Holistic, Not Fragmented. Long-Term, Not Quarterly

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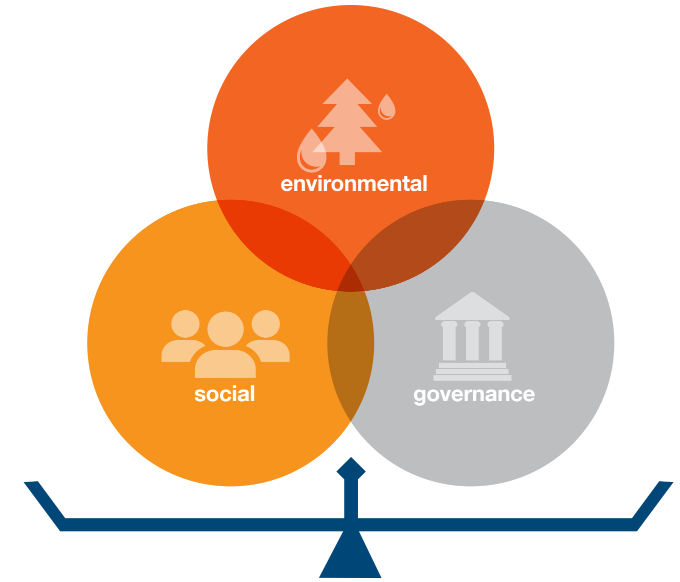
An investment model emphasizing environmental, social and governance considerations would support fairness and stability. Post-crisis regulation has shifted risk to those who may be unable to manage it.

Current capitalist systems, and general financial market practices, do better than the alternatives at allocating scarce capital to its most productive uses. Witness the rapid per-capita income growth of recent centuries, which is unprecedented in human history. The economic outcomes in health, shelter, security and choice have never been greater.

However, not all is well. Social cohesion, culture and the environment continuously come under immense pressure. Likewise, modern economies lurch between boom and bust. The income and opportunity divide remains wide between and within countries. Cultural dominance strips communities of their sense of purpose. And the environment is being degraded at the cost of future generations. At times, capitalism and financial markets, when left alone, yield outcomes that can be unfair, unstable and unsustainable. How do we create more inclusion and stability?

At the least, financial efficiency and stability are met when all relevant financial risks are adequately identified, priced and allocated to those best able to manage them. However, if these activities go astray, the economic system will go astray also. In fact, left unfettered, it is almost guaranteed that economic booms/busts will continue to occur. The well-known economic problems of myopia, asymmetric information and the "curse of the commons"—in which individuals acting in their self-interest undermine the interests of the community—will ensure perpetual problems.



This means we can anticipate protracted periods of economic, environmental and social instability until we take a holistic and long-term view of our investment activities. Much is to be done, and urgently. I offer three thoughts, two general and one specific.

1 First, investors must foster closer relationships with the companies they invest in, making environmental, social and governance considerations central. Investors must bring the true "price" of companies' activities to the fore. The distanced, arm's-length relationship that blows hot and cold with quarterly results is not defensible.

2 Second, all must focus very hard on the unintended consequences of regulation. For example, while a new wave of post-financial crisis regulation is aimed at making the system more stable, it is shifting risk to those who may be unaware of it, or simply unable to manage or mitigate it.

For example, with banks having withdrawn from being price-making intermediaries in many markets, liquidity has evaporated and transaction costs have risen. Outsize market roles are being thrust upon other, non-bank, non-insurer, global financial institutions. Collective savings vehicles such as pension and sovereign wealth funds are increasingly carrying risks they may be unaware of or least suited to manage.

Unintended regulatory consequences must not remove the fundamental endowment of the large long-term investors: their ability to be patient. Patience enables countercyclical investment, thereby providing markets with the liquidity needed during times of dysfunction.

3 Finally, let's think smarter about the role of our international financial institutions (IFIs). How can they better leverage their horizon and reputation, more than their capital?

There is no shortage of private and public capital looking to invest for the long term, filling the infrastructure void in developed and emerging economies. There is no shortage of demand for that capital also. However, the market will never "clear" as long as access to investment opportunities is hamstrung by the lack of consistent deal flow, as well as fear of property right interference and regulatory instability.

IFIs could play a significant role in underwriting sovereign/government contract breaches. A simple insurance construct—similar to the ideas underpinning social bonds—would greatly leverage the impact the IMF, World Bank, European Bank for Reconstruction and Development, Asian Development Bank, and the new Asian Infrastructure Investment Bank could have on the collective desired outcomes. How IFIs price this service depends on their ability to leverage their reputation.

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