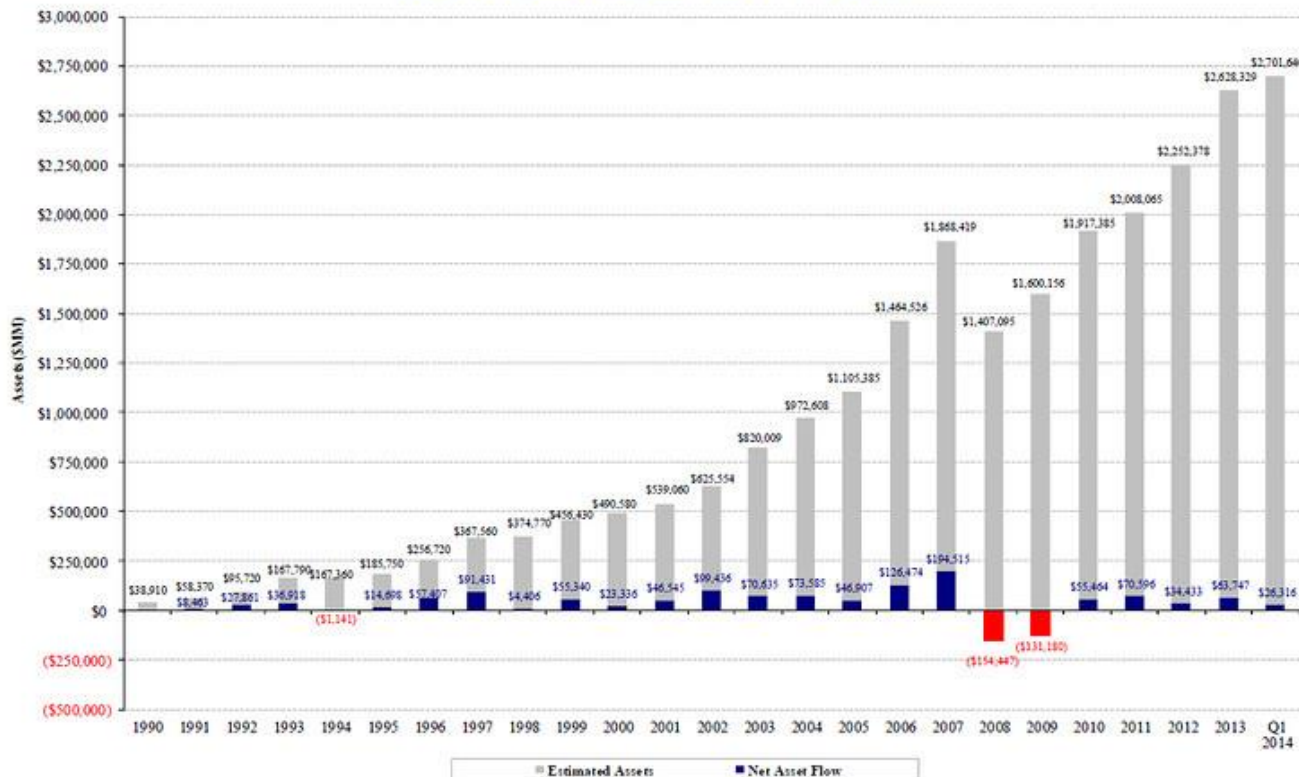


Forced Risk Taking / Over-
reach?



Reaching for yield...

Estimated Growth of Assets / Net Asset Flow
Hedge Fund Industry 1990 – Q1 2014



Bad kind
of innovation



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Dis- and Re-Intermediation

High Return Targets



Forced Risk Taking / Over-
reach?

Low Return Environment



Using Competitive Advantages



Using your unique advantages...

University of California proposes creation of new venture fund to invest in UC innovation

UC Office of the President

Monday, September 15, 2014

Home > Investment > AustralianSuper brings it in-house

AustralianSuper brings it in-house



The \$46-billion industry-superannuation fund, AustralianSuper, has started the search for a senior portfolio manager to head a new internal equity-management team.



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Fees and Costs → Dis- and Re-Intermediation

High Return Targets → Forced Risk Taking / Over-reach?

Low Return Environment → Using Competitive Advantages

Data and Tech → Unraveling Complexities



You may be surprised who gets replaced by robots...





❑ Move 37 (Game #2) and **semantic discovery**:

“That’s a very strange move,” said one commentator.

“I thought it was a mistake,” said the other.

“So beautiful,” Fan Gui kept saying. “So beautiful...”

❑ True Understanding of Complexity is coming...



Will you survive the robot invasion?

❑ *Frey and Osborne* study (2013, with 2010 data): 47% of US employment

❑ Likelihoods of replacement by machine intelligence in next 10-20 years:

▪ Financial Examiners	17%
▪ Actuaries	21%
▪ Financial Analysts	23%
▪ Financial Specialists, All Other	33%
▪ Economists	43%
▪ Market Research Analysts	61%
▪ Accountants and Auditors	94%
▪ Budget Analysts	94%
▪ Credit Analysts	98%
▪ Loan Officers	98%
▪ Brokerage Clerks	98%
▪ Insurance Claim and Policy Processing Clerks	98%
▪ Insurance Underwriters	99%



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Dual Objective Investing → New Successful Strategies



“We believe our purpose as impact investors is to earn an attractive return by funding positive transformation.

“The best founders want to radically change the world for the better.

“ It doesn’t matter whether everyone agrees with the entrepreneur about the world-historical nature of the project – if the entrepreneur seeks an impact beyond his own payday and can convince employees of the same, the project is much more likely to get done.

“Early in a company’s life, an entrepreneur can make enough money to satisfy his own needs (though often not much of a return for the investor); to take a company from \$50 million to \$50 billion requires singular vision and dedication. “Wild-eyed passion is not a bad thing by any means.”



Wise words from a successful impact investor...

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Impact Alpha isn't a new concept...

TEMASEK HOLDINGS

18% IRR over 40 years



KHAZANAH
NASIONAL

13% IRR since 2004 reform



“Investing For Development”

16% IRR since 2004



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Fees and Costs



Dis- and Re-Intermediation

High Return Targets



Forced Risk Taking / Over-reach?

Low Return Environment



Using Competitive Advantages

Data and Tech



Unraveling Complexities

Dual Objective Investing



New Successful Strategies

Collaboration



Sharing, Pooling



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TIAA-CREF, AP1 & AP2 Create Strategic Joint Venture to Invest in European Office Properties

Joint venture, established and managed by TH Real Estate, to create a leading, pan-European office platform committed to building €4bn+ office portfolio

CalSTRS, Dutch manager team up for infrastructure

Alliance to focus on energy projects in North America

MARKETS

Canada's Omers Ventures Raises \$199 Million in New VC Funding

Ontario Municipal Employees Retirement System venture capital arm taps Cisco Systems, BMO



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Trigger

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Sharing, Pooling Platforms

New Resource



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