The Future of the Savings Industry

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Introduction

The subject of this paper is the future of the savings industry. I intend to show that this future is bright, and offers many opportunities to those who work in it. I will also argue that it will be significantly different from the present, that there are major changes afoot which will affect institutions and individuals alike, and that they – individually, severally as companies and collectively as an industry – need to adapt to survive.

Concern for the future is one of the most basic of human instincts. Indeed, it has been said that an awareness of time - in other words an ability to consider and relate to the past, the present and the future - is one of the main hallmarks that distinguishes humans from other animal species. It is not very surprising therefore that mankind has always, from the earliest days of civilisation, prepared for its future. Whether this is a modern professional setting up his or her personal pension plan, or a Stone Age man storing food he has gathered today for eating tomorrow, the basic rationale is exactly the same. It involves saving, the setting aside of resources for future consumption. Whatever the claims of a certain other industry to be "the oldest profession", perhaps the savings industry can claim to be the second oldest!

Given the long historical precedent for saving, I will begin this discussion on the future of the industry by dwelling for a few moments on its past. And in doing so, I will endeavour to show how the industry is rooted in the dominant culture and leitmotifs of the age. The savings industry is part of the fabric of society, and at any given moment in history it inevitably reflects what society is thinking at that time.

With that preamble, let me start by going back to the latter part of the 19th century.

The 19th Century

1800s
Empires
Freedom of movement
Nation Building in Europe (e.g. Germany, Italy)
Emerging USA
Pirates

In geopolitical terms, this was a time of Empires, and of nation-building in Europe - both the German and the Italian states came into existence in the second half of the 1800s. The emerging economy of the age was the USA, and the dominant feature of the international scene was freedom of movement, aided of course by the new steamships which opened up the world, and the telegraph which helped the world communicate over long distances literally at the speed of light. Oh, and the main threats to the commercial world were pirates.

Economically, the 19th century was a time of growing freedom.

1800s
Globalisation
Increasing Capitalism
Gold standard
Largely stable exchange rates
Deflationary boom
European reserve currency (£)

Globalisation was the main theme, and increasing capitalism. The Gold Standard, and the Pound Sterling as the world's reserve currency, offered certainty of monetary value, and there were largely stable exchange rates. In fact, for much of the latter part of the 19th century there was a deflationary boom - prices fell as productivity gains brought benefits to all. As an example to illustrate this, prices halved in the UK from 1815 to 1914 - the long century of Pax Britannica - which is an annual "inflation" of -0.7% for 100 years.[1] It led to unprecedented prosperity, particularly in Europe. Not all deflation is evil.

What about the savings industry at this time?

1800s
Personal provision of pensions
Oversight of performance by principals/owners
Absolute return targeted
Risk management via limits and restrictions
Personal financial advice (family stockbroker etc)
Savings industry fragmented
Insurance companies dominant

This was a time when individuals still expected to provide for their own old age. In a sense, they always had - after all in earlier times a major reason for having children was to have someone to look after you when you were old. But in the latter part of the 19th century, provision for one's old age increasingly became a financial matter. Those above the breadline set money

1 Source: Bank of England

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aside in investments, and crucially they oversaw their investments themselves. Absolute return was the main target, with risk management conducted via hard restrictions - investments were largely limited to what the investor himself felt comfortable with. Personal financial advice was the order of the day, for example from the family stockbroker. This led to two major themes: the savings industry was fragmented, and insurance companies (i.e. those who could provide life assurance) were the dominant players.

Now let me turn to the 20th century, and let me again start with geopolitics.

The 20th Century

1800s	1900s
Empires	Military blocs
Freedom of movement	Migration control
Nation Building in Europe (e.g. Germany, Italy)	Fragmentation in Europe (e.g. collapse of Austria-Hungary, Soviet Empire, Yugoslavia)
Emerging USA	Iron and Bamboo curtains
Pirates	World Wars

In place of Empires, the 20th century saw military blocs dominate. In place of freedom of movement, we saw increasing migration control. It is worth noting that passports are largely a 20th century invention. In place of nation-building in Europe, we had the fragmentation of states, as Austria-Hungary, the Soviet Empire and Yugoslavia among others all fissured into their component parts. In place of emerging economies, we had the Iron and Bamboo curtains which radically restricted the free flow of peoples, money and ideas. And, to complete the picture, in place of pirates we had world wars.

In macro economics the contrasts were no less complete.

1800s	1900s
Globalisation	Nationalisation
Increasing Capitalism	Increasing Socialism
Gold standard	Paper money
Largely stable exchange rates	Huge FX market volatility
Deflationary boom	Inflation/Stagflation
European reserve currency (£)	American reserve currency ($)

Just as violence was nationalised - for the transition from piracy to world wars can be interpreted as the nationalisation of armed aggression - so increasingly were economies. Even the "free world" lurched towards collectivism, with socialist policies (whether with a large or a small S) increasingly dominating. The gold standard was replaced by fiat or paper money, with fairly disastrous consequences: inflation (and in the 1970s its evil cousin, stagflation) and huge FX market volatility were the lot of our fathers' generation.

What was the effect on the savings industry? Well, as I said earlier, the industry is but a mirror of society's more general trends, and so it is not a great surprise, at least to me, that it too took on a more collective hue.

1800s	1900s
Personal provision of pensions	Collective provision of pensions (state, corporate)
Oversight of performance by principals/owners	Oversight of performance by agents/managers
Absolute return targeted	Relative return targeted
Risk management via limits and restrictions	Risk management via tracking error
Personal financial advice (family stockbroker etc)	Professional financial advice (consultant industry)
Savings industry fragmented	Savings industry consolidation
Insurance companies dominant	Corporate pension schemes dominant

The most striking feature of the 20th century is the role of collective provision for retirement. Whether through the new state pension - introduced into this country just about 100 years ago - or through company pension schemes, retirement income provision was collectivised, and people lost the direct link with and responsibility for their future welfare. The savings industry was also professionalised, with the new collective schemes creating a profession of pension fund managers: people whose job it was to oversee other people's benefits. And whereas owner-overseers are primarily interested in absolute return, the creation of agent-overseers led to a focus on relative return, and risk management became increasingly dominated by tracking error analysis.

What other changes resulted from this? Perhaps the biggest change - after the rise of the professional manager/agent - was the rise of the professional financial adviser. And both the savings industry and those who oversaw it and advised it consolidated. We entered the era of the big institutional funds (mainly corporate pension funds), managed by big institutional asset management companies (such as State Street Global Advisors (SSgA)) and advised by big institutional consultants. Most of us grew up in this environment, and in many senses we are still in this paradigm.

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It is a comforting, familiar world. But I am sorry to say I do not think it will last. Let me demonstrate why I believe this is so, and in doing so finally turn to the 21st century.

The 21st Century

1800s	1900s	2000s
Empires	Military blocs	Trading blocs
Freedom of movement	Migration control	Freedom of movement
Nation Building in Europe (e.g. Germany, Italy)	Fragmentation in Europe (e.g. collapse of Austria-Hungary, Soviet Empire, Yugoslavia)	Nation Building in Europe (e.g. European Union)
Emerging USA	Iron and Bamboo curtains	Emerging China and India
Pirates	World Wars	Terrorists

Once again I start by rooting my discussion in global geopolitics. Empires are disintegrating and being increasingly replaced by trading blocs. Within those blocs, freedom of movement - of peoples, of money, of ideas - is once more increasing, though we have a way to go before we return to the open borders of 150 years ago. Nation-building in Europe is also on the increase again (for however tentative the Grand Project is in practice, this is the clear intention behind the creation of the E.U.). Emerging economies, led by Brazil, Russia, India and above all China (the BRICs) are once again re-engaging with the world economy. (Note that the emerging economies' share of PPP-adjusted world GDP is now back over 50%, for the first time since the Industrial Revolution in the late 18th century).[2] And to continue my footnote on the main threat to world peace, this is now not from military rogue states but increasingly from terrorists - the 21st century equivalent of the 19th century's pirates and nihilists.

And that gives away my main theme. For it is not just in the sphere of violence that we seem to be returning to the 19th century.

In economics, we also seem to be returning to the past. Increasingly, the theme is once again globalisation. Communications have taken another leap forward - today's internet is revolutionising communications as the 19th century's telegraph and telephone did. Capitalism is on the increase again. Currency blocs are once again giving the world's exchange rates new stability. Deflation is once more a real prospect - and in some industries is a reality. Just consider how computing power has got relentlessly cheaper and cheaper in recent years. And we appear to be close to another change of reserve currency, this time perhaps to an Asian base for the world economy.

As for the savings industry, the changes are even more profound. The collective provision of retirement incomes is being rolled back and unwound remarkably fast. Pension provision both by the state and by companies is being unravelled in front of our eyes. For most people under 30, the only safe assumption is the one their Victorian great great-grandfathers made: they will have to fund their own retirement, with no help from anyone else. People will have to take responsibility for their own future welfare, which takes us straight back to personal investments and oversight of performance by owners not agents. Is it any surprise that, as in the 19th century, absolute return is increasingly the yardstick by which investment success is measured? When it is my money I am overseeing, I want a positive absolute return - doing marginally less badly than a falling index is of no interest at all to me! And in this new

1800s	1900s	2000s
Globalisation	Nationalisation	Globalisation
Increasing Capitalism	Increasing Socialism	Increasing Capitalism
Gold standard	Paper money	Currency blocs
Largely stable exchange rates	Huge FX market volatility	Largely stable exchange rates
Deflationary boom	Inflation/Stagflation	Deflationary boom?
European reserve currency (£)	American reserve currency ($)	Asian reserve currency?

2 Source: IMF

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world, personal financial advice will once again dominate: independent financial advisers and tax advisers will be the main providers of advice.

What will the consequences be for the savings industry? Let me start on a bullish note. I expect it to grow, and grow rapidly, as the younger generation increasingly come to realise that they have to save now to avoid a bleak future. I also expect it to become a multi-faceted industry, with the retail end fragmenting. Personal savings will increasingly dominate, and this means retail funds, especially mutual funds, will grow in importance.
It may also mean a return to the former dominance of the insurance industry.

legislative background in Australia is not of course identical to the UK's, but their starting point was very similar to the UK's current pension arrangements, and the dynamics driving the evolution of pensions are universal, so I think it would be a brave investment manager who ignored the Lesson from Down Under.

Can the industry change in time? I am optimistic. It faces a future, as I have already said, in which more money - much more - will be saved, not less. That is surely a positive backdrop. And it is well placed to meet the challenge of serving tomorrow's savers. The savings industry still for the moment a relatively lightly regulated one, in which the spark of initiative is not yet seriously at risk from over-burdensome regulation. It is still an industry for which the hallmark is innovation. Markets are continually opening up – the

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Absolute return targeted	Relative return targeted	Absolute return targeted
Risk management via limits and restrictions	Risk management via tracking error	Risk management via VaR
Personal financial advice (family stockbroker etc)	Professional financial advice (consultant industry)	Personal financial advice (IFAs and tax advisers)
Savings industry fragmented	Savings industry consolidation	Savings industry multi-faceted: retail end to fragment again?
Insurance companies dominant	Corporate pension schemes dominant	Retail mutual funds dominant? Insurance companies dominant?

Who are at risk of being the main losers? This I think is easier. Anyone whose main client base is the agent-overseer, the pension fund trustee, the large institutional fund, needs to ask themselves how they plan to diversify from what will inevitably be a shrinking pool of capital. The most at risk are I think the big institutional fund managers and the big consultants, both of whom need to find a way to access and connect with the more fragmented pools of savings that will dominate our industry in the future. Large defined benefit plans will continue to wither: they are already on the decline in the UK, and if you want to see what the future

holds, you need look no further than Australia, where outside the public sector there is hardly a defined benefit scheme left. The

number of countries which accept outside investment into their markets is growing all the time. Just to illustrate this, SSgA's parent company State Street Corporation today provides global custody services in well over 100 countries.[3] The future is, I confidently believe, a bright one.

But the industry will need all its flexibility and willingness to change to meet the challenge. And those that do not change, that do not realise and react to the developments I have outlined, risk being the losers in the new world of the 21st century.

3 SSgA is a division of State Street Bank & Trust Company, whose parent is State Street Corporation.

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Summary

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Freedom of movement	Migration control	Freedom of movement
Nation Building in Europe (e.g. Germany, Italy)	Fragmentation in Europe (e.g. collapse of Austria-Hungary, Soviet Empire, Yugoslavia)	Nation Building in Europe (e.g. European Union)
Emerging USA	Iron and Bamboo curtains	Emerging China & India
Pirates	World Wars	Terrorists
Globalisation	Nationalisation	Globalisation
Increasing Capitalism	Increasing Socialism	Increasing Capitalism
Gold standard	Paper money	Currency blocs
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European reserve currency (£)	American reserve currency ($)	Asian reserve currency?
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Absolute return targeted	Relative return targeted	Absolute return targeted
Risk management via limits and restrictions	Risk management via tracking error	Risk management via VaR
Personal financial advice (family stockbroker etc)	Professional financial advice (consultant industry)	Personal financial advice (IFAs and tax advisers)
Savings industry fragmented	Savings industry consolidation	Savings industry multi-faceted: retail end to fragment again?
Insurance companies dominant	Corporate pension schemes dominant	Retail mutual funds dominant? Insurance companies dominant?

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