2 LESSONS FROM 2020 AND CHALLENGES AHEAD

KEY FINDINGS

OPERATIONAL LESSONS FROM 2020

1. The fundamental importance of risk management

- Firms' increasing focus on risk management since the Global Financial Crisis (GFC) in 2008 has played an important role in helping them navigate the most recent crisis.
- Liquidity management is particularly under the spotlight, with industry and regulators in the UK already considering the issue in the context of a number of concerns, including previous suspensions of commercial real estate (CRE) funds.

2. Resilience and the necessity of investing further in technology

- The coronavirus pandemic has meant that firms have needed to shift to a working from home (WFH) operating environment at unprecedented speed and scale. The transition has been relatively smooth and is a reflection of both a committed workforce and investment in technology.
- Firms stressed the importance of continued investment in technology as it is likely that the workforce will be split between the office and working from home for the foreseeable future.

3. The growing significance of the D&I agenda

- Improved diversity and inclusion (D&I) are high priority themes for the industry, give further impetus by events during 2020. In addition to the operational benefits that D&I brings to company performance, it is increasingly important that the industry better reflects its customers and wider society.
- There has been increasing focus on gender diversity over the last few years but recent events in the US have brought more focus on ethnic diversity within the industry.
- A more holistic approach to diversity is needed with many firms beginning to look at the interconnectedness between different aspects of identity.

WIDER CHALLENGES AND OPPORTUNITIES

1. Defining a clear role for industry in the economic recovery

- As the UK continues to navigate through the social and economic impacts of the coronavirus, there is an expectation that the financial services industry needs to make a strong contribution to the UK's economic recovery. This includes the investment management industry's role in recapitalising listed UK companies.

2. Delivering value for customers in a difficult economic environment

- Regulatory changes in recent years have centred on delivery of customer value through greater price competition, alignment of interest and transparency. The debate on value is also now focusing on product development, including how to give investors access to investment opportunities in less liquid asset classes, particularly given the pressure on income.

3. Setting the agenda for responsible and sustainable investment

- Covid-19 has focused the minds of investors on the importance of responsible investment with interest in social impact investments in particular increasing. IA data point to exceptionally strong inflows of new retail investment, while fund performance has also been extremely strong.
- The data collected in the Survey this year is based on the IA's framework published in late 2019. We found that 38% of total AUM applied ESG integration and 19% applying exclusion policies.

4. Enhancing UK international standing in the context of Brexit

- Firms have been preparing for a range of scenarios in the Brexit negotiation process for the last few years, however there remains concern around delegation rights.
- Looking ahead at how the UK can maintain its global competitive advantage over the long term firms identified city clusters and access to talent as key features of the UK investment management industry. However there is some concern that in the last few years certain regulation has made the UK increasingly unattractive for international firms.

In recent years, the industry has been going through a period of accelerating change, driven by a range of factors, notably:

- Policymaker and regulatory expectations

- The evolution both of customer needs and the wider economy

- Industry innovation and product development.

As we set out in Figure 6 the operating environment is now also characterised by very significant uncertainty given the challenge through 2020 of a global pandemic. While most firms have made the necessary preparations, the impending end of the Brexit transition period also presents its own set of challenges.

In our discussions and interviews with firms, we asked particularly about initial lessons learned from the pandemic and challenges ahead in the context of the wider changes already affecting the industry, its customers and the economy. What they told us falls into seven broad themes, three particularly focused on operational lessons, and four broader sets of challenges and opportunities:

Operational lessons

1. The fundamental importance of risk management

2. Resilience and the necessity of investing further in technology

3. The growing significance of the Diversity and Inclusion (D&I) agenda

Wider challenges and opportunities

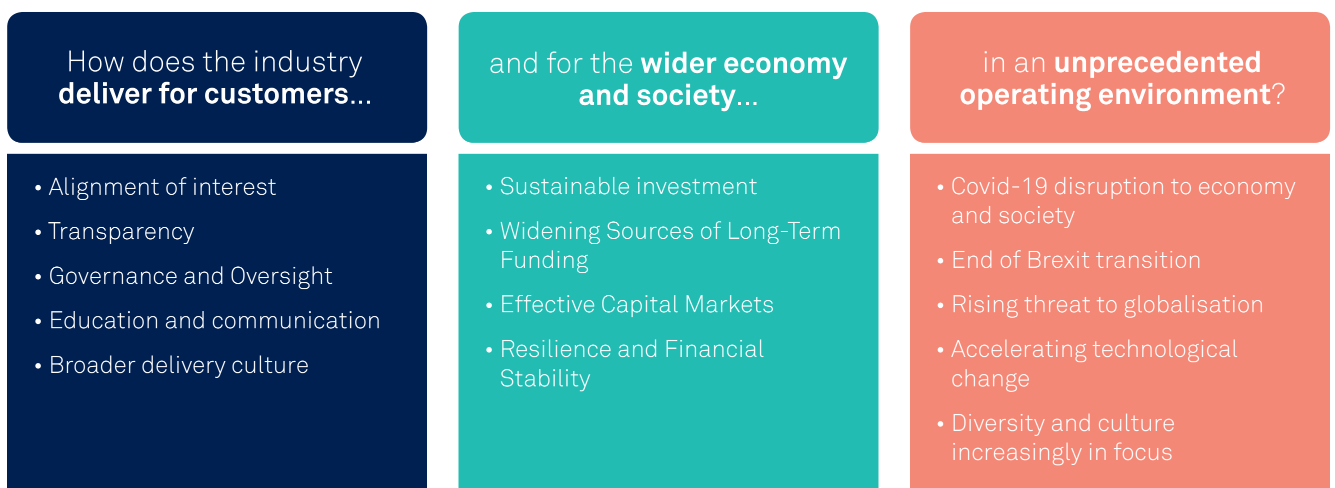
1. Defining a clear role for industry in the economic recovery

2. Delivering value for customers in a difficult economic environment

3. Setting the agenda for responsible and sustainable investment

4. Enhancing UK international standing in the context of Brexit

FIGURE 6: A THREE-PART SET OF POLICY AND REGULATORY THEMES



1: THE FUNDAMENTAL IMPORTANCE OF RISK MANAGEMENT

While the Global Financial Crisis (GFC) of 2008 was heavily linked to activities in the banking sector, it highlighted the importance of risk management across financial services. In the decade that has followed, this theme has since become even more firmly embedded in firms' governance processes, not least in response to market and broader economic conditions that continue to be characterised by ongoing record low interest rates and unconventional monetary policy.

IA members have stated that this increased focus on risk management has played an important role in helping them navigate the most recent crisis. From investment in risk management technology to war-gaming exercises to map out the impact of tail risk events, all contribute to firms' preparedness and resilience through crises.

"The lesson is that the next crisis never looks like the last one. The fallout from this is very different – it's more like a natural disaster in many respects. It's a reminder that the funds we manage for clients have to be prepared for all eventualities. It has reinforced our view that risk management and having really robust analysis and technology is a necessity not a luxury. We have the ability to pull apart our portfolios because of our risk management technology and to truly understand everything about them."

"The biggest lesson is around consideration of severe tail risk events. We had done an executive roundtable exercise on cyber-crime scenarios a few months before the lockdown which was helpful. The time you spend on resilience of extreme events and mapping those through is the biggest lesson for our business. We are fortunate in being a globally distributed business and we were able to learn lessons from China which allowed us to develop those scenarios very quickly. That ability to share learning and adapt accordingly has been fantastic."

One particularly significant element here is liquidity management, which was already high on the industry and regulatory agenda in 2019. A combination of concerns, including the experience of commercial real estate (CRE) funds following the Brexit referendum result in June 2016, led the Bank of England Financial Policy Committee (FPC) to initiate a workstream with the FCA to look at how to address potential liquidity mismatch within investment funds. The duration of this work has now been extended to take into account market experiences in March 2020 during the early stages of the coronavirus pandemic. For its part, the industry is also doing extensive work on liquidity management frameworks, including measurement and disclosure. Some of the wider implications for access to illiquid asset classes are covered in later sections of this chapter (see p.33-34).

A broader aspect of risk management is the perceived importance among many larger firms of a diversified business model. For some, that message has been reinforced by the experience during Covid-19, but it is not a new theme, nor is it clear yet whether the consequences of Covid-19 will further drive consolidation in an industry that has long been characterised by comparatively low barriers to entry and successful specialist firms.

"Our business has stood up extremely well. There is a lesson around diversification, you don't want all of your eggs in one basket in terms of both client type and investment strategy. Our business is very robust because it is diversified."

As we set out in Figure 6 the operating environment is now also characterised by very significant uncertainty given the challenge through 2020 of a global pandemic. While most firms have made the necessary preparations, the impending end of the Brexit transition period also presents its own set of challenges.

"One challenge is continued fee pressure and a focus on value for money, particularly in a low interest rate environment. The increased regulatory burden combined with continued fee pressure will trigger further consolidation in our industry. Scale matters more than ever both in terms of trying to capture efficiencies and price accordingly but also because you need resources to be able to respond to the demand for sustainability and operating in complex markets."

2: RESILIENCE AND THE NECESSITY OF INVESTING FURTHER IN TECHNOLOGY

After a period in which senior industry figures have been significantly emphasising the importance of investment in technology, it is clear that Covid-19 has seen some of that investment substantially pay off. While not complacent, the general view within the investment management industry is that the unprecedented speed and scale of the shift to remote working during the pandemic has resulted in a highly effective operating environment. This is seen as a reflection of a combination of a strong and committed workforce and the quality of the technological infrastructure.

"I'm enormously proud of the people I work with. Everyone has demonstrated such strength and resilience, continuing to serve clients in a first-class way, whilst adapting to new and often challenging circumstances on the home front. The quality of our people has manifestly been a contributing factor to our success."

"Technology has been instrumental in enabling us to work remotely, keeping the error count low and driving incredible efficiencies across our operating platforms."

At the same time, firms are in different places along the spectrum of technological change, and this is increasingly seen as a source of competitive advantage or, conversely, disadvantage.

"Technology will be the single biggest differentiator between companies that understand it and do well and those that don't. There have been significant advances in use of technology for risk management in terms of data aggregation and concentration risks- things that have occurred through Covid-19. Fund managers, risk managers, operations and marketing teams who harness technology can do a better job as it enables better insights. In an industry that is continually compressing fees, tech is your only answer in remaining relevant and able to compete."

Firms stressed the importance of continued investment in technology and the crisis is also accelerating industry thinking about future approaches to client communication and distribution: for example, the importance of shifting away from paper-based disclosures towards more innovative digital disclosure which should lead to greater innovation and customisation in the space.

"We have been investing in technology for 15 years and it's times like this you realise the wisdom of that investment. It allows you to continue to serve clients seamlessly. Our performance has held up extremely well. We've been able to work almost completely remotely and operational errors have been mostly very low."

In terms of the wider implications of remote working, a debate has already started on the future world of work. This is likely to take some time to work through. There are clearly significant advantages of more remote working, with some employees benefiting from greater time flexibility and reporting increased productivity. Certain activities, including sales, may even be accelerated with the ability of using video presentations to achieve greater reach and scale. IA members are looking at how the working from home (WFH) period could be leveraged to accommodate a more balanced lifestyle for their employees.

At the same time, some firms made a number of observations about the limitations of remote working, notably challenges for team-based work and the dependence on strong local communication and data infrastructure, which is not universally the case in the UK. During the pandemic there has been a growing focus on mental health as employees adjusted to isolated living and working conditions. IA members have introduced employee assistance programmes (EAPs) with many organising mental health awareness staff groups.

"Because everyone is working from home the real challenge as corporates is we don't own the last mile. A lot of this hinges on peoples' individual broadband connections. For this to continue, this will need to be very consistent across the UK and other parts of the world. If it's not consistent that is potentially creating risk for your business but it is not a risk we can control."

It is likely that for the foreseeable future the workforce will be split between the office and working from home. This has an impact on culture in particular as more people move back to working in the office there is a risk that those who continue to work from home could feel less included. This brings challenges for leaders who will need to manage effectively across both populations.

"There are lots of people returning to work. There are certain things you can do very well from home, but team based work is hard. It's hard to brainstorm virtually. Practically, if some form of social distancing has to be applied for longer, it may mean more office space rather than less because we can only fit in a quarter of staff based on current rules."

3: THE GROWING SIGNIFICANCE OF THE D&I AGENDA

The issues around diversity and inclusion (D&I), and lack thereof, have tended to come to the fore during recent crises, albeit for different reasons. Since the GFC, a growing body of academic research has highlighted the role that groupthink played in destabilising the financial system. D&I is a key indicator of culture and diverse workforces allow firms to have access to a broader range of views that can open up necessary challenges and discussions to ensure better outcomes.

"The science is irrefutable on this point – there is sound academic research explaining why you make better decisions with a diverse workforce with different points of view. To have a good culture, you need a diverse workforce."

However, this operational set of considerations is overshadowed by the growing imperative to ensure that the investment management industry is better reflective of the customers and wider societies it serves. This development is seen at multiple levels, focusing initially on gender diversity but increasingly on ethnic diversity.

"Diversity has been a key topic for this industry for a long time because if you want to be relevant in today's society you need to reflect the customers that you're acting on behalf of as a fiduciary. The industry needs to do a better job."

2

GENDER DIVERSITY

Gender diversity has taken centre stage in recent years with a number of initiatives in place to tackle the issue within the industry. The mandating of Gender Pay Gap (GPG) reporting has meant that firms with over 250 employees have very publicly had to declare their GPG positions and as such have been forced to focus on the drivers of the high gender pay gap. By and large, many firms highlighted the underrepresentation of women in senior risk taking roles as the primary driver.

Although the gender pay gap reporting deadline for 2020 was suspended due to the coronavirus pandemic, gender equality and closing the gender pay gap remains high on the investment management industry's priorities. In May 2020 the IA launched the 'Addressing the Gender Pay Gap: Industry Initiatives' report, which looks across the IA membership and showcases innovative initiatives focused on recruitment and attraction as well as retention and advancement.

Many firms have come a long way on gender balance in graduate recruitment which will take some time to work its way up the pipeline into senior management roles.

"We make sure that the list that executive search firms come up with are more diverse and interview panels are more diverse. The more diversity you create in hiring processes the more likely you change who you hire. From a gender perspective, we have hired 50/50 in the last 12 months but a lot of that came from how we're sourcing and who we're putting on the interview panel."

"What we've done with women is fixing the bottom level intake but that takes years to flow through into senior leadership positions. We set up a returners programme for the mid-level roles with good talented women who have taken career breaks."

A diverse workforce is not enough. Firm are also conscious of the need to foster inclusive environments to empower diverse groups, who in many cases are in the minority, to challenge the majority view. This is where culture can play a crucial role. The view of those that we spoke to was that the Covid-19 move to flexible working, particularly working from home (WFH), may help mitigate some of the retention issues among women and also help in attracting a wider pool of candidates. At the same time, there is also an awareness in the industry that WFH carries the possibility that women will be disproportionately affected by caring and family responsibilities, with a potentially detrimental not positive impact on work.

"The one wonderful thing that WFH does is level the playing field from an inclusion perspective because it is forcing us to be more flexible with time. There has always been a stigma around flexible working and WFH. That whole debate is going away. The opportunities for offering people flexible working arrangements are greater and will help us tap into a more diverse pool of people who would not otherwise have applied."

ETHNIC DIVERSITY

In the midst of the coronavirus pandemic, the world witnessed the tragic death of George Floyd and the subsequent political movement in defence of black lives garnered support across the world. The events provoked conversations around race with a number of firms publicly acknowledging that as an industry we have a real issue with black representation. The IA's 'Closing the Gap' report highlighted the importance of measuring and monitoring key metrics in order to assess progress. One of the issues around black representation is that historically the industry has looked at data on Black, Asian and Minority Ethnic (BAME) as a collective, which has masked the underrepresentation amongst the black community. This focus is starting to change. The IA published in 2019 a seminal report, Black Voices, on the issue and firms also stress the need to do more, particularly starting with good data to clearly target the problem.

"We've looked at data comparing the investment management industry to the population across various areas of diversity. We're not underrepresented in LGBT and Asian staff but we have a big problem with women in senior risk taking roles and black talent. The BLM movement has focused our minds and highlighted that we haven't put the same energy into that problem. We've dealt with diversity very broadly but we haven't really challenged ourselves on black representation."

"Data is the challenging one - particularly with ethnicity. One of the challenges across the industry is the notion of self-identification. It has been much harder to move that issue forward because we don't have very clear data. If you have a dataset that is saying you're not doing a very good job, that will incentivise action."

Many firms are also now approaching diversity within their organisations more holistically and some are beginning to look at the significance of intersectionality (i.e. the extent to which aspects of a person's identity, such as gender, race, sexuality, class, might combine to create unique modes of discrimination and privilege) and are taking steps to create an inclusive working environment that will address diversity across the board.

"We are trying to get our heads around how you create an all-encompassing view of D&I. We need to focus on the end objectives and outcomes as opposed to initiatives focused on singular issues. That is the only way you can objectively monitor and measure and hence achieve the right outcomes."

"It's about trying to get a holistic picture of diversity. Investment managers do fundamental bottom up research, we should be able to throw the proper intellectual analysis at this in a disciplined way."

WIDER CHALLENGES AND OPPORTUNITIES

Alongside these lessons from the direct experience of operating through the Covid-19 pandemic to date, firms also identify four key challenges looking ahead to 2021-2022

1: DEFINING A CLEAR ROLE FOR INDUSTRY IN THE ECONOMIC RECOVERY

As the UK economy starts to take the first steps to recovery after the violent contraction of the first half of 2020, different parts of the financial services sector are examining how best they can provide support. Senior figures we interviewed are acutely aware of the expectations of financial services, including investment managers, and recognise the need to play a pro-active and visible part in the recapitalisation process and the path back to recovery.

"This is an opportunity for the industry broadly to reinforce its purpose. Whether it's serving pensioners and savers with income at a time when income is scarce or providing long term capital for companies in this country and abroad. Demonstrating the value of having a large and successful investment management industry that invests for the long term and helps people meet their savings and retirement goals is an extraordinary opportunity."

"We must make sure we give back in this environment. It's really important that we don't just hunker down and we are aware and stay connected with our stakeholder base. We're very fortunate, we can WFH. We don't have place based work, we're not teachers in schools and we're not pilots. We own restaurants, we don't run them. We should consider ourselves very fortunate."

For the investment management industry, the most visible source of that support is through the recapitalisation of listed UK companies. At the time of publication, UK companies had raised over £14 billion, primarily in private placements, since early March. This process is expected to continue, and likely accelerate through the rest of 2020 into 2021. Investment managers, alongside other institutional and retail investors, play a critical part, and also exercise significant corporate governance oversight.

"Our industry is a source of long term capital. There is a whole range of economic activity that can be funded by the judicious and intelligent use of very large pools of capital, ranging from SMEs to large, dividend-paying FTSE100 companies. When put to good use, that should benefit the economy and provide jobs and investment. That is the most important thing we can do as an industry."

At the same time, the investment management industry is constrained ultimately by the fact that it is primarily investing the money of its customers, to whom it owes a fiduciary responsibility. Managers are acutely conscious of the need to balance that responsibility with the wider role they are expected to play in supporting investment and long-term economic growth.

"We will have to demonstrate that we are playing an active part in the UK economic recovery while being fiduciaries to our clients. I don't think those two things are contradictory and in fact they support each other. There are going to be terrific investment opportunities for clients that also support the recovery."

"Investment managers have to balance delivering outcomes and fiduciary responsibilities to investors with supporting growth in companies in the economy. The tension between those two things in the next few years is going to be many multiples of what it has been in the last few years because of the enormous amount of recapitalisation, the enormous demand for income in a zero interest rate environment and the demand for solving pensions gaps all over the world in a time when retail customers cash flows are likely to be constrained. The question in all those things is why do we need the industry? It's to do all those things and to deliver those outcomes. This kind of environment shows how hard that is to do and the criticality of getting that right as an industry going forward."

INCOME AND THE ROLE OF THE DIVIDEND

In the context of weak economic growth, the challenge of whether to maintain or cut dividends has been a particularly significant and sensitive issue for companies and investors. As countries began declaring national lockdowns, companies were facing huge hits to their revenue streams. At time of writing 390 UK companies have taken the decision to cancel, defer or reduce dividend payments in the short term (approx. £32 billion in value) in order to retain cash needed to protect their businesses for the long term. Payout forecasts for FTSE 100 companies have been adjusted down from £91 billion at the start of the year to £62 billion by the end of Q2 as a result.[9]

The decision regarding dividend payments is a delicate one. As well as a significant component of total return, dividends are an important source of income for both retail savers and institutional investors, including pension funds and charities. The IA letter to FTSE 350 chairs expressed the industry's view that companies should take a prudent approach to current and future dividend payments, understanding the company's ability to withstand financial stress and ensuring that employees and suppliers can be paid, while not unnecessarily reducing or rebasing the dividend level.

For those reliant on dividend income to meet their liabilities it is likely they will need alternative sources of income as interest rates are likely to remain suppressed and bond yields remain low. However, opportunities are limited, which raises significant questions about the extent to which investors are prepared to take additional risk in areas such as credit, particularly in an environment where central bank interventions may be having a significant impact on current valuations. After over a decade of record low interest rates, the 'hunt for yield' has already been a central driver in the growth of private markets, as we explore further in Chapter 3.

"Certainly, there is a need for income and not that many ways to get it. You've got equity dividends, property rental and credit. Property and equities both have problems and credit will have problems once we open up and companies are standing on their own two feet and trying to generate cash flow. I don't think there is a safe place at the minute."

"There are companies being supported because they had viable businesses pre-coronavirus that may not have viable businesses after coronavirus, but their credit isn't reflecting that because it is being bought by official channel buyers. The credit markets could therefore be quite dangerous unless you've got good credit analysis. Investors will need to be very careful not to buy indiscriminately."

[9] Dividend Dashboard Q2 2020, AJ Bell

2: DELIVERING VALUE FOR CUSTOMERS IN A DIFFICULT ECONOMIC ENVIRONMENT

The focus on good customer outcomes, whether in the retail or institutional markets, has never been greater, whether from an industry or regulatory perspective. The Covid-19 crisis and the economic challenges it brings comes amidst an unprecedented set of changes affecting industry delivery for UK customers.

Across the UK retail fund market, 2019-2020 has seen the final implementation of a range of measures put in place as part of the FCA Asset Management Market Study, whose final report was published in June 2017. Other components of the market, notably platforms, are subject to ongoing implementation measures arising from the Final Report of the FCA Platform Market Study. In the institutional market, remedies proposed by the CMA as part of the Investment Consultants Market Investigation Final Report in December 2018 are also being implemented.

A number of common themes emerged as part of these competition studies, particularly around alignment of interest and transparency. Significant changes for the industry included:

- Requirement for minimum levels of independent governance representation on authorised fund manager (AFM) boards.
- Value assessment reports, published annually, which set out the AFM's assessment of how funds have delivered for customers according to a number of specific criteria. The first generation of those reports has been appearing through the first half of 2020.
- Clearer communication in areas such as fund objectives, use of benchmarks and performance reporting
- A new institutional market cost reporting framework, being operated on a pan-stakeholder basis through the Cost Transparency Initiative (CTI)

A combination of these changes, combined with wider commercial trends already apparent in the UK and elsewhere, are driving an increasing focus on fees and wider value, which in turn is also driving consolidation. However, the debate on customer value is also turning increasingly to product development and how to ensure that in such a challenging economic and market environment, customers are able to access an appropriate product set, particularly in areas under pressure such as income. Here, one increasing theme is the role of illiquid investments, particularly as private markets continue to become more important (see also p.46)

LIQUIDITY AND WIDENING SOURCES OF RETURN

UK institutional investors have been investing in illiquids for many decades. For DB pension schemes, property historically played a significant role in portfolios through the 1970s and 1980s. In the last twenty years, alternative allocations have been more diversified, with much broader exposure including private equity, private debt and infrastructure. For DC pension schemes and retail investors, it has been less straightforward to access such markets, partly because of a lack of available fund structures, partly also because of other constraints related to a platform delivery infrastructure mainly built on an expectation of daily dealing and daily redemption.

Those we spoke to as part of the interview process emphasised the need for a broader range of fund vehicles for the DC and retail market to take full advantage of the investment opportunities available. A flagship industry proposal in this area is the LTAF (see p.34), designed to move away from the conventional model of daily redemptions in order to facilitate greater access to illiquid investments.

"We're in a low yield environment and dividends are going away. Solutions that provide income that might have less liquidity, such as infrastructure, might be coming more into the mainstream. Institutional investors have been buying infrastructure for a long time but my hope is that we come up with a solution that allows retail investors to do that because you're not getting income elsewhere. While public market equities continue to shrink, alternatives, including private credit and private equity, continue to grow for both institutional and retail investors."

TIME FOR A NEW FUND VEHICLE TO ACCESS ILLIQUIDS?

Events within the funds industry through 2019 also shone a light on some of these themes, as the high-profile suspension in June of the LF Woodford Equity Income (WEI) Fund gave rise both to questions about fund industry governance and the issue of access to private markets. An FCA investigation is still underway into the exact circumstances that led to what would eventually see the winding up of LF WEI.

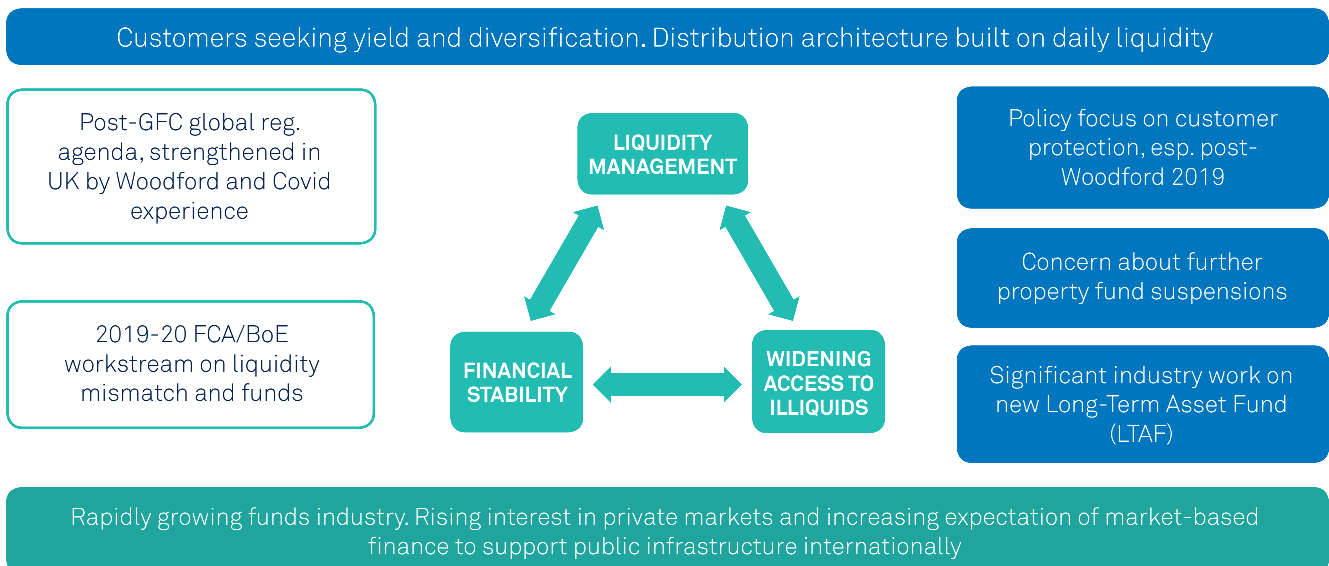
Looking to the structural issues raised by the debate over illiquids and the role of investment funds (see Figure 7), the IA has proposed a new Long-Term Asset Fund (LTAF) which would move away from daily dealing and have wider investment powers than a NURS or UCITS. The LTAF could facilitate new routes for capital to support the economy, while providing investors with a significant source of diversification. In addition to this customer benefit, the LTAF could also help address some of the concerns expressed by central banks and regulators internationally about the potential for liquidity mismatch in investment funds.

There is also strong recognition in the industry of the need to ensure that customers, particularly individual savers, understand the characteristics of illiquid assets. This will mean that great care will be needed regarding the terms of access.

"If retail consumers prioritise immediate consumption and stretch cash flows we will have an even more sizeable pensions gap. How do you get returns within those pensions? You have to invest in long term, illiquid assets."

"The whole debate is particularly acute in SME investing. We need a fund structure that is long term in nature, that digests that liquidity and doesn't offer you daily liquidity and you make sure clients understand what they are buying. There is a solution out there."

FIGURE 7: FUND LIQUIDITY: A COMPLEX LANDSCAPE



3: SETTING THE AGENDA FOR RESPONSIBLE AND SUSTAINABLE INVESTMENT

In light of the pandemic, some market commentators expected responsible investment (RI) and sustainability commitments to take a backseat, as savers and investors as well as Government and other institutions grappled with the immediate implications of the economic dislocation. This expectation is not borne out either in initial data on customer behaviour, or in what investment management firms are highlighting as critical priorities through the crisis. As Chapter 5 shows in more detail, sales to RI funds through the crisis have accelerated, albeit still from comparatively low levels.

Looking across the E, S and G of Environmental, Social and Governance (ESG) criteria that sit at the heart of responsible investment processes, a number of observations were made in senior industry interviews this year:

- **Environment:** The pandemic has illustrated different levels of inter-connection, both across the globe between multiple nations, and between the human and natural world. This appears to be reinforcing the broader concern for the environment that saw millions around the world taking to the streets in 2019 to join the 'Global Climate Strike'. The UK will be hosting the next UN Climate Change Conference (COP26) in November 2021 after it was postponed due to the pandemic. The conference is intended to accelerate international efforts to reach the goals of the Paris Agreement. In a speech to COP26 Business Leaders in June, Business Secretary, Alok Sharma, addressed investment managers directly seeking a commitment to "build a greener more resilient financial system" through initiatives such as the Coalition for Climate Resilient Investment and the Task Force on Climate-related Financial Disclosures.

"There are initiatives to get the FTSE 100 to sign up to a number of commitments on carbon net zero. As an industry we are going to be under the spotlight. There is going to be real focus on us and the responsibility we have managing assets on behalf of individuals and pension funds to hold these companies to account on these commitments."

"The world has come together fairly quickly to combat the coronavirus, the question is can we come together to tackle climate change more aggressively and can we work together with companies as an industry to do so. Governments will need to start incentivising certain companies to change their behaviour. We will see continued demand for sustainable investing quite strongly."

- **Social:** The economic consequences from global lockdowns are going to be felt for some time. With government deficits at record highs, there is a growing level of expectation around the role that investment managers can play in helping the UK's economic recovery. Historically, the 'social' component of the ESG prism has been notably smaller compared to engagement with companies around good governance. However, the pandemic and latterly public discourse on racial and wider income inequality has shone a spotlight on social matters, reinforcing the importance of these considerations and galvanizing efforts for investment managers to focus on social as well as environmental and governance considerations.

  Social impact investing, where investment managers aim to generate specific and often measurable social benefits as well as financial returns, is attracting growing interest. Most notably in the potential role of private finance in supporting positive social impact projects such as social housing. This is likely to remain a challenging area as both investment managers, and institutions such as pension schemes, seek to square off fiduciary responsibilities with wider responsibility in the area of social impact. However, there is growing appetite to explore this in practice and a number of IA member firms have noted an uptick in interest from clients around social impact investments.

"There is a sense that the Covid-19 crisis has impacted everyone, we've all been stuck in our homes. But, on the other hand it hasn't impacted people equally. The crisis has shown that society is not uniformly resilient. Companies being held to account on issues such as how they treat workers and BLM has brought ethnic diversity to the fore. The social side is going to be incredibly important. We will probably see fair society funds launched to tackle the "S" side."

"On the social side we can do more in the real asset area, building socially inclusive communities. Where we go in to build in city centre locations, we can make sure that we are building social housing into those communities. It might be easier to deal with the social side in the built environment rather than make a big deal of it in the stock market."

- **Governance.** There is an ever increasing spotlight on institutional investors and by proxy, investment managers to utilise their 'stakeholder voice' to ensure that companies move beyond traditional metrics associated with shareholder value maximisation. Issues under scrutiny include executive remuneration, diversity on boards and long term economic sustainability. Through the early stages of the coronavirus pandemic, investment managers acted to support companies in their corporate governance processes in a number of ways, including on financial reporting, dividend payments, virtual AGMs and executive remuneration.[10]

[10] https://www.theia.org/sites/default/files/2020-04/Letter%20to%20FTSE%20Chairs%20-%20April%202020_0.pdf

2

RESPONSIBLE INVESTMENT DELIVERY

Questions have been raised around whether responsible investment (RI) strategies can compete with non-responsible investment strategies on delivery. Looking at performance, the economic impacts of Covid-19 have affected the non-RI offerings of firms we spoke to harder than their RI offerings. Part of this outperformance stems from the overweighting of sectors such as healthcare and technology that have fared well through the crisis and the underweighting of energy companies that were hit hard through the economic shutdown. A range of analysis has also pointed to the governance piece, and the importance of investing in well run companies with strong corporate cultures.

"I can remember years ago there was this perceived trade-off that if you invested responsibly there was a cost of doing so, you would have to give something up. There is a growing body of evidence that not only are you not giving something up, but sustainable products are outperforming their non-sustainable peers."

"Our own proprietary engagement model covers the vast majority of companies we engage with and shows that those rated A and B have outperformed those with lower ratings."

"Our sustainable funds have outperformed regular equity funds. This is partly because of some of the sectors these are not invested in and partly because companies that are managed in a sustainable manner deliver better results. That will fuel the demand. There will be a push for profit with purpose and stakeholder capitalism."

SIZING THE MARKET FOR RESPONSIBLE INVESTMENT

Over the last few years, our data collection exercise has reflected the evolving conversation around what it means to invest responsibly. In the last few iterations of this Survey we have therefore been unable to compare the data one year to the next. Last year's data was collected based on the Global Sustainable Investment Alliance (GSIA) definitions. On the back of an extensive consultation to develop industry-agreed definitions, the IA published its Responsible Investment Framework in November 2019, which forms the basis of this year's data. Since this is the first year of data collection based on the IA's framework, we expect the way that firms report data to us to continue to develop. Investment managers' application of responsible investment practices will inevitably flex and change to meet evolving investor expectations and a rapidly changing investment landscape post Covid-19. As we work towards consistency in interpretation, this may mean that over time AUM increases as a result of changes to reporting as well as asset appreciation and the mainstreaming of ESG integration and other RI approaches.

Chart 5 shows that 38% of total assets are integrating ESG factors into their investment selection processes. This figure is based on firm level policies rather than at the individual fund or mandate level. There is often an overlap with firms using a combination of approaches outlined in the framework. Last year ESG integration stood at 26% of total assets, so there has been considerable growth. Exclusion policies are applied to 19% of total AUM. Despite the growth in AUM and the investor interest reported by members, sustainability-focused approaches and impact investing remain a relatively small proportion of the industry with 1.4% and 0.3% of assets respectively.

CHART 5: PROPORTION OF ASSETS UNDER MANAGEMENT BY RESPONSIBLE INVESTMENT CATEGORY

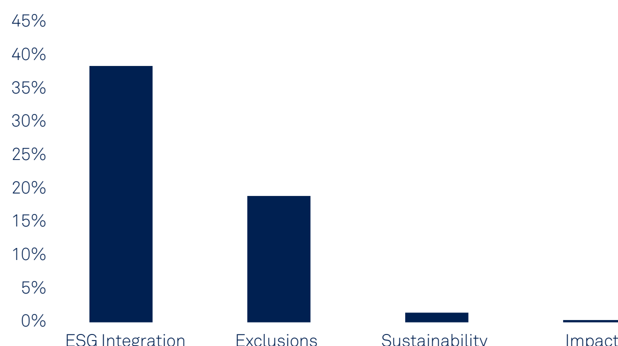


TABLE 3: DEFINITIONS BASED ON IA RESPONSIBLE INVESTMENT FRAMEWORK

Category	Definitions
ESG Integration	The systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions. ESG Integration alone does not prohibit any investments. Such strategies could invest in any business, sector or geography as long as the ESG risks of such investments are identified and taken into account.
Exclusions	Exclusions prohibit certain investments from a firm, fund or portfolio. Exclusions may be applied on a variety of issues, including to align with client expectations. They may be applied at the level of Sector, Business activity, products or revenue stream, A company or Jurisdictions/countries. Exclusions determine that a fund or mandate does NOT invest in certain things. It does not constitute an approach that is characterised by proactively allocating capital to specific assets. It may involve excluding investments from a certain sector or investments that derive a portion of their income from the sale of certain specified products.
Sustainability Focused	Investment approaches that select and include investments on the basis of their fulfilling certain sustainability criteria and/or delivering on specific and measurable sustainability outcome(s). Investments are chosen on the basis of their economic activities (what they produce/what services they deliver) and on their business conduct (how they deliver their products and services).
Impact Investing	Investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return. There are four key elements: 1. Intentionality: Impact investments intentionally contribute to social and environmental solutions. This differentiates them from other strategies such as ESG investing, Responsible Investing, and screening strategies. 2. Financial Returns: Impact investments seek a financial return on capital that can range from below market rate to risk-adjusted market rate. This distinguishes them from philanthropy. 3. Range of Asset Classes: Impact investments can be made across asset classes. 4. Impact Measurement: A hallmark of impact investing is the commitment of the investor to measure and report the social and environmental performance of underlying investments.

4: ENHANCING UK INTERNATIONAL STANDING IN THE CONTEXT OF BREXIT

The UK investment management industry is a leading centre of excellence and one of the most international in the world in terms of both the customers and businesses we serve and the assets that we invest in.

Last year we spoke to a range of firms to capture their views on maintaining the UK's competitive advantage in a post-Brexit environment and the conditions needed for future growth. This year we asked firms again about their views, following the UK's exit from the EU on 31 January 2020 and as all eyes are on the negotiations as we edge closer to the end of the transition period on 31 December 2020.

Firms have been preparing for a range of scenarios, including a no deal Brexit, for a number of years but many are concerned about business continuity given the shortening negotiation timelines and increasing demands on government resources due to Covid-19. For some firms, the outcomes of these negotiations could pose the single biggest threat to the UK's position as a financial services centre, and its overall attractiveness as a venue for their operations when measured against other emerging centres.

"The end of the Brexit transition is on all of our minds and is approaching very rapidly. That free trade agreement and the treatment of financial services still dwarfs anything else in relation to issues for the UK as an international financial centre. Making sure there is an agreement in place is the biggest dependency."

FIGURE 8: FOUR MEASURES OF A GLOBAL INDUSTRY

"The industry will be carefully watching what the trade agreement looks like with the EU and the extent to which it draws a line under negotiations and the future relationship. There is a big difference between scenarios where various countries are trying to chisel away pre-eminence of UK financial services vs. having positioned things very securely in a long-term agreement. It creates a different mindset around the extent to which executives have to be worried about those issues on an ongoing basis."

Many IA members run global businesses and in every interview we held, the ability to delegate portfolio management functions was raised as the most critical area of uncertainty that needs to be addressed in order to continue to serve customers internationally. Delegation is an international norm that allows investors access to global expertise and investment opportunities, whilst also benefitting from significant cost savings

"The battle is going to be to make sure delegation rights for fund managers operating out of the UK and managing assets for other European fund domiciles. If that is threatened, it is bad news for the investment management industry and you will have to move more substance to Europe."

Looking beyond Brexit, there are a number of aspects that continue to give investment managers confidence in the UK despite the political uncertainty. One of the key features of UK financial services are the city clusters such as those located in London and Edinburgh. The physical proximity of the industry to other market participants, such as investment banks, wider professional services, including legal and audit, and most recently fintech are key components of the UK's success.

Following the onset of Covid-19, the investment management industry transitioned very quickly and effectively to remote working. This raises a question over whether city clusters could become less significant, particularly given real estate costs. However, for many the pandemic has reinforced the importance of the physical proximity to teams, clients and ancillary industries. Firms we spoke to for the Survey have noted that external networks and relationships are particularly difficult to navigate once outside the cluster.

"In most industries, including finance, there is a benefit in clustering. Despite the Covid-19 effect, where we've all learned how to work remotely, industries do tend to cluster and proximity is important for making sure you have a good flow of talent and sharing ideas."

"In our Brexit planning we looked at all sorts of permutations for how we should be structured as an organisation. When you start looking at other potential locations you start to realise how much is here. The Fintech community here is very vibrant and is an important part of why you would come here."

The breadth and depth of the talent pool in the UK is another key feature of UK investment management that is often underestimated. Many globally headquartered firms have indicated that the talent pool is a key driver in setting up regional offices in the UK versus other jurisdictions. As long as Brexit does not impact the UK's ability to attract global talent, the continued success of the UK as an investment management centre is assured.

"If you look at the talent and the infrastructure we have here- that is not easily replicated in other locations quickly. That is why it continues to attract people. The UK will remain the leading financial services and investment management centre."

While certain immutable advantages such as time zone, language, and a stable legal system have helped the UK position itself as a global leader in investment management, it is clear that post-Brexit this alone will no longer be sufficient. In order to ensure that the UK remains a dominant player on the international stage, regulators must create an attractive operating environment that does not place an undue burden on firms. More broadly, firms point to the importance of the wider environment for business, notably around critical points such as the tax regime, immigration and the broader operating infrastructure.

While the industry recognises the value of robust, customer-focused regulation, there are also examples in recent years of approaches to regulation that have made the UK increasingly less attractive for international firms. Notably, the Financial Services Compensation Scheme (FSCS) has an important purpose in protecting consumers when firms fail, but because it does not operate on a 'polluter pays' principle, its recent funding mechanisms have focused disproportionately on firms with little direct connection to the problems it is trying to address. The annual levy on firms has also risen significantly in recent years and is variable, making it a financial forecasting challenge for firms.

"The weight of regulation over the last 5 years has been enormous. The way that the FSCS has been structured is specifically disincentivising large international offshore managers setting up in the UK. In the context of competing as an international centre, the volume of regulation are straws that look like collectively breaking the camel's back. You can't be complacent about the UK's attractiveness."