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Chains of Finance: How Investment Management is Shaped

Unplugged - My Own Book Review

Diane-Laure Arjaliès, Philip Grant, Iain Hardie, Donald MacKenzie and Ekaterina Svetlova (2017), Oxford University.

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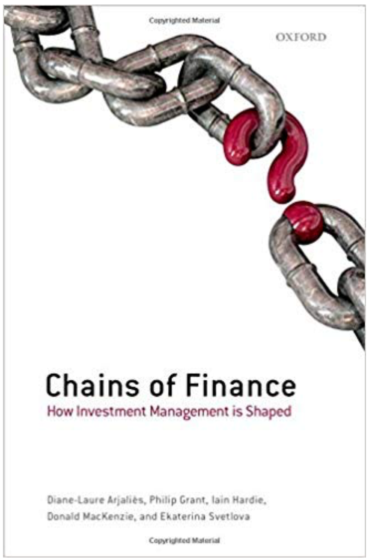

The "unplugged" section seeks to experience new forms of book reviews. We regularly grant a wild card to a world-class scholar to review his/her own Classic. In "My own book review", authors will tell us the story of "what I was trying to do" with sometimes some auto-ethnographic considerations. By recounting the building process of one seminal research with a contemporary lens, they may give some insights for the current craft of research and also share with us renunciations, doubts and joys in their intimate writing experience.

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WHY DID WE WRITE THIS BOOK?

Investment management firms are estimated to control assets totalling $100 trillion, equivalent to about one year of total global economic output, and that power has a massive impact on the economy and society (TheCityUK, 2014). We may be entering 'the age of asset management,' suggested the Bank of England's Director of Financial Stability (now Chief Economist), Andrew Haldane, in an April 2014 speech. Yet today's investment management system is a bit like a black box – it is complex and a mystery to most people, including management scholars. The media and academic attention have been focused far more on banking or various types of 'traders' than on the investment management industry itself – despite the large impact of the latter on the economy and society more broadly. By writing this book (Arjaliès, Grant, Hardie, MacKenzie, & Svetlova, 2017), we hope to account for the inner workings of the industry, shedding light on the known but above all the unknown of investment management practices.

Our team is diverse and somehow represents what the field of 'social studies of finance' is today: Diane-Laure Arjaliès and Ekaterina Svetlova come from accounting and asset management; Philip Grant is a social anthropologist; Iain Hardie is an international political economist and Donald MacKenzie is a sociologist. We bring knowledge from various disciplines, but have in common a deep engagement with the field – four of the authors having worked in financial markets. The arguments and case studies presented in the book are based on ethnographic and auto-ethnographic work in the investment industry spanning several years in four cities (Paris, Zurich, Frankfurt, London) and 451 in-depth interviews with investment management industry employees in those locations as well as Edinburgh, New York, and other places in the US and Canada. Our ethnographic field research allows us to provide a thorough analysis of the investment management industry from a social science perspective and brings insights that could not be obtained by a purely theoretical work.

WHAT IS INSIDE THE BOOK?

The key message of the book is simple: The investment management industry is better understood as a *chain* of multiple intermediaries linking savers to the companies and governments that issue financial instruments, rather than as a set of professional groups tied to a specific set of expertise, such as fund managers, securities analysts, and investment consultants. The investment industry today has actually little to do with individual savers choosing which shares or bonds to buy directly. Rather, most of their money flows through the investment chain, an often-extensive sequence of interdependent go-betweens (cf. Figure 1).

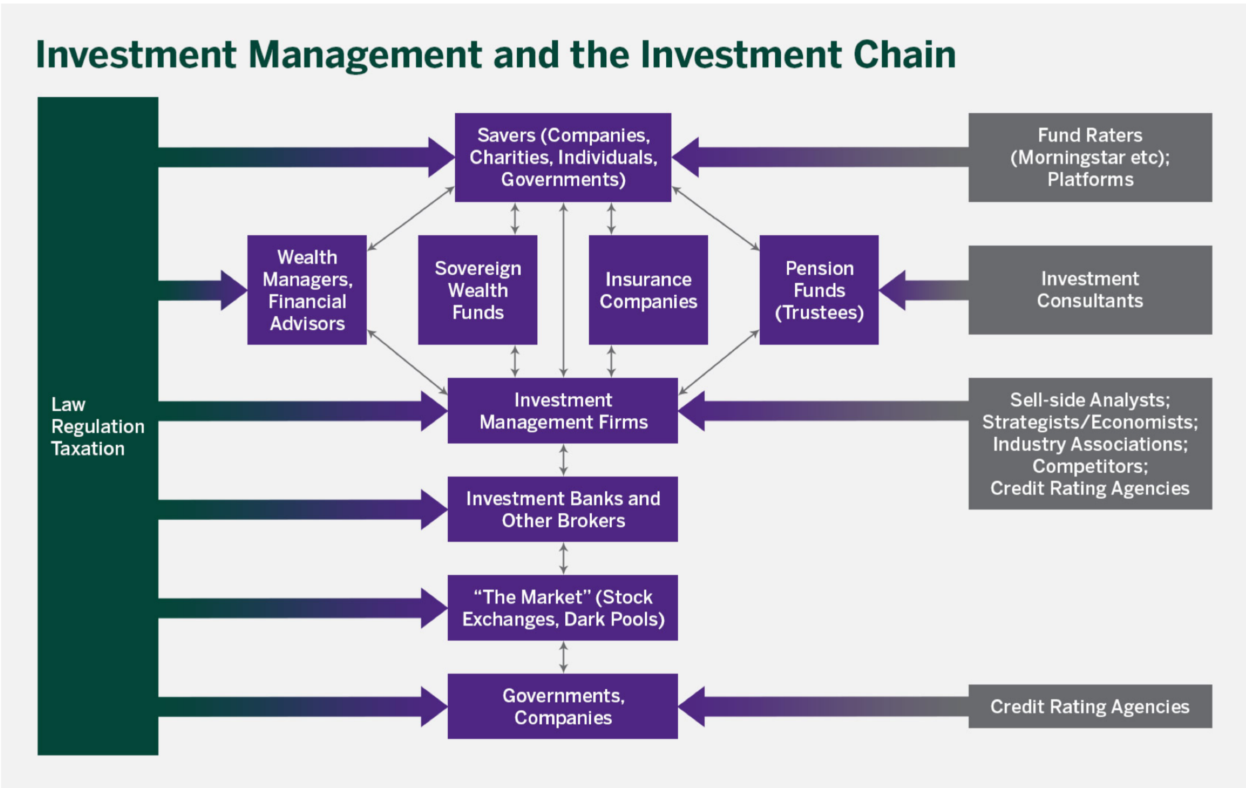

Figure 1 . "The Investment Chain," Chart courtesy of *Chains of Finance*.

For example, savers' decisions are frequently guided by financial advisers and 'wealth managers'; they may also be influenced in their choices of mutual funds by specialist firms such as Morningstar and Standard & Poor's that award these funds ratings. Furthermore, most 'savings' in fact take the form of contributions to workplace pension funds. These funds, with some variations across jurisdictions, usually have trustees responsible for investing the assets, an activity which they generally delegate to investment managers. Trustees' decisions about which investment management firms to use are often guided by investment consultants. Following the chain in a different direction, fund managers (and traders in their firms acting on their behalf) need to choose where to execute their orders to buy or sell shares or bonds, and these decisions are strongly affected by fund managers' relationships with brokers or dealers, in particular to those who work for big investment banks.

We explore how the intermediaries of the investment chain shape each other's practices, channel the flows of savers' money, and ultimately form audiences for each other's performances of financially competent or expert selves. This *performance of expertise* is all the more important in an industry where performance is everywhere measured by putatively objective numbers, and where it is statistically almost impossible for an investment manager to consistently deliver above market returns—and yet where firms continue to charge clients substantial fees and individual fund managers are generally well remunerated. This generates a situation where links in the chain act as critical observers of others with whom they are linked—consultants and trustees critically observing and measuring fund managers, for example—and at the same time need these same others—trustees generally feel legally obliged to delegate investment management functions to professional firms, and consultants need managers for their own profession to exist. We thus picture the investment chain as a series of relations that both constrain and enable. We show that investment managers' decisions cannot properly be understood by focusing simply on a fund manager's beliefs about particular securities or markets, but are co-shaped by clients, brokers, investment consultants, securities analysts, and even unions and politicians.

In one chapter, we show how the investment management division of a Frankfurt bank formed a new 'quant' team. Reacting to the external expectations set by clients, investment consultants and competitors, the division's managers decided they need a new, quantitative, 'rigorous', 'scientific' approach alongside their existing 'fundamental' method. In other words, the establishment of this quantitative department was driven by marketing, precisely because it could help to present the fund managers' work as more rigorous and scientific, important as confidence in the financial industry had fallen in the aftermath of the dot.com bubble. Clients such as pension funds, and the investment consultants who advise them, want to hear about rigour and 'process', a theme we came across time and time again in our research. Elsewhere in the book, we demonstrate that the client–fund manager relationship is not a simple principal–agent problem, but a multi-faceted, contextually dependent, malleable matter. Institutional investor clients such as pension funds have the power to set the terms of investment to constrain fund managers. Simultaneously, fund managers can also reshape what their clients imagine their interests to be, influencing their clients to align their goals with those of the managers.

While the chain can enable, we also show that the chain can constrain and impede decisions. For example, one part of our study focuses on attempts by a number of links in the investment chain to pressure the US subsidiary of a French automotive manufacturer to recognize unions at its plants and improve working conditions there. In unprecedented meetings, fund managers, pension fund trustees, representatives of different French unions, French politicians, and US workers came together to try to work out a way to use a shareholding in the car company to bring about meaningful change in line with responsible investment objectives. What ensued, however, was a demonstration of the difficulty of moving the chain due to the constraints intermediaries impose on each other through their relationships. The fund managers would only act on instructions from the clients; the clients, as represented by the pension fund trustees, did not want to do anything that might contradict their legal duties; the politicians were unsure whether they could bring about pressure on an American subsidiary; the unions were focused on getting the best deal for French workers.

WHY DOES IT MATTER?

Our analysis of an investment chain comes at a time when the view of financial markets as networks is influential (Allen & Babus, 2009; Uzzi, 1999). We do not see this as a rival theory. The chain is, however, a way of thinking about financial markets that helps make clearer the character of the various interactions and practices. For example, the idea of the investment chain sheds light on the nature of asset *valuation practices* in financial markets. Valuation is an activity that is inevitably relational (Helgesson & Muniesa, 2013). Thus, in order to understand how various investment professionals value assets, one has to clarify the relations they are involved in. In other words, valuation is not something that happens in one node of the chain but is based on the ongoing flow of numbers, narratives, expertise, money, and impression management performances. For example, the view of a particular portfolio manager on a stock is based on her individual valuation technique but, at the same time, is a part of the organizational frame (what we call the investment chain *inside* the investment management firm) and the market-wide investment chain that includes all related parties such as equity issuers, investment consultants, clients, securities analysts etc. The valuation of a stock depends on how portfolio managers receive information from and about listed companies and whether and how they communicate with security analysts (information flow), whether they are already invested in the company and, if yes, how heavily (money flow) and how closely clients and consultants observe their investment process and performance (staging of the competent self). We started to work out the idea of *valuation as a chain* in the chapter on responsible investing in fixed income management.

Furthermore, the concept of the investment chain also allows a complementary approach to the question of where influence resides within finance. Until now, the focus of research has tended to be on those who make the final investment or lending decision, fund managers or banks, with, if they are acknowledged at all, other market actors being seen as below these decision makers in a hierarchy. The book shows that power lies rather in the chain and its multiple influences on investment decisions.

The chain matters to outcomes in financial markets that might have broad *societal consequences*. The book focuses on investors' investment time horizons, responsible investment broadly and, as already mentioned, attempts by trade unionists to use the pension fund investments of their members to influence a company's treatment of its workers (see also Kay, 2012). In each case, the investment chain had a major influence. In particular, the fund manager 'link' increases the likelihood of short-term investment and thwarts trade union efforts. The discussion of sustainable investing in one of the chapters shows in addition how the relationships within an investment management company can act as a hindrance to responsible investment.

Despite the investment chain's importance, and its ubiquity in official reports across a variety of concerns with financial market operations, the chain is rarely the subject of explicit academic enquiry. It is even less often the subject of public debate. But if a poorly functioning investment chain contributes to lower growth, inequality, poor workers' rights, and a hotter planet, its functioning should be a matter of urgent academic and political enquiry.

Finally, the investment chain concept has methodological consequences. Until now, sociological investigations of financial markets were primarily guided by localised ethnographies focusing on one particular professional group (e.g., security analysts or option traders). However, if we agree that financial activities are genuinely relational and that differences in financial practices depend on market participants' position within the investment chain, multi-sited ethnographies might become the tool of choice. Multi-sitedness in this context does not mean comparison of isolated practices, e.g., what is the difference between valuation practices of portfolio managers and security analysts. It is rather about following the chain in *one* research project, e.g., finding out how portfolio managers' valuation practice is connected to and influenced by security analysts, clients, consultants etc.

WHY SOME PEOPLE MIGHT NOT LIKE THE BOOK?

First, because we question the whole story of control, reward and punishment implied by the principal-agent theory, according to which, if fund managers fail to deliver performance, investors will exit. Such approach has long shaped the academic approach to economics and finance and continues today to inform the hypotheses used in most of the papers dealing with such topics in the field of management. We argue that the relationship between asset managers and asset owners is much more nuanced than a straightforward principal-agent approach suggests. Rather, this relationship is multi-faceted, contextually dependent and malleable. Moreover, relationships between clients and fund managers are often characterized by reciprocity, loyalty and even amity, not just by control and punishment.

Second, we provide an alternative lens to one of the dominant approaches of social studies of finance, according to which markets are first and foremost shaped by calculative devices (Callon & Muniesa, 2005; Knorr-Cetina & Bruegger, 2002). We rather show that calculative tools are just one component in the diverse practices of financial decision-making and that other components – such as human judgment, personal relationships, observation techniques of the others etc. – also deserve closer attention (see also Svetlova (2018)). For example, following the chain, we show that fund managers (and traders in their firms acting on their behalf) need to choose where to execute their orders to buy or sell shares or bonds, and these decisions are strongly affected by fund managers' relationships with brokers or dealers. One of the book chapters shows that the first generation "dark pools" did not succeed because of existing "soft dollar" arrangements tying together fund managers and brokers, links based on the latter providing the former with free research, but often extending beyond that to include concert tickets, wine, books, and expensive trips. Furthermore, long-term friendships were built between brokers and fund managers and highly influenced which broker was chosen to execute the orders. These personal relationships explain why new, anonymous, computerized market devices did not sweep away traditional human intermediaries, even though the latter were not only far more expensive but also distrusted as possible conduits of information leakage.

Third, because we deconstruct the political games and vested interests that sustain the connections between the different actors of the chain. We uncover the social choices underpinning this construction and the side effects of the latter on savers and society at large. Solving these issues is not easy. Most intermediaries of the chain have been introduced to strengthen trust – supposedly addressing the problems of the principal-agent evoked above. Dissatisfaction with intermediaries, and with the need to trust them, is an important part of the rhetoric surrounding cryptocurrencies and blockchain technologies. Although we do not evoke the development of fintech (technology + finance) in our book, there seems to be a direct relationship between the constitution of the investment industry as a "chain" and the development of blockchain technologies, and other peer-to-peer systems. Unlike the chain we describe however, the societal underpinnings of these new forms of interactions remain to be built.

Last, because our work is far from being exhaustive. We chose to focus on different nodes of the chain – e.g. the fund managers and their clients, the dark pools, the investment managers and their relationships to society, the quantitative analysts and the other teams, to go deeply in the analysis. There are many more nodes that we could have covered and accounted for. This book is a first step towards the uncovering of these links, one we hope more researchers will follow.

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