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Beyond the Horizon: A CEO's Guide to Unseen Risks

An exclusive report from behind the closed-door CEO Boardroom at IMpower 2023

Introduction

Asset management leaders were given unparalleled insights from a range of expert speakers at IMpower incorporating FundForum 2023, which this year focused on the theme of “All the risks we cannot see”. Across two days, C-suite executives were given privileged access, via the Leaders Club and CEO Boardroom, to better understand the risk landscape, which has undergone significant change over the last 12 months.

These risks, including generative AI, climate litigation, higher inflation and interest rates, and the shifting sands of geopolitics, are summarised in this report. Its aim is to give CEOs and CIOs actionable intelligence as they consider the future direction of their respective organisations.

Contents

01 Generative AI

Generative AI has become the buzzword of 2023. Large language models such as Chat-GPT, present huge opportunities for asset and wealth managers but they also introduce new risks.

Nina Schick, Author, Advisor and Generative AI Expert and James Pomeroy, Global Economist, Global Research, HSBC, spoke about the need for companies to invest heavily in R&D to take full advantage of the technology, but to also educate people on the positives and assuage fears; particularly in the US and Europe where concerns of jobs being replaced by AI are in stark contrast to countries like China, where public sentiment is more positive.

"Let's cut through some of the noise in the public debate," said Schick. "What are we going to do to up-skill our labour force? How should we rethink education?"

Pomeroy pointed out that in the context of Europe, one of the most innovative countries in the world is Sweden, when discussing how important free society is at pushing innovation. There are many countries in the world with the most comfortable social safety nets who want to be the most innovative.

"At the same time, you get a lot of innovation in economies where there is an incentive to gamble. You can see that happening in parts of the US and places like India, not just in terms of AI development but broader technology investment." said Pomeroy

Nina Schick
Author, Advisor and Generative AI Expert

James Pomeroy
Global Economist, Global Research, HSBC

02 Climate Litigation

ESG and impact investing continues to be an increasingly important priority for investors. While there are myriad opportunities to deliver positive impact, as well as favourable returns, fund managers have to be mindful of the risks involved.

The topic of climate litigation risk was covered in a fascinating session entitled "*CEOs and how to avoid climate litigation: What CEOs need to know*", with Laura Clarke, CEO of Client Earth. Client Earth is a leading environmental charity that uses the law to accelerate change towards climate risk.

CEOs can think about climate risk across three broad categories:

Physical risk

The damage that extreme weather and sea level rises can do to physical infrastructure.

Regulatory risk

As governments change the regulatory landscape, organisations could find they have invested in stranded assets, as the renewable transition picks up pace.

Litigation risk

A legal tool used to make CEOs think about managing risk in terms of the long-term commercial viability of their organisations.

Clarke explained that there is a need to move beyond the way things were done previously,

Companies need to change their decision-making, such that they do not only think about short-term returns for shareholders but also the long-term sustainability of those decisions. This cannot be achieved by thinking about E, S and G in isolation. Indeed, the E and S are inextricably linked, from an impact perspective.

One might think that Big Energy – the major oil and gas producers – is the biggest area of potential climate litigation risk but as Clarke explained, Big Food, and its connections with deforestation, human rights abuses, and pollution through plastics in supply chains, is equally important.

"We are working on two cases, one against a large agricultural company in the US for not sufficiently addressing its links to deforestation and human rights abuses in its soil supply chain, and a second case against a company for the plastic in its supply chains under corporate responsibility," she explained.

Laura Clarke
CEO of Client Earth

Asset managers have become increasingly aware of greenwashing risks. Are their fund products truly doing what they say on the tin, and can fund disclosures related to ESG be evidenced to investors? Moreover, can they show that their net zero emissions targets are valid? As Clarke noted, one cannot simply offset one's carbon emissions and carry on with business as usual.

"That doesn't work. You have to be reducing emissions and in addition you could buy some credits that help biodiversity projects and carbon removal: you have to do both, it's not an either/or," said Clarke

This is a transition point.

Last year, Europe used more solar and wind than it did oil and gas. As such, organisations need to look to the future by investing in environmental leaders to get a first mover advantage. "Climate and biodiversity litigation is only going to increase," remarked Clarke, and will require CEOs to think about rigorous engagement.

"Asset managers should have a good handle on who their investees are…do they have proper net zero transition plans?"

She continued, "does their lobbying align with their net zero commitments? We've done a few things in terms of guidance for investors on how to spot greenwashing."

One CEO in the audience spoke about a tendency in financial services to follow the herd. How can the industry enact system change that allows it to be on the leading edge not the bleeding edge? Clarke's response was that one cannot tinker on the sidelines.

"We need wholesale systemic change in how we do things and a lot of that has to be driven by money. You need corporate leaders trying to do their bit, but you also need litigation making the point. Then you might get the authorities bringing in the right regulations, but it will take time," she said.

Others in the room pointed out that in terms of competitiveness, pushing the agenda in Europe is one thing, but how does that work in reality when countries like India, China and Africa, for example, are on a different path? After all, more than 50% of global emissions come out of Asia. Clarke conceded that it is a hard road and that some countries (and organisations) will be slower to move than others.

"We don't want to make the best the enemy of the good. We want to support those that are trying to do the right thing. When you get an egregious example of an organisation saying it's doing the right thing, when actually it's doing the opposite, that's when we will use litigation."

03 Geopolitics

Geopolitical risks have to be front and centre of global asset management firms as they navigate the complexities of an increasingly unstable economic environment. Ever since the invasion of Ukraine in February 2022, the power dynamics, East and West, have shifted.

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CEOs had a rare opportunity to ask the views of one of the world's leading geopolitical commentators, General Sir Mark Carleton-Smith, Head of the British Army (2018 – 2022) and former Director Special Forces. Unsurprisingly, Carleton-Smith had a captive audience.

Some of the questions raised during the session included:

- What might a second Trump administration look like – could it be even more dysfunctional than the first?
- How to understand the new era underway in Saudi Arabia?
- With the threat of recession in Europe, and a looming US election, how much would it take for Europe or the US to quietly pull out of Ukraine?

We are, according to Carleton-Smith, living beyond the high watermark of globalisation. The world is becoming increasingly bifurcated, with much hinging on how the US and China relationship evolves in coming years.

One of the toughest geopolitical risks to have manifested itself is the war in Ukraine and the subsequent impact this has had: global institutions have had to calculate their exposure to Russia and take action, as well as deal with the knock-on effects of supply chain disruption, commodity price elevation etc.

Carleton-Smith's view was that the invasion of Ukraine was a major strategic miscalculation, not just by Putin, but actually by Western liberal democracies as well.

"We have been guilty of a degree of complacency in how we manage Russia," he said.

The mistake made by the West was to assume a reasonably benign world as globalisation accelerated but there are negative aspects, which, according to the General, are manifesting in three mega trends.

The first is the redistribution of global power, from a centre of gravity in the West moving to the East.

General Sir Mark Carleton-Smith
Head of the British Army 2018-2022

03 | Geopolitics | General Sir Mark Carleton-Smith

The second is the changing nature of systemic competition, with great power rivalry once more the currency of international relation. This represents a new challenge to the political elites.

The third is the escalating pace of change through technological revolution.

"The reality of today is we're confronting a range of 21st century information age problems, and the senior leadership in many of these institutions are the least well-equipped to manage this rapidly accelerating change," said Carleton-Smith.

With regards to the United States, "Pax Americana" faces a three-pronged risk: Russia, China and Iran, each of which is looking to develop its own independent sphere of influence.

Addressing concerns by CEOs over the war still raging on Europe's borders, Carleton-Smith stressed that it had served to act as a catalyst for European nations to reexamine, and revise, their approach to energy defense and security policy. The way that the EU restructures how it relies on energy could have profound changes, not only on the energy mix (with higher reliance on green energy) but the level of investment that will be needed to fund such a transition.

utin might have banked on schisms through Europe bedeviling our ability to present a united response "so we need to build on that sense of a common purpose", said Carleton-Smith.

An expansionist Iran represents the most malign influence today, as it looks to capitalise on the end of an American era of hegemony in the Middle East and fill the vacuum.

China's influence in the Middle East has seen it act as a peace broker between Riyadh and Tehran. Strategic alliances and investment into the Middle East are creating a regional shift in global finance.

Against the geopolitical backdrop, investment opportunities are rising, as more US financial institutions open offices in the region to tap in to institutional capital. Saudi Arabia's Vision 2030 has led to an extraordinary social transformation.

In Carleton-Smith's view, we've seen the peak of China's economic might. Having seen how difficult things have been for Russia, President Xi will be careful to play with fire in regards to Taiwan.

"I think China understands that it's much easier to start a war than it is to finish it successfully."

The consequences of a degraded and damaged Russia could mean that it "balkanises". It is not hard to imagine a scenario where Chinese influence extends in to the heart of Europe. This would be an uncomfortable position, strategically and geopolitically for Europe heading into the next decade.

He believes that European government commitments to deterrence and increased defense spending would overcome any concerns that negative investor sentiment towards defense companies could have.

"You can't have soft power in isolation. You also need a proportionate, commensurate balance in hard power," he said.

04 Market Risk

The world is going through a period of transition.

In western economies, the threat of sticky inflation combined with higher interest rates is placing central banks in a difficult position; as evidenced in the UK, where the Bank of England is struggling to bring inflation down anywhere close to its 2% target. The financial industry must consider what the long-term consequences could be if rates stay higher for longer, and how they ought to approach building businesses of enduring value and resilience.

If indeed we are at an inflection point, what should asset managers be thinking about when communicating their value proposition?

Åsa Norrie is CEO of Principal Asset Management Europe. Speaking on the panel, "Winning leadership strategies for a high inflation/interest rate era: actionable insights",

Norrie spoke about the importance of having investment teams with deep knowledge in a global network to control and govern risk when providing solutions to investors.

To build resilience and adapt to an uncertain world, in February 2023 Principal Financial Group integrated its global asset management and pension business and renamed itself Principal Asset Management.

"That risk-based approach of how to govern portfolios is key to our work, putting pension capital into investment engines," said Norrie. "We've never before had the insurance, the pensions retirement and the asset management business talk to each other. Inevitably, that is going to mean a lot of improved efficiencies from a cost perspective."

Trust will play an even more important role, going forward, as CEOs think about attracting the next generation of investors, who now have a plethora of investment platforms to choose from. They represent a very different kind of customer and as Tim West, UK Partner and Alternative Investments Leader, Wealth & Asset Management, EY, noted, it will require asset managers to be nimble. He said that in terms of trust, the greenwashing agenda associated with ESG investments means that "people might move away from certain brands".

Åsa Norrie
CEO of Principal Asset Management Europe

Tim West
UK Partner and Alternative Investments Leader, Wealth & Asset Management, EY

"There is also the fact that you've got to think about giving something back to make the world a better place. As fiduciaries, it is not just about fund returns it's about what else we do. If you are a high margin business, where does your money go?" Tim commented.

The session highlighted that credibility, approachability and organisational stability are all important but to what extent do fund managers put their clients' interests ahead of your own?

This is an important question for CEOs to consider. If returns generated in the last decade are not likely to be repeated over the next decade, trust will become a key differentiator.

As one CEO remarked, one of the problems facing the industry is people questioning the value for money. "We need to demonstrate a purpose behind preserving investors' capital, and the educational part of it is very important," they said.

With reference made to the Credit Suisse collapse, the session highlighted the need to strengthen the social aspect of investing. Greenwashing scandals cannot be swept under the carpet. What is needed is to engage more with boards of directors and to speak out more publicly, otherwise trust in the industry will continue to erode. In that sense, the burden of proof on asset managers has intensified, as it pertains to ESG.

"Maybe ESG is not for everyone and we should say that. We need to be more pragmatic at least until there's some sort of global ESG framework in place," said one CEO.

Another added: "We refer to it as progress, not perfection."

Over the coming years, if indeed the world is facing an inflection point, asset management CEOs and leadership teams will be required to show dexterity and a quicksilver mind set to navigate a rapidly evolving, and complex risk environment. As the saying goes, "Forewarned is forearmed".


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