

**MATTHEW TAYLOR, UKSIF ANNUAL LECTURE**

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**Tough times for shareholders**

This has not been a good year for shareholders.

When I say this I am not just talking about the financial losses – bad as they have been.

Nor am I talking about the process whereby rights issues were pressed onto shareholders, only to be swiftly followed by nationalisation.

I am talking about the failure of shareholders to control their representatives.

The economist John Kay once compared the Anglo-American principal-agent structure to a Soviet state – in which the hostile takeover is the military coup and the AGM the ritualised election. You can see what he means. Take the flow of information, which is managed by incumbents and, except in times of acute crisis, is uniformly favourable. Or the nominal process of accountability through which directors are elected. There are no genuine alternative candidates. Incumbents are invariably re-elected with overwhelming majorities.

The gap between shareholders and managers has always been there. As the markets have boomed, it has got wider. Excessive remuneration was the most flagrant sign of this. It also made itself clear in unreasonable costs and charges, and in the volume of secondary trading.

But it is only in the last few months that we have seen how great that gap really was.

**The credit crunch**

The immediate cause of the credit crunch was the inappropriate sale of subprime mortgages. This was in part made possible by the division of

ownership and control. Put simply, there was no bank manager who 'owned' your mortgage, and hence was concerned for its security.

The systemic cause of the credit crunch was the risks taken by banks. Again, this was made possible by the division of ownership and control. The financial system allowed fund managers, and bank directors, to take excessive risks with other people's money. There was a power vacuum, left by absentee landlords. The gap between shareholders and their representatives vitiated the entire system.

The companies themselves are responsible for this. They have not invited accountability – quite the reverse. Institutional investors are particularly culpable. The men and women whose equity they hold in trust represent the vast bulk of UK shareholders. Yet these people are never consulted.

But blame does not lie with the firms alone. Shareholders – and I include myself in this – have not been holding their representatives to account.

Think how often financial empire building or risky business strategies are justified by reference to “shareholder value”. This is us they are talking about.

The short-term pursuit of shareholder value has damaged businesses – and, in the end, damaged shareholder value. In part, we are responsible for that.

### **Public companies**

Some people – including the *FT*'s Luke Johnson and the *Investors Chronicle*'s Chris Dillow – say that public companies are finished; that this form of ownership has had its day.

I don't agree with them. But I do think there is a problem – a serious problem.

The solution to this problem is greater public involvement. Let me say a few words on that.

## **Greater involvement**

This is going to be an era in which citizen involvement is absolutely critical. We have seen this in America, where both candidates made it central to their campaigns.

There are at least three reasons why this is the case.

First: because it works. To deal with the challenges we face today, we need collective responses. The state is insufficient for the task. So is the market. Climate change; obesity; the decline of social mobility; the difficulties caused by waves of immigration: these are challenges that can only be met by Government working in concert with citizens as individuals and community members. Government is more likely to get people to commit to a new policy aim if the same people have been involved in agreeing that aim and deciding how best it can be achieved.

Second: public engagement is the only way organisations can give their activity real legitimacy. The decline of deference means that people are no longer satisfied with expert authority. Decisions need to be made with the public. [Little Hans] If they are not, the fall-out will be that much greater when things go wrong.

Third: because, simply, that is the reality. We are now at last waking from the myth of the separate, autonomous individual – and seeing that we are social beings. The change in the debate is being powered by social psychology and neuroscience. The key insight is that we are profoundly interdependent.

Interdependence is normally talked about as a feature of modernity. And it is certainly true that the political decisions of the last fifty years have enhanced our mutual dependence. Economic globalisation has linked national economies in ever deeper ways. The scale of human industry has connected us environmentally. And the creation of the welfare state has pooled risk by allowing citizens to access services according to need rather than wealth or

personal circumstance. Interdependence here is the flip side of providing universal services.

Not all interdependence is chosen, however. A mounting body of evidence shows that mutual reliance is the basic human condition.

Some of this is empirical. In his book *The Copycat Effect*, the suicide prevention expert Loren Coleman records numerous occasions over the past 300 years when the suicide of a prominent public figure has been followed by a bulge in the number of suicides. Coleman records, for instance, that there was a 12 per cent rise in suicides in the month after the death of Marilyn Monroe. There were 197 suicides in that month the US that corresponded closely to that of the film star. And most of them were among young blonde women.

People copy each other. We take cues from others in our peer group about how to behave. This is a more powerful social force than legal restrictions.

One explanation for this comes from neuroscience. Surveys of the brain are beginning to undermine the idea of the self as the border between the inner self and the outside world. Rather, each mind is embedded in a complex web of external stimuli. Our selves are continuous with the world that we occupy, especially the social world.

Neuroscience tells us that decision-making — whether it's taking out a loan or deciding whom to marry — isn't a coldly rational, self-conscious act. A decision is something that comes at the end of a long chain of processes, most of which happen below the level of awareness. Many of these processes are social. We absorb a way of perceiving the world from parents and neighbours. We mimic the behaviour around us.

Of course decision-making is not a purely social act. There is still self-conscious oversight. Despite all the subterranean social influences, there still is that final stage of decision-making when individual choice matters.

In fact, this insight actually makes the responsibility for decision-making even greater. Each time a deal is struck, a decision made, it reinforces a new definition of acceptable behaviour for neighbours, family and friends.

In this world, behaviour sets off ripples. Every decision is a public contribution or a destructive act. This is the real meaning of interdependence.

### **Financial interdependence**

What does this mean for finance? Quite a lot.

If the credit crunch has shown anything, it is that we are radically interconnected. We are connected via global markets and national institutions. And we are connected via peer effects – via the herd.

The neo-liberal assumption was that markets reflect a balance of forces, changing only in response to new information. Unfortunately, things don't seem to work that way.

Markets have internal dynamics. They're self-propelling systems driven in large part by what investors believe other investors believe. Participants trade on rumours and gossip, on fears and expectations, and traders speak for good reason of the market's optimism or pessimism. It's these internal dynamics that make it possible for billions to evaporate from portfolios in a few short months just because people suddenly begin remembering that housing values do not always go up.

These internal dynamics – what Keynes called “animal spirits”, what George Soros explained as reflexivity, Alan Greenspan's irrational exuberance – are the reason boom and bust are inherent to capitalist economics. There will always come a time when people are certain that prices will never go down. When they do, nothing will stop them speculating.

Regulation will never be able to abolish this. It will only ever create the contours of the next crisis. This is not to say that regulation is not important. As former banker Paul Woolley argues, the scope for profit making - what he calls the croupier's take - from the inflation of market bubbles provides a powerful incentive to keep blowing. Regulation needs to lessen the incentives to grow financial bubbles and increase the safeguards for when bubbles burst. But regulation will never be enough – and it will never come on time.

When contagion sweeps the markets, it is hard for governments to act. This is not just because the rich want to get richer but also because everyone else wants to get in on the act. Imagine the outcry had Governments in either the US or the UK sought to stop sub prime lending or 100% plus mortgages. 'We want to borrow', 'the banks want to lend' and 'why shouldn't we be allowed to get our share of the housing boom' would have been the loud and angry public response. Government could have been portrayed as both interfering and a block on aspiration. To have done this when City experts were dismissive of any warning voices would have made it even harder.

Bubbles are endemic to the capitalist economy. We cannot design them out. Any reworking of capitalism should take this into account and aim to make sure that the whole cost of the economic cycle is funded, including the inevitability of any future bust.

A reworking of capitalism should also make sure that investors are more involved the management of their money. Not in a way that exacerbates boom and bust economics; in a way that enhances accountability.

### **Pensions**

As Adair Turner has shown many wise words can be said about pensions but the basic situation can be expressed in one sentences. Our employers won't look after us, the state won't look after us, and many of us can't or don't seem to want to look after ourselves.

At the individual level the millions of us who aspire to comfort in old age but are not saving enough exemplify the frailties of human decision making. At the social level the failure to support a policy framework that will deliver our collective aspirations for a decent old age (something which other countries most notably Norway and Australia have done) is an example of what we at the RSA calls the social aspiration gap. We won't create the future we say we want relying on existing modes of thought and behaviour.

So we need a change of attitude, a robust policy framework and innovations that offer people better ways to do the right thing by themselves and wider society.

I want to describe the contribution the RSA hopes to make, in particular how we aim to foster greater public engagement. But first a quick word about the other ways in which we might encourage a change of attitude about pension saving.

Ever since Daniel Kahnman won the Nobel Prize for his work on behavioural economics there has been growing interest in how people actually behave as financial actors in contrast to the free market myth of rational man. This culminated this summer in the fascination among opinion formers with Richard Thaler and Cass Sunstein's book *Nudge*.

Sunstein and Thaler show that defaults – what happens when a decision is not made – are some of the strongest influences on behaviour. The Government built this insight into policy which is why from 2012, employees will be automatically opted into Personal Accounts.

So far so good. Or is it? It may well be that, because state benefits are means tested, low-paid employees find extra retirement savings offset by a fall in benefits when they retire. Millions of workers on modest incomes – the group that so desperately need to save – may be tacitly 'advised' by their employers to un-enrol themselves from the scheme.

Nudging may be a better way of thinking about behaviour than the crude Treasury model but it can't change the underlying realities and incentives.

A second strategy which tends to emerge when we are faced with the idiosyncrasy of mass financial behaviour is the promotion of financial literacy. When most people in this country don't even know what the stock-market is, how can they be expected to be more responsible and involved?"

As so often, "education" is the black box into which difficult issues are thrown. I am afraid that conventional attempts to improve financial literacy will always be of limited value.

It is because financial literacy as with much sex education is taught in abstract terms that sex education, for example, is such a failure. It does not relate to real life situations. I recall watching a television programme once about teenage mothers. The interviewer asked one of the girls, who must have been about 16, why she hadn't learnt anything in sex ed classes. And the girls said "Well, I understood all they told me. But I don't think about school when I'm on the job!".

For most people, financial know-how is a disposition, rather than a skill. It is not like learning how to drive— it is like learning how to drive on the road. It is a craft and its technique, not a test of know-how.

The rational view of financial education has led us down some blind alleys. It has encouraged us, for example, to think that giving people more and more information helps them make better choices. It does not. In fact, it may make our decision worse.

The behavioural economist David Laibson has conducted two sets of experiments with undergraduates in the United States. In the first set, he asked the students to remember a three-digit number, then gave them the choice between a piece of fruit and a big, sticky chocolate bun. Most chose the piece of fruit. In the second set, he gave them the same choice, but this time asked he asked them to remember an eight-digit number – a number right at

the limit of our cognitive capacity. The students overwhelmingly chose the chocolate bun.

In our lives now, we face ever more complex decisions – most often about things we know very little about. We are flooded with new information. So we are constantly at the point of cognitive overload.

When this happens, our mental biases – shaped by years of evolution – take over. In the primal jungle, time horizons were short. Only the distant future mattered. When we are placed under stress, we are returned to this mindset. This is why the traders in the City are so susceptible to the call of the herd. This is why people fail to save for their retirement.

The economic historian Avner Offer makes this point very neatly when exploring why Governments find it harder and harder to win the case for intergenerational transfers. Offer talks about a myopic Government leading a myopic people.

Another perspective on the question of how we ensure people protect their interest is abandon mass engagement in favour of the one percent solution. Instead of waiting for everyone to get involved, we should concentrate on getting the most out of those who already are.

In government the one percent are the people who run community groups, write petitions, turn up to public meetings. In business, the one per cent are the shareholder activists.

These activists come in many forms . It is not always easy to tell the difference between the genuinely public-spirited, and drive-by activists intent on shifting the share price for their own ends. And some place the problems in banking at the door of the carpetbaggers who drove demutualisation.

But as wise politicians recognise the activist you get in part the activist you deserve. There is an opportunity here. As I'm sure you know, the RSA is working with David Pitt-Watson on his Tomorrow's Investor project. A few years ago, David co-authored a book called *The New Capitalists*: these new capitalists were the shareholder activists. Now I am not as convinced as David that things will turn out so rosy – David is a lapsed Marxist, and his account had more than a hint of Marxist teleology about it. But this book – and I recommend it to anyone – did show how activists can help improve value for everyone, shareholder and firm alike.

I'm no businessman. But in local government, the one per cent solution suggests three priorities for reform.

First, securing and strengthening people's right to participate. Second, making sure that participation counts when it comes to real decisions about resources and priorities. And third, ensuring that the right checks and balances are in place to preserve accountability.

But the one percent solution is just that – it leaves most people unengaged, vulnerable and prone to outrage when mistakes are made on their behalf. So we need other solutions.

The first is I know an area on which many of expend much time and effort. This is ensuring that investors get robust and useful information upon which to base decision. And because you strive for this you know how far we have still to go.

True accountability involves not only holding to account, but also giving an account. Yet the information given out by many companies is impenetrably written and self-serving, using metrics that are at best crude, at worst downright misleading.

In relation to ethical claims, the *Guardian's* recent series on green washing claims made this vivid. They used the example of Manchester airport, whose

owners pledged last year to make the airport carbon-neutral. There was only one caveat: the target did not include flights.

Financial institutions are also at fault. They frequently claim to be approaching carbon neutrality, as if all that mattered was whether they offset executive flights or put double glazing in the boardroom. It is their investment decisions which really make the difference, and they should be honest about them.

*Reporting needs to be improved. So does the way we gather information. The second, more innovative solution to the engagement problem involves taking better advantage of the dispersed knowledge of small and secondary investors.* While we may not feel to make decision as investors we daily make decisions as consumers, and we all collect information from a web of experiences and stories.

In his book *Infotopia*, Cass Sunstein talks about a series of methods currently being used to aggregate dispersed and tacit knowledge. None of them are new – but they are all being used in new ways.

Sunstein is particularly excited by prediction markets – such as those used for gambling, in particular. These are astonishingly accurate. The Hollywood Stock Exchange, for example, predicts Oscar winner nine times out of ten. Yet they are rarely used in business.

Google, ahead of the curve on the so many things, has a prediction market for some of its products. The product the prediction market says will do well invariably does.

The financial companies of the future should take a similar approach. It should look to find ways of capturing dispersed knowledge – partly to engage people in a fun, active way; but also to gain a competitive advantage. In her study of US investor clubs the sociologist Brooke Harrington found evidence

that gender mixed clubs did better because they drew of the different insights of men and women as workers, citizens and consumers.

This goes back to the comparison between companies and states. Friedrich Hayek, the great philosopher of markets, showed that reason why the Soviet state was so inefficient was because it denied tacit knowledge. The authoritarian regimes of the post-war period only took on board the ideas and knowledge of a few highly-placed individuals. Their rigid, hierarchical structure was self-stultifying. This is where financial institutions are right now.

### **Tomorrow's Investor**

I started this speech talking about responsibility. So instead of ending by telling you what you should be doing, I want to end by telling you what the RSA is doing to resolve this situation.

Over the last six months, the RSA has been working on our Tomorrow's Investor project, looking at how ordinary people view their investment, in particular their pensions. We conducted our deliberative forum as part of this project.

We found that ordinary investors felt insecure about their investments, and wanted to be able to take steps to secure their retirement income – but that they had a realistic awareness about their own limitations and their lack of financial know-how. They wanted to be able to register their preferences – in particular about the levels of costs and charges. But the apparatus was not available for them to do so.

The participants in the deliberative forum said that what they wanted above all in a fund was a combination of low costs with responsible capital stewardship.

It is our ambition to develop this fund.

After the deliberative forum, we held an expert seminar – I can see some of its members here. One of them – I’m afraid I cannot remember who – compared the current state of British fund management to the British car industry in the 1970s, when we were always told that it was impossible to combine reliability with value for money. Either you had a car that didn’t work, or you stumped up the cash. That was the deal.

Then the Japanese came along.

That is the RSA’s ambition: to be the Japanese in this sector.

In the second stage of Tomorrow’s Investor, David Pitt-Watson, the aforementioned Marxist, will be working to develop a fund that works on these principles.

We want this fund to be low cost. We also want it to engage with its investors – both in the form of explicit accountability and tapping into dispersed knowledge. We want products designed around how we actually think and behave.

Let me give you an example. When you get your statement from your pension fund, the chances are that charges will be expressed as an annual percentage of the funds being managed. It will be a small number. In *Nudge*, Thaler and Sunstein have something to say about this. They describe how, if people are told that a sausage is ‘90 per cent fat-free’ they are far more likely to buy salami than if they are told it is ‘10 per cent fat’. This fund will tell its clients about the 10 per cent fat – by expressing its charges as a total cost over the lifetime of the investment. A large number.

Of course, for us, this will be sound business sense. Most funds at the moment take about forty per cent of the total investment over its lifetime. In pension terms, that’s equivalent to ten years worth of contributions. We think we can cut that cost by at least a quarter.

Now, David may not succeed. I think he will – but he may not. That does not mean it is impossible. That does not mean we should keep on trying.

It is this sort of innovation we need to see in to financial markets. In this way, the advantages of democratic participation can be taken on board by markets. It may sound far-fetched, but this credit crunch may be the financial equivalent of the fall of the Berlin Wall. I certainly hope so.

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