

The quiet revolutionary

Margaret Doyle, Partner at Deloitte UK and Tony Gaughan, the UK Investment Management Leader, had an interesting conversation with Euan Munro, Chief Executive at Aviva Investors on regulation, risk management, and pensions freedom in this ever-changing and politically-challenging time.¹



Euan Munro

Euan is CEO of Aviva Investors and a member of the Aviva PLC Group Executive Committee. He is also strategic adviser on Aviva's AIMS range of portfolios and chairs the Strategic Investment Group, a company-wide forum that approves the investment ideas that populate AIMS funds.

¹ The interview took place in March 2017

² Euan Munro, speech at the Financial News Asset Management Awards, London, 5 October 2016. See: <https://www.fnlondon.com/articles/aviva-investors-ceo-euan-munro-issues-challenge-to-fund-managers-20161006>

³ Ibid.

⁴ Financial Conduct Authority, Asset Management Market Study, Interim Report, 18 November 2016. See <https://www.fca.org.uk/news/press-releases/fca-finds-weak-price-competition-some-areas-asset-management-sector>

The chief of Aviva Investors wants to end the fixation on fees. Euan Munro believes that active managers' fees can be justified by great *risk-adjusted* returns.

Euan Munro is an unlikely revolutionary. The chief executive of Aviva Investors acknowledged late in 2016 that the public views him and his fellow fund managers as "a privileged elite."²

The Scot sympathizes with the public view that "our industry is not interested in the needs of real people."³ His own vision for Aviva Investors is that "everyone should have some sort of specialist skill, so they'll be an expert in infrastructure or credit risk, or equity markets, but they should also remember that what we are building for the end client is not just a fund with a bit of outperformance, but it's something that solves a client's needs."

Munro tells Deloitte bluntly: "I don't really think there are very many examples of asset management firms that have that ethos right through the organization."

In Munro's opinion, none of the industry, policymakers, or regulators, with their focus on fees, have got it right. The huge growth in passive investment vehicles, such as low-fee exchange-traded funds (ETFs) that track benchmark indices like the FTSE 100 or America's S&P 500, is one of the most glaring symptoms of the problem, in his view.

Munro, as the CEO of a traditional active fund manager, acknowledges that these kinds of passive vehicles have their place and, indeed, uses them himself. However, that place is simply as "vehicles through which you can articulate a view," he argues.

Regulatory oversight

While critical of his fellow fund managers, Munro also feels that regulators are misguided in their approach. The UK's Financial Conduct Authority issued a critical report on the industry in November 2016, accusing it of failing to justify high fee levels.⁴

Munro believes the focus on fees to be fundamentally misguided. "It's easy to look at fees," he declares, "but it's not actually answering any questions."

"We are in a world where, as an active manager, you have to preface everything you say with 'Past performance is no guide to the future.' If you're not allowed to lean on that, explicitly or implicitly, the only thing you can point to is fees," he elaborates.

"If you're projecting forward on higher fees or lower fees, you get the kind of ridiculous numbers that this manager would charge you—over your lifetime, one hundred thousand [pounds] more than another one. That might be worth it if you get a better outcome. It's very difficult to prove ex ante that you are going to get a better outcome. But what you can do, right now, is prove that you are not taking more risk. That should really matter, and it doesn't seem to matter in the policy debate right now."



“If the recent market events have taught us anything, they have taught us the danger of what might have been considered to be low probability but high impact events—tail risks.”

Risk management

The absence of adequate risk management is one of Munro’s beefs with robo-advice, touted by many in policy circles as the solution to Britain’s looming “advice gap,” where millions of people need advice, but are unable or unwilling to pay for it.

We ask whether robo-advisers can bridge the gap between passive investment and the sort of outcome-focused management as advocated by Munro. Robo advocates say that their algorithms can (cheaply) assess clients’ risk appetites before allocating assets to different passive portfolios to obtain an outcome that matches their aspirations. Munro is deeply skeptical.

He is concerned that automated advice is built on flimsy foundations. “One of the things I worry about with robo-advice is the risk of over-fitting on historic data,” he says. “So, you can take in twenty, thirty years of data and look at the correlations and interactions between different asset classes and come up with something that looks optimized. But the data you’ve pulled in, if you just looked at the last twenty, thirty years—you have looked at a massive bull run in long-term and short-term interest rates.”

He adds, “I fully expect that the correlations and interactions between bonds and equities, for example, will change quite significantly and perhaps dramatically from history, once we’ve completed this journey from a world where interest rates are seven, eight per cent, falling to zero, and as we move into a world where interest rates are either low and stable, or rising.”

Munro warns, “If the recent market events have taught us anything, they have taught us the danger of what might have been considered to be low probability but high impact events—tail risks.”

Munro’s broader concern is that the industry is obsessed with meeting (or beating) index benchmarks, with little regard for the risk involved in doing so.

Munro’s own particular interest and expertise, stemming largely from his actuarial training, is in risk management. He fears that a number of trends in the industry—the stampede into passives, the asset allocation metrics in “balanced” retirement funds, and the algorithms underlying most robo-advice, tilt too many portfolios toward stocks, which he feels expose investors to avoidable risk.

By contrast, Munro says, “I am building funds that are targeting an outcome of five percent over cash. There is absolutely no way I can guarantee that that will be the outcome. What I can absolutely validate is that, whether you use value-at-risk or scenario stress testing, the portfolio is less risky than a balanced fund.”

Pensions freedom

Munro understands that the questions of investment risk and return have become ever more important in the UK, thanks to the rise of defined contribution pension funds and the new freedoms that investors have over their pension pots from the age of 55.

Munro welcomes “pensions freedom,” even though it has dented profits at bigger life companies, like Aviva. He also acknowledges the contradiction in introducing pensions freedom so soon after auto-enrollment, which “nudges” individuals to invest in workplace pensions. “I do see the illogicality of encouraging people into auto-enrollment and then, at retirement, allowing a free-for-all,” he admits.

However, "I am more of a libertarian," he declares. "As long as there is a minimum level of state pension and benefit, then people should be able to use their own capital accumulated as they see fit." He also points out that the context for the pensions freedom move was one of extremely low annuity rates: "What I don't like is forcing people to, for instance, buy an annuity when interest rates are ridiculously low when we're in an environment where central banks have pushed bond yields down to a level where it's ruinous for people to buy an annuity."

However, Munro acknowledges that investing is tough for most people, given low levels of financial literacy. He says, "I do like the idea of auto enrollment and encouraging people to build up funds, and even some element of compulsion, like the Aussie model." He adds, "Encouraging people to save has got to be a good thing to do from a societal point of view, but not being too doctrinaire about what investment philosophy you're going to impose on people." [▶](#)

The absence of adequate risk management is one of Munro's beefs with robo-advice, touted by many in policy circles as the solution to Britain's looming "advice gap," where millions of people need advice, but are unable or unwilling to pay for it.



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**Market efficiency?
(Inefficient markets hypothesis)**

The rise in low-fee passives reflects an underlying view that markets are efficient. If markets are indeed efficient, managers cannot beat the market, the argument runs, so investors should focus on the one thing they can control: costs.

Munro challenges the notion that markets are efficient. He accepts that efficiency may provide a gravitational pull on asset prices, but contends that “for a long time, markets can stay away from equilibrium.”

Munro obsesses about “the marginal investor, and what might be their motivations,” declaring, “I get very excited if their motivation is not to maximize return.” These non-profit maximizing players give active players like Aviva Investors their chance to make money.

Fortunately for Munro, this club includes some very big investors, such as central banks performing quantitative easing (QE), the purveyors of structured products, and insurers hedging their liabilities.

Munro is angry that Warren Buffett, the legendary value investor, advised his own heirs to put 90 percent of their legacy into “a very low-cost S&P 500 index fund.”⁵

Munro declares, “I think it’s arrogant of Warren to assume that when he dies, active management dies with him.” In his case, Munro is building a team, one with collaboration and cross-fertilization of ideas—what Munro calls “joining the dots” at its heart. It is this collaboration that allows Aviva Investors to profit from its unconstrained mandates, he suggests.

5 Warren Buffett, Letter to Shareholders, 28 February 2014. See p. 20, <http://www.berkshirehathaway.com/letters/2013ltr.pdf>



Mis-priced assets

Munro believes that non-profit maximizing players have produced a number of badly mis-priced assets. Chief among these are developed market bonds, which Munro describes as “insanely expensive.” US equities are also expensive in comparison to Europe and even Japan. By contrast, Munro says, “I really do like emerging markets at the minute.”

Munro is not forecasting a recovery in sterling, which had depreciated by more than 15 percent against the dollar since the UK voted to leave the EU on 23 June, 2016. He feels that the uncertainty during exit negotiations will keep the currency subdued. However, he also believes that the Bank of England may be forced to raise rates to combat imported inflation, preventing a further downward lurch in the pound.



Political risk

The future of the British pound might also be affected by the prospect of a second Scottish independence vote. We meet Munro days after Nicola Sturgeon, Scotland’s First Minister, had called for a second referendum, and before Theresa May had responded. The UK Prime Minister declared that “Now is not the time,” attempting to stave off a vote at least until after the Brexit negotiations had concluded.

Munro acknowledges that the prospect of independence had to be factored into the group’s strategy and investment approach. “I think political risk is massive,” he says, adding, “There is some serious risk that we fracture into little mini-states.”

With regard to the fund management industry (historically large north of the border) and independence, he asks: “For big firms like us, how matched are our liabilities? Do we have too many assets in Scotland versus our liabilities? These are things that historically wouldn’t have been built into models. We’ve had to build them in fast.”

Munro acknowledges that events such as the Nationalists’ strong showing in Scotland and the Brexit vote in the UK were not unique, but are part of an apparent shift toward isolationism, including in the US.

The rise of such political risk in the West makes Munro even more comfortable with political risk in emerging markets. He points out that he can get a two to three percent real return in local currency bonds in markets like South Africa or Turkey, which “is pretty attractive when developed markets are delivering negative real yields.”

Munro feels that taking such a risk is not merely acceptable but necessary for him to achieve customers’ goals. He declares: “My vision is that I want to build solutions that give the outcome that customers really need, which is not necessarily delivery of a return identical to the FTSE All Share or the S&P 500, but delivery of a level of return that allows them to retire in dignity and, when they come to retirement, they have a level of income that is sensible, which is no small feat in a zero-interest-rate world.” ●

To the point:

- **Passives:** ETFs and passives are tools, vehicles through which you can articulate a view.
- **Robo-advice:** One of the things I worry about is over-fitting on historic data.
- **Politics:** I think political risk is massive. There is some serious risk that we fracture into little mini-states.
- **Scottish independence:** Do we have too many assets in Scotland versus our liabilities? These are things that historically maybe wouldn’t have been built into models. We’ve got to build them in, fast.
- **UK pension policy:** I do see the illogicality of encouraging people into auto-enrollment and then, at retirement, allowing a free-for-all.
- **Pensions freedom:** What I don’t like is forcing people to buy an annuity when interest rates are ridiculously low.
- **Fees:** It’s easy to look at fees, but it’s not actually answering any questions.
- **The Efficient Market Hypothesis:** For a long time, markets can stay away from equilibrium.
- **Sterling:** I don’t think it’s going to bounce back quickly, but I also don’t see it falling dramatically because I think the Bank of England is going to have to respond if inflation stays elevated for longer than they are factoring in.
- **Investment aim:** I want to build solutions that give the outcome that customers really need, a level of return that allows them to retire in dignity, which is no small feat in a zero interest rate world.