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BEFORE GOING ABROAD, UNDERSTAND THE RISKS

By Rhea Wessel

Investment professionals increasingly see an international posting as an essential part of their careers and development. For many, it has simply become a “CV must” to work internationally. But many underestimate the complexity of succeeding when they take their careers abroad.

The trend is gaining momentum. The number of expats who have served five or more international assignments increased from 18% in 2013 to 25% in 2015, according to a global study of expatriates commissioned by Cigna Global Health Benefits and the National Foreign Trade Council. The same survey found that professionals are increasingly working abroad out of choice rather than necessity.

But career paths in one market don’t always translate to others. As with virtually any career track, networking is key, but global mobility requires different networking strategies. The cost of international assignments is much higher—not only for employees but also for employers. The failure rate is much higher as well. And personality traits, such as resilience, can become even more important for success.

For some professionals, the additional risk may be a turn-off, but for others, the risk makes the adventure that much more exciting.

How can you know if an international assignment is right for you? To help answer the question, career experts and practitioners share their insights and personal experiences for this article.

KEY POINTS

The rate of international assignments has increased significantly in recent years, and going abroad is essential for a growing number of career paths.

The failure rate for professionals and employing firms is much higher for international assignments relative to professionals who stay in home markets.

To succeed, professionals who go abroad need to understand risks and how job markets vary from place to place.

"IT'S NOT ABOUT THE FIRST JOB"

Wendy Kendall, a global leadership consultant and former military psychologist, says, “When it comes to international assignments, people tend to self-select based on their own abilities and confidence, and they usually get it right.”

For Ted Stephenson, CFA, self-selection for a career abroad came easily. It was 1994 and he was 28, with a freshly minted MBA. Stephenson faced a slumping job market at home in Canada. He had lived abroad briefly as a child and had become curious through lots of travel, so Stephenson didn’t think much of packing some bags and heading off for Vietnam with a non-governmental organization (NGO).

At first, he began teaching business in Hanoi; then, he became a financial controller for a $15 million project. “Asian Tigers—I was in the right place at the right time,” he says.

Since starting off in Vietnam, Stephenson has worked in Taiwan, Malaysia, the United Arab Emirates, and Thailand and has been back to Canada multiple times.

Stephenson’s advice to those who want to go abroad and aren’t willing to wait around for company sponsorship is to go. “If you’re sitting at home trying to get a job over the internet, it will be very difficult,” he says. “But once you show up at a place, it’s always fairly easy to take one job and turn it into another. I’ve seen many, many people do that successfully. Sometimes it’s not about the first job you get but what can happen next.”

Looking back after spending a third of his life abroad, Stephenson says it somehow all makes sense. First, wanderlust took him outside Canada, but upon return, he faced reverse culture shock and found himself more easily bored. That meant it was time to move back abroad, where the job became more interesting. “When you’re working internationally, when it’s smaller teams, you become the jack of all trades.”

"EXPOSURE AND EXPERIENCE"

Deon Brenner, CFA, a recruiter for the investment industry in Cape Town, South Africa, advises candidates who have gone abroad but want to return to think about shop size from the start.

“Obviously, if someone has worked abroad and specifically if they have worked with a reputable investment bank or asset manager, it says a lot about the exposure and experience that candidate has gained," says Brenner. "By all means, that candidate is a more well-rounded candidate. From that perspective, having gone abroad is seen as a positive."

Now comes the caveat. If working abroad means you have acquired a niche skill set, that specialization can be a detriment upon return. For example, financial markets are much smaller in South Africa than in the UK, and one person in South Africa may do the same work as two or three people in the UK. "We call it 'from cradle to grave' [meaning a transaction is handled from beginning to end by one person]," says Brenner. "This can create a bit of a problem for candidates who 'only' have experience handling one portion of a transaction."

But going in the other direction is a positive. "It's beneficial from the large firm's point of view to move from a small firm to a large firm," says Brenner.

"STEER AWAY FROM TRADITIONAL SEGMENTATIONS"

Vijay Vaishnav, co-founder and managing director of Indusion Consulting, recruits in India and is focused on getting more expats to join firms in the subcontinent. He encourages job seekers to focus on the job and not the location.

As he puts it, don't go abroad for the "greener grass"; go for the "watery grass." And as you do that, steer away from traditional segmentations. Choose an opportunity based on your long-term goal and the asset class that you wish to excel in.

Vaishnav speaks highly of career opportunities in India. "There's so much local money that is basically chasing the asset management fraternity," he says. "My sense is that there will be more job opportunities in India than in Asia-Pac."

Vaishnav also points out the "push" and "pull" factors that are a part of every job search. "You need to look at what is the driver for you," he says. "Is it the location? Is it the role? Is it the quality of the organization, the compensation package?"

"GO FOR A QUALITY NETWORK"

Using the right networking strategy is part of the advice that Leila Rezaiguia gives based on her own experience.

Now co-founder and managing partner at Kompass Consultancy, which works with finance professionals in the Persian Gulf region, Rezaiguia was headhunted from a job in the UK to one in the United Arab Emirates before she went independent with her own company. It was her goal to move to Dubai, but looking back, Rezaiguia says she had the wrong networking strategy at the beginning.

When trying to make the initial move from London to Dubai, Rezaiguia had only a small international network and didn't understand the market. She would send out CVs, but no one would respond. A year later, after building up her network and realizing that she must work with recruitment agencies, she sent a CV and got a job interview within a week. That interview led to her first job in Dubai.

"Whether I'm working with a junior person or a senior person, people really struggle with networking strategy," she says. "They don't feel they have the right network, or they don't actually have one, never mind having an international network."

Her advice for international networking is to keep in touch with like-minded people wherever they go, often via LinkedIn. Rezaiguia stresses the importance of a good, professional profile picture and recommendations on your profile. "Go for a quality network, not one focused on quantity. Reach out to people and speak up about your interests, passions, and plans," she says.

"INHERENTLY DESTABILIZING"

If you thought getting the job and moving to a new country was work, don't forget about what's ahead once you've landed.

According to Kendall, some companies have failure rates in their international mobility programs as high as 50%. Failure in this sense means the professional did not meet the company's objectives in being sent abroad. He or she didn't perform on the job as expected or went home early.

Such failure can be costly. Kendall says companies can spend three times your annual salary to send you abroad.

Because of these risks and the large number of people she works with who struggle with parts of their international assignment, Kendall began researching the role of resilience in international careers.

Not only do people on international assignments face far more complex, asymmetrical, and shifting environments than five years ago, those environments are likely to be multi-dimensional, non-hierarchical, cloud based, and virtual, according to Kendall. This can increase the need for more personal resilience, because the complexity of the job comes on top of the unfamiliarity with the new country and culture. Some expats must also deal with family members who need additional support after being pulled out of their comfort zone.

"Moving abroad is the one thing that a company asks a person to do that fractures personal and professional lives," she says. "When you're established in a place, it's almost like being part of a tapestry. There are all kinds of threads that hold you there—your family, your friends, the reputation you have established. … When you move, you have to snip all of those threads. To re-establish yourself, you have to reconnect all those threads again."

Whether you've gone abroad because your company urged you to or your overseas stint is of your own choosing, you will need to be resilient. Many people simply underestimate the cultural and mindset differences they will face, not to mention such things as schools, doctors, housing, taxes, visas, and transport.

To ease the transition into your new world, Kendall recommends having conversations about how to make the international experience valuable and meaningful, not focusing on what you will leave behind. And look for what is exciting in the job. That's what taps into your strengths.

"It's inherently destabilizing to move abroad," says Kendall, "but leaving something behind can open up possibilities for the future. Moving abroad is a phase of tremendous opportunity. It's about making sure you position yourself to go up the learning curve rather than fall down into the doldrums."

Rhea Wessel is a freelance writer based in Frankfurt, Germany.

Career Tracks to the Future

CAREER IMPLICATIONS WILL VARY ACCORDING TO FOUR INDUSTRY SCENARIOS

By Ed McCarthy

As investment professionals look at industry trends, they have to wonder about future career implications. A recent study by CFA Institute provides a helpful outlook.

In April 2017, CFA Institute released the *Future State of the Investment Profession* (FSIP) study. The report considered scenarios that could develop as several megatrends that are not specific to finance interact with finance-specific innovations and disruptions. The megatrends are (1) aging demographics, (2) tech-empowered individuals, (3) tech-empowered organizations, (4) economic imbalances, (5) government footprint, and (6) resource management.

KEY POINTS

A new study examines likely future industry scenarios and their career implications for investment professionals.

Despite accelerating technology trends, "human skills" are expected to be the traits that give professionals an edge and to become increasingly valuable.

Key skills for the future will vary significantly among regions.

The study examines the potential impact of these megatrends mixing with finance-specific forces in different combinations to generate four scenarios over a 5- to 10-year period:

FINTECH DISRUPTION: New business models result from new technologies in a disruptive and creative environment. Challengers do better than established players, and the world of work experiences major disruptions.

PARALLEL WORLDS: Different societal segments engage in the world differently, which means changing product preferences for personalization, simplicity, and speed will change the baseline for financial services.

LOWER FOR LONGER: The current low interest rate environment becomes the norm for the next 5 to 10 years, combined with lower levels of global growth and increased political instability.

PURPOSEFUL CAPITALISM: The investment industry develops more ethical, professional, and client-centric practices that align to specific purposes and are delivered at lower cost and more efficiently.

To understand how these scenarios might influence career paths, *CFA Institute Magazine* asked two of the study's co-authors—Rebecca Fender, CFA, and Robert Stammers, CFA—to discuss the ramifications. Fender is the head of the Future of Finance initiative at CFA Institute. Stammers serves as director for investor engagement at CFA Institute.

Which of the megatrends and scenarios the study discusses are likely to have the greatest effect on the skills CFA charterholders and candidates need to succeed?

ROBERT STAMMERS: Among all the scenarios, I think CFA charterholders are going to have to start building more of what we call social skills. That's being able to build relationships with people, persuade people, more creative thinking skills. But I think each of the scenarios probably provides some additional insight into the skills that each CFA charterholder should be thinking about.

REBECCA FENDER: One theme of the paper is that there's a lot of change in the industry, a lot of disruption coming, and so the people who are going to succeed in it really are those that are going to be upgrading their skills and learning more along the way. For each of the individual scenarios, you can pick out a few things. For example, in fintech, that's a very clear "in your face" topic at the moment. Everyone in our membership wants to talk about what will be the impacts of fintech for this industry in the future, so more and more members are starting to find ways to increase their technical skills in this regard. It's already been reported in *CFA Institute Magazine* and elsewhere that there's going to be more in the CFA Program curriculum on fintech going forward. It's certainly an area for new people getting into the industry but also for continuing education [for those who have already established their careers].

ROBERT STAMMERS: One of the interesting things the report discusses about fintech is that the new work is essentially cyborg in nature. It's person plus machine, but it's the human skills that will really give people an edge. It's their demand for social intelligence, innovation, creativity, and so on that's going to allow them to work better in the new model.

REBECCA FENDER: I'd also note that if you think about what a typical investment analyst did 10 or 20 years ago, a lot of it was about gathering data and crunching numbers; whereas now, the great thing is a lot of that can be provided to you. What's going to set you apart and make you succeed is the ability to analyze and make judgments around that.

ROBERT STAMMERS: I think if we have a lower-for-longer scenario, people are going to have to get better versed in things like private equity, real estate, some of the assets they may not have been as comfortable with in the past. We talked a little bit [in the FSIP study] about impact investing and ESG (environmental, social, and governance) factors with purposeful capitalism. The parallel-worlds [scenario] is about understanding your clients: How do you create personalized services, personalized products for those different audiences?

Traditionally, investment professionals worked with high-net-worth investors. Now, they are working with a much broader class of clients. Some of these clients are affluent, but they have very different financial needs and objectives. So, people are going to have to learn more about their clients and how they can serve them.

How might the megatrends and scenarios affect the career paths that CFA charterholders could encounter?

ROBERT STAMMERS: The parallel-worlds section talks about the potential to add more value to clients by better understanding their needs and customizing portfolios to better meet their objectives. That involves a lot of skills that you probably don't have at the very beginning of your career. It involves a lot of understanding of the basics—first of all, the technical skills we teach in the exam—but then that experience of listening to clients and building those relationships of trust over time. We also focus on need for the leaders of investment firms to articulate a compelling vision for their organizations. That was really the number one thing that was needed for firms to succeed as well as for individual leaders, and something that was in relatively short supply. We think that in the next generation in particular, to attract people into this industry, firms will need leaders who can explain the purpose of the investment industry, that investment firms help real people meet their financial objectives and have a better quality of life.

Are professionals in other parts of the world likely to experience different skill and career path impacts under the scenarios compared with those in the US?

REBECCA FENDER: That was a really interesting aspect, because we asked what will be the important skills in the future and also what skills are hard to find. We saw differences by region in both those questions. For example, in developed markets, a majority, 56%, said the ability to articulate a compelling vision is becoming more and more important to CEO success. That was compared to only 34% in developing markets.

Think of areas where you have great pressure on returns. The lower-for-longer scenario talks about the challenges for the industry if we have a low-return environment for a while. In contrast, in developing markets, you see a lot more optimism and much higher absolute-return expectations. So the things that stood out were the need to have the ability to build relationships and to manage crises. Those were both in the top three skills for CIOs and portfolio managers in developing markets. So, 42% said that relationship building is a top skill. If you think about operating in a global context and understanding cultural differences too in some major developed markets, you probably can have a domestic portfolio and feel fine about it, but really more and more people have much more global portfolios. In developing markets, understanding how to build these cross-cultural relationships is front and center. Also, I think the point about managing crises is an interesting one. In markets with more volatility, they recognize that having leaders who can understand how to get firms through difficult periods can make or break a company.

Some charterholders will have the additional skills as a result of their backgrounds and experiences, but others will require training. What types of training do you see developing?

REBECCA FENDER: I think that some of the ways that the markets are evolving create this desire for specialized financial skills. What I'm talking about here is, for example, a move to more alternative investments and people looking for deals. You see more and more large pension funds doing direct investing. You see people looking for new structures in order to get higher returns. That's a different way of thinking than maybe a traditional portfolio manager role. You also have a lot of risks that are out there that people are realizing are a bit difficult to quantify. So there are a lot of risks that are not necessarily on the accounting statements, and this is front and center in conversations around sustainability and ESG, for example. The purposeful-capitalism scenario refers to this; a lot of organizations are working to standardize some of these other risks. That will help give us a better language to understand not only risk in a negative sense but opportunities to make more impact with investments, where people can tie that vision for the institution and for serving the end client to also benefiting society. That's the next frontier of how these skills can tie together.

ROBERT STAMMERS: I also think there's a real focus on ESG principles. The next generation of investors wants to make an impact in addition to just receiving a financial return, so investment professionals are going to have to understand more and more about how their investments impact externalities. What are the things that are affected by their investments and the organizations that they invest in?

REBECCA FENDER: Also, as it relates to skills and leadership, investment leaders seem to be focused even more now on the combination of skills on their teams. In general, you see a move away from the star portfolio manager to a team-based approach. That's coincident with an interest in diversity—cognitive diversity on teams, getting different perspectives, so that you are actually thinking about problems in new and different ways. A lot of the research that has been done on an interdisciplinary basis shows that diversity is most useful when it comes to certain types of tasks that involve complex decision making, and that's what you find in the investing space. If you're looking to outperform in an environment that's changing quickly, where there's lots of competition, building a more diverse team can provide an edge, and it's something that firms haven't explored too much.

KEEP GOING

Future State of the Investment Profession: Pursuing Better Outcomes for the End Investors, the Industry, and Society (www.cfainstitute.org/learning/future).

Ed McCarthy is a freelance finance writer in Pascoag, Rhode Island, and author of *Foundations of Computational Finance with MATLAB®* (Wiley, forthcoming).

TOUGH TALK

NEED TO TALK TO AN EMPLOYEE ABOUT A SENSITIVE ETHICAL ISSUE? HERE'S HOW.

KEY POINTS

If an ethics breach occurs, don't procrastinate. Promptly address the matter with sensitivity, tact, and discretion.

Frame the conversation by considering your tone, words, stance, and expectations.

Some cases require only correction or education, but other cases require more severe discipline or even termination. Adapting appropriately is key.

By Lori Pizzani

If you are planning a conversation with someone at work regarding a sensitive ethical issue, there are ways to discuss the topic and get a positive outcome. The last thing an employee or co-worker wants is to feel unfairly targeted, chastised, or alienated. And the worst thing you can do is avoid the discussion altogether.

"The secret is to confront behavior swiftly, directly, and without equivocation," says Suzanne Bates, CEO of Bates Communications in Wellesley Hills, Massachusetts. "It's important to make sure people understand that they not only put themselves and their entire careers on the line but that they are also jeopardizing the future of the company and their colleagues and friends."

Can even the most difficult conversations have a good result and produce the desired effect if handled the right way? Fortunately, the experts consulted for this article have practical advice for investment professionals who need to find effective solutions for addressing ethical matters with employees.

CULTURE STARTS THE CONVERSATION

To begin with, ethics should be a core part of a firm's corporate culture and general business practice, according to Amir M. Kahana, managing partner of the law firm of Kahana & Feld in Santa Ana, California. "I would strongly advise the need for a strong ethics focus for a workplace that goes beyond compliance," he says.

"The key to creating an ethical culture is to talk about it often, beginning the day people are hired," says Bates. "I recommend that the first meeting with a new employee include a conversation about the firm's values. If you live the values and hire people who adhere to values, then those who are inclined to cheat on the margins stand out and either self-select out of the firm or make themselves obvious."

In addition to the explicit ethical rules of the road that a company lays out for employees, there are often other small and nearly imperceptible messages that employees must sometimes grapple with. "People pick up signals in an organization about what is acceptable behavior," says Bates. "There is a saying that your culture is defined by the worst behavior you will tolerate."

ONE OF THE KEY THINGS IS MANAGING DEFENSIVENESS. IF SOMEONE FEELS UNDER THREAT, ATTACKED, OR JUDGED, THEY'LL ENTER INTO FIGHT-OR-FLIGHT MODE AND YOU'LL EXPERIENCE GREATLY DIMINISHED RESULTS.

FRAMING THE DISCUSSION

Setting the tone and defining expectations are important initial steps for addressing uncomfortable ethical questions. The end goal for a tough discussion is to produce ethical behavior. The trick, of course, is how to get there.

But the first obstacle to overcome is resolving to have a discussion. If you find yourself choosing to ignore your inner voice and procrastinating to avoid having what you anticipate will be a tough conversation, you're not alone.

"By avoiding conversations, we are keeping ourselves safe," says Jason Jay, a senior lecturer at the MIT Sloan School of Management and co-author of the book *Breaking through Gridlock: The Power of Conversation in a Polarized World*.

Changing your mindset about the conversation can help. "Visualize a good outcome to a discussion, and ask what would that look like," says Jay. How you approach the person and the topic has everything to do with what you say, the words you use, your tone, your stance, and your general demeanor. "One of the key things is managing defensiveness," says Jay. "If someone feels under threat, attacked, or judged, they'll enter into fight-or-flight mode and you'll experience greatly diminished results."

Jay recommends not entering into a conversation with a heat-of-the-moment mindset. "Take a pause, reflect on assumptions and judgments you may be bringing, and consider how these emotions will bleed through." Adjust your way of thinking, and then determine how best to approach the situation.

To prevent the other person from shutting down emotionally, Jay suggests beginning a difficult conversation by expressing curiosity and attempting to understand both the person and the situation. For example, he says, "Let's inquire together [about] what happened and why it happened and what we can do together to change this."

People often find themselves caught in a set of conflicting demands—for example, to sell or perform a certain way. "We often know that we want to act with integrity, but we may be pressured by our company to act in another way," says Jay.

Allow people to unveil any ambivalent feelings and to confront the pressures they are experiencing through your balanced show of understanding and compassion. "Create an environment where people will foster learning and improvement and want do the right thing," says Jay. "Be clear as to what outcome you are looking for, as often this can be unclear."

If an employee indicates that a directive was very different from the standards you are enforcing, the inconsistency should be a red flag that needs further investigation.

HARD CHOICES

Some ethical violations may be embarrassing and need to be addressed, but they don't necessarily create liability situations. "If something innocuous was done, it may not be a legal issue," says Kahana. However, she notes that other cases may have potential implications for criminal or legal liability.

If an ethical breach has occurred but there's no potential liability, Kahana continues, "the last thing you want to do is embarrass that employee."

Either way, he cautions employers not to overreact and recommends that the appropriate superior talk directly to the employee while being very sensitive to the person and the situation. "If you bring in a lawyer to talk to them, that can often freak out that employee," he says.

An accidental breach, although wrongful, can often be accepted but should be quickly rectified so that it does not happen again in the future. Much more serious types of breaches (such as outright theft of assets) shouldn't be tolerated to any degree.

Continuous breaches by the same employee make for a different situation.

"If an employee is someone you cannot correct the behavior of, it's often better off letting them go," Kahana says. He counsels that in cases of an employee's dismissal, employers should deftly handle the situation. "Do not announce an employee has been terminated. That, in itself, is a liability, and an employee may then elect to shake down the firm."

It's better to have a generic talk with other employees to discuss ethical breaches without naming the person who was dismissed, according to Kahana. "Be ethical yourself but also be private and discreet," he says. "How you treat employees and how you let them go is important. Don't beat up an employee on the way out, which can invite a lawsuit."

Lori Pizzani is an independent business and financial services journalist based in Brewster, New York.

OVERCOMING ETHICAL CHALLENGES

CFA INSTITUTE PROVIDES RESOURCES TO HELP WITH REAL-WORLD QUESTIONS

KEY POINTS

"Many people don't even know when they're in the midst of an ethical dilemma," says Leilani Hall, CFA, CIPM, head of Professional Conduct at CFA Institute.

CFA Institute provides resources to members to help them understand the requirements of professional ethics, especially the CFA Institute Code and Standards.

The Ethics Helpdesk enables members to contact CFA Institute via email to seek more specific guidance for their personal circumstances.

By Lori Pizzani

As all CFA Institute members know, the challenge of maintaining high professional standards is often harder and more complex than just saying no to obvious unethical behavior. Requirements at different levels from firms to regulators increase complexity. In addition to the CFA Institute Code of Ethics and Standards of Professional Conduct, each investment management firm must have its own individual compliance manual and employment guidelines that also apply to CFA Institute members. Fortunately, CFA Institute stands ready to help members deal with ethical issues in the workplace and give them the resources they need.

PROFESSIONAL STANDARDS

CFA Institute offers the *Standards of Practice Handbook* (effective as of 1 July 2014) to help investment professionals "translate" genuine, everyday ethical dilemmas into real-life practice. It provides guidance to members as to what situations may cause a breach of the Code of Ethics or Standards of Practice and why. It also discusses how to avoid breaches.

Although the handbook cannot address every ethically sticky situation, it does cover many of them, and it discusses emerging issues with guidance and suggestions, such as how to handle social media dilemmas. "The Code and Standards are intended to be long-lived while still relevant to current industry practices," says Glenn Doggett, CFA, director of professional standards at CFA Institute. "Elements of the principles stay the same even where some roles or new technology emerge."

The basic tenets of "loyalty, prudence, and care cover all of our members," he adds.

Detailed learning opportunities are available through the CFA Institute Ethical Decision-Making Framework, which offers practical guidelines in navigating ethical situations. Also available is an online learning course and a live webinar, both of which qualify for continuing education credits.

ETHICS HELPDESK

CFA Institute maintains an email-based ethics helpdesk that members can contact for more personalized guidance. “Through this helpdesk, members can learn what’s expected of them vis-à-vis following CFA Institute ethical standards,” says Doggett. “But we cannot give out legal advice.”

Questions received by the helpdesk are generally broad, and common inquiries pertain to handling conflicts of interest and maintaining objectivity. Other frequent inquiries are about appropriate use of the CFA charterholder designation and how to engage in the “dissociation” process if an investment professional sees greatly concerning workplace behavior. “Dissociating means not knowingly participating in illegal or unethical behavior,” notes Doggett.

Investment professionals with concerns about workplace misconduct are encouraged to first have a conversation with a direct supervisor: “It’s best to always try to solve the problem at the point of contact,” says Doggett.

MANY PEOPLE DON’T EVEN KNOW WHEN THEY’RE IN THE MIDST OF AN ETHICAL DILEMMA. OUR TOOLS ARE OUT THERE TO HELP OUR MEMBERS MITIGATE THE RISKS OF BREACHES AND SHOW THEM HOW NOT TO MAKE A FATAL MISTAKE THAT CAN RUIN THEIR CAREERS.

What are the most common violations of the CFA Institute Code of Ethics and Standards of Professional Conduct?

- Insider trading
- Misrepresentation/omission of a material fact
- Manipulation, price collusion, excessive markup
- Forgery, falsification of a document
- Breach of the fiduciary duty to a client

If that doesn’t work or if suspected misconduct caused client harm, then you should go up a level to a higher supervisor or compliance officer who will investigate. The CFA Institute ethics helpdesk can be a valuable resource. “We can help them ask the right questions,” explains Doggett. “Conversations and communication are the key to all of this.” Just because actions appear troublesome may not mean there is a true ethical breach. “You may not be aware of certain disclosures that others have provided,” he cautions.

However, if you’ve exhausted your options, you have to make the hard decision between your personal reputation and your career. Separating from the firm altogether should be considered.

PROFESSIONAL CONDUCT

As a self-regulating professional organization, CFA Institute sets the policies not only for professional conduct but also for the disciplinary process when a member is found to have breached the Code of Ethics or Standards of Professional Conduct. “We’re a part of the enforcement side, alongside the Disciplinary Review Committee,” says Leilani Hall, CFA, CIPM, head of professional conduct at CFA Institute. Her department investigates potential violations and uses a “sanction matrix” to help determine the recommended sanction. The matrix considers both mitigating and aggravating factors, including whether a breach was unintentional or intentional, whether it was exacted on sophisticated investors or particularly vulnerable ones, and whether it caused considerable harm to investors.

The most common violations of the CFA Institute Code and Standards fall into five categories:

- insider trading;
- misrepresentation/omission of a material fact;
- manipulation, price collusion, excessive markup;
- forgery/falsification of a document; and
- breach of the fiduciary duty to a client.

One area of concern involves transitions from larger firms to smaller firms. A large firm typically can afford to maintain a robust compliance program, astute compliance officers, and broad resources to prevent ethical blunders. This level of support may not be possible at a small firm. When professionals make a switch, the change could increase the risk of mistakes.

“Many people don’t even know when they’re in the midst of an ethical dilemma,” says Hall. “Our tools are out there to help our members mitigate the risks of breaches and show them how not to make a fatal mistake that can ruin their careers.”

Lori Pizzani is an independent business and financial services journalist based in Brewster, New York.

KEEP GOING

CFA Institute Standards of Practice Handbook
(www.cfainstitute.org/ethics/codes)

CFA Institute Ethical Decision-Making Framework
(www.cfainstitute.org/en/ethics/ethical-decision-making)

CFA Institute Ethical Decision-Making online course and live webinars
(www.cfainstitute.org/en/ethics/ethical-decision-making)

ASSESSING VALUE IN THE DIGITAL ECONOMY

ANALYSTS NEED NEW TOOLS TO EVALUATE NEW BUSINESS MODELS

Sherree DeCovny

Do analysts need a new analytical framework? If the goal is to assess corporate value in the new digital economy, the answer is yes because business models have changed so much since valuation practices began in the industrial era. In 2015, Tom Goodwin, executive vice president and head of innovation at Zenith USA, summed up the strangeness of the new economy when he said, "Uber, the world's largest taxi company, owns no vehicles. Facebook, the world's most popular media owner, creates no content. Alibaba, the most valuable retailer, has no inventory. And Airbnb, the world's largest accommodation provider, owns no real estate. Something interesting is happening."

KEY POINTS

The value of strategic assets may reflect changes in corporate value more reliably than company earnings reports do.

Intangible assets are generated internally but are not reflected on companies' balance sheets, which creates a distortion.

New types of metrics, lack of information and benchmarks, and inconsistency across companies present challenges for analysts.

The digital economy could also be called "the second machine age." That's the term used by MIT professors Andrew McAfee and Erik Brynjolfsson. They say the first phase of the second machine age began in the mid-1990s when digital technologies started taking over routine tasks done by humans. Now we are in the second phase, in which computers can do nonroutine work and technologies once thought of as science fiction, such as driverless cars and artificial intelligence, are real.

Back in 2011, economic theorist Jeremy Rifkin wrote that we have reached maximum productivity with older technologies. According to his book *The Third Industrial Revolution*, with the advent of big data and the Internet of Things, an economy is emerging in which we will manage scarce resources through sharing, clean energy, and fuel-efficient transportation, and we will produce at zero marginal cost. The way we do business is completely changing via a new digital infrastructure that is efficient and cost effective, with a built-in mechanism for establishing trust.

Somehow, analysts need to find ways to make sense of all of these changes and gain valuable investment insights. [*For more perspective on the challenges of valuing intangibles, see the column by Ray Rath, CFA, in the Opinion section of this issue.*]

DEFICIENT MODELS

Earnings no longer reliably reflect changes in corporate value and are an inadequate driver of investment analysis, according to a *Financial Analysts Journal* article titled "Time to Change Your Investment Model," published in September 2017. The authors, Feng Gu of the University of Buffalo and Baruch Lev of New York University, advocate shifting the focus from a company's earnings to its value-creating strategic assets and their deployment.

So what are strategic assets? Gu and Lev say they are assets that generate net benefits, are rare or in limited supply, and are difficult for competitors to imitate. The authors particularly note the rise of the online, direct-to-consumer, subscription-based model, with its emphasis on the customer franchise, patents, and trademarks.

The digital economy has become more intertwined with the traditional economy as mainstay companies have jumped on the bandwagon. For example, Procter & Gamble launched a subscription-based offering for its Tide PODS products. In 2016, Unilever bought Dollar Shave Club, which has millions of members, for $1 billion (about five times estimated revenues). Unilever's 2016 annual report states that "we will preserve [Dollar Shave Club's] entrepreneurial approach, taking valuable lessons for the rest of our portfolio."

Gu and Lev warn, however, that analysts rarely perform a comprehensive competitive analysis of how companies are taking inventory of their strategic assets, enhancing and defending those assets, and deploying them for value creation.

Glen Kernick, managing director and technology industry leader at Duff & Phelps Corporation, a global valuation and corporate finance adviser, agrees with Gu and Lev. He says earnings are losing their relevance, particularly for companies that are making significant investments in strategic intangible assets through R&D and other activities. He explains that the US GAAP accounting model, developed during the industrial age, is not equipped to evaluate technology companies and the digital economy.

For example, a company would typically expense R&D through its profit and loss statement. No asset is created from that R&D investment, so there is no future benefit related to it. To this end, the valuations of such companies as Amazon.com and Netflix have not been highly correlated with their accounting earnings. Clearly, investment in R&D is driving future benefit, but balance sheets do not reflect that benefit. In fact, these companies may be incurring large period losses from these investments.

So does it matter whether the market values of digital economy companies have no relationship to their book value or to the assets on their balance sheet? Kernick sees a problem because part of the market value of S&P 500 Index companies is attributed to intangible assets that are largely not reflected in those companies' financial statements.

"Most investors and users of financial statements would prefer enhanced disclosure and more information about assets that are generating future income and future cash flows," he says. "So the fact that those assets are not reflected on the balance sheet, I think, is a deficiency in our accounting model."

In a cost-based accounting model, a company buys an asset for a certain amount of money, records it on the balance sheet for the amount paid, and subsequently depreciates that asset. In today's mixed accounting model, tangible assets are measured and booked at cost. But intangible assets acquired in a business combination (a transaction in which the acquirer obtains control of another business) are measured at fair value and recorded on the balance sheet. They are potentially re-measured and only written down—never up—if there is an impairment.

But if intangible assets are generated internally, they are generally not reflected on the balance sheet, and this scenario creates a distortion. If certain value-driving assets are recognized because they are considered important in the context of an acquisition or business combination, then why are they unimportant while being developed internally?

Kernick suggests the accounting model is deficient because it lacks a complete fair-value balance sheet. Instead, in the mixed model, certain assets are recorded on the balance sheet at cost and other assets reflect fair value. Unless intangibles were acquired in a business combination, they are not generally recognized on the balance sheet at all.

For instance, digital economy companies such as Facebook and Alibaba have disclosed that they are using data to enhance their income and margins, but their balance sheets do not capture this dynamic.

THE RATIO OF INTANGIBLE ASSET VALUE TO TANGIBLE ASSET VALUE IN PUBLIC AND PRIVATE COMPANIES HAS GROWN SIGNIFICANTLY DURING THE LAST COUPLE OF DECADES, AND THE TREND IS LIKELY HERE TO STAY. TO THIS END, EVEN NON-SPECIALISTS NEED TO AT LEAST UNDERSTAND THE DRIVERS OF VALUE.

"It is widely known that digital economy companies use artificial intelligence and proprietary software algorithms in combination with data to improve and customize the user experience, which ultimately results in higher income and margins," says Kernick. "But there's nothing reflected on the balance sheet for those assets."

According to Robert Reilly, managing director at Willamette Management Associates, the alternative is to switch from US GAAP to International Financial Reporting Standards (IFRS), which are based on fair value accounting. Under IFRS, companies hire valuation analysts to revalue their intangible assets annually, the results are independently audited, and the balance sheet is restated to current fair value.

"Unlike IFRS, US GAAP only applies those standards in a relatively small percentage of circumstances," he explains. "You don't know what intangible assets exist in a company that wasn't acquired because they don't show up on the balance sheet. Audited financial statements of companies in most other countries show this information."

In addition, if companies do not need to value intangible assets for tax or regulatory purposes and investors and financiers are not asking for it, most companies are unwilling to pay for the valuation.

Vincent Papa, director of financial reporting policy at CFA Institute, believes there is a good argument for not recognizing intangible assets until they are measured reliably.

"The notion that financial statements in general—and earnings in particular—are becoming less relevant for investors should be taken with a pinch of salt," he says. "This is despite the demonstrated declining association with stock prices over the years or even the evidence that investors are increasingly relying on other information sets, including non-GAAP measures."

While agreeing that intangibles reporting needs to be updated, Papa also questions the notion that GAAP and IFRS have failed entirely to adapt for 21st century business models. For example, the recently issued IFRS 15 and Topic 606, pertaining to the recognition of revenue from contracts with customers, were designed to be fit for purpose for various business models, including subscriber-based and intellectual property–intensive ones.

Papa believes the IASB and FASB should significantly enhance the presentation requirement around the income statement and cash flow statement so that components are better disaggregated and the classification of economically similar items is more meaningful. But he still thinks GAAP/IFRS information remains foundational despite its inherent limitations, such as largely reflecting past transactions. Admittedly, this reporting is not as timely as press releases and other information that investors rely on within management presentations. Moreover, there is an increasing appetite for more forward-looking information beyond what US GAAP and IFRS information may meaningfully convey.

IGNORING A KEY VALUE DRIVER?

Companies are now disclosing new types of key performance indicators (KPIs) or metrics. Among them are daily active users (DAUs) and monthly active users (MAUs) on their platforms, average revenue per user (ARPU), customer acquisition cost, and customer churn rate.

For example, Facebook's third-quarter earnings release showed that its DAUs were 1.37 billion on average for September 2017 and its MAUs were 2.07 billion as of 30 September 2017. The company also included a slide on "Limitations of Key Metrics and Other Data," which explains "there are inherent challenges in measuring usage of our products across large online and mobile populations around the world."

Alibaba uses slightly different terminology in its third-quarter presentation. It reports having 549 million mobile MAUs, which it defines as the number of unique mobile devices used to visit or access certain of its mobile applications at least once during that month. It also reports having 488 million annual active consumers on its Chinese retail marketplaces, which it previously referred to as annual active buyers.

Ultimately, the company has discretion as to what and how much it discloses, so lack of information remains a challenge for investors and analysts.

"It requires a lot of analysis and digging to ensure you're not just taking the data that exists at face value and you're comparing apples to apples," says Kernick. "That's true of any financial analysis, but even more so with these types of KPIs or metrics that companies are now disclosing."

Three models are typically used to value strategic assets—an income-based approach, a market-based approach, and a cost-based approach—but each has limitations and trade-offs. Valuing the strategic assets of digital economy companies involves a higher level of uncertainty. The biggest limitations are around access to data, inconsistency across companies, and the lack of benchmarks. Strategic assets are unique by nature and often unique to the specific company in terms of how it can extract value from them. Frequently, these assets have no comparable market transactions.

"The general perception is that the inputs may be unreliable, and therefore the output is unreliable. But that's not an excuse to ignore something that is a key value driver for the company," Kernick says. "Some estimate is better than no estimate."

Reilly points out that this problem is not new. For decades, he has faced the same issue when valuing telecommunications and cable TV companies. But he agrees that there is some inconsistency in the way public and private companies report certain metrics.

"Security analysts and investors, who just get a 10K or who may be on the analyst call with the CEO or the CFO, find it difficult to get to the underlying information," he says. "But when we're working for [an analysis of] the company, we can sit down with the people who are collecting data to understand how it's gathered. We can get to a normalized revenue per customer, income per customer, and cash flow per customer. Then we can estimate the remaining useful life of those customers based on the churn rate data and perform the intangible asset valuation."

Currently, no standard-setting body has meaningfully defined the requirements for metrics such as average daily or monthly users. The International Integrated Reporting Council (IIRC) is encouraging companies to tell a coherent long-term value-creation story and focus on various types of capital that are material for them. IIRC identifies six types of capital: financial, manufactured, intellectual, human, social and relationship, and natural. Together, they represent stores of value that form the basis of an organization's value creation.

Although the CFA Program curriculum covers valuing intangible assets, many CFA charterholders may find the process mysterious unless they work for a valuation firm and develop expertise at such valuations. That said, the ratio of intangible asset value to tangible asset value in public and private companies has grown significantly during the last couple of decades, and the trend is likely here to stay. To this end, even non-specialists need to at least understand the drivers of value.

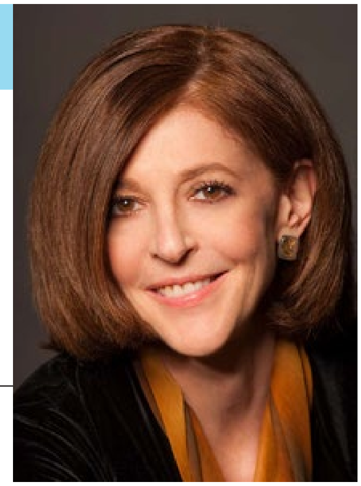
The bottom line is that analysts can no longer limit their work to looking at historical earnings and projecting future growth rates. They need to understand the strategic assets that drive growth, such as the relative strength of a brand or the differentiation of a technology, the risk associated with them, and whether growth is sustainable. Although a lot of value is based on a company's existing platform and assets, it is important to understand the ability to generate future strategic assets. This ability is tied to human capital, so metrics such as employee retention and attrition have also become more relevant than ever before.

KEEP GOING

Feng Gu and Baruch Lev, "Time to Change Your Investment Model," *Financial Analysts Journal* (Fourth Quarter 2017) [www.cfapubs.org].

Sherree DeCovny is a freelance journalist specializing in finance and technology.

"A DECEPTION EPIDEMIC"



YOU CAN LEARN HOW TO DIAGNOSE DECEPTION, SAYS LIESPOTTING EXPERT PAMELA MEYER

By Nathan Jaye, CFA

We are living in the midst of "a deception epidemic," says deception expert Pamela Meyer. In fact, research indicates that we are lied to more than 200 times a day. And in an industry that relies on factual information, any deception can have big impacts on our firms and careers. Meyer is founder and CEO of Calibrate, a leading deception detection training company, and her TED talk "How to Spot a Liar" has received more than 25 million views. In this interview with *CFA Institute Magazine*, Meyer talks about the BASIC method of lie detection, optimizing the technique of baselining, how to spot potential inside threats, and building organizations based on honesty and integrity.

KEY POINTS

Professionals face a world in which deception has become an everyday occurrence, with some studies indicating that people are lied to more than 200 times a day.

It is possible to learn skills that will help you detect deception, deal with it more effectively, and avoid misguided overreactions.

Leaders who want to develop a culture of integrity within their firms must demonstrate their own commitment to transparency and honest communication and go beyond simply providing employee handbooks and codes of values.

What's the BASIC method?

The first step is to baseline the person you're interacting with. That's the B in the BASIC method. When you baseline someone, you're establishing a reliable reference point for measuring behavioral change. You're going to interact under very normal circumstances, but you're paying closer attention to what you observe. You want to ask questions like: "How are you? How was your weekend? What did you do? Did you go shopping?" You're getting a sense of a person's norms, so that you know what to observe if their behavior shifts.

For example, if someone is a foot tapper, it's not significant if they're *always* a foot tapper. It's only meaningful if they're *not* tapping their foot and then when you ask them a question they start tapping their foot. You have to understand their normal behavior first or you'll make mistakes.

What behavior do you look for in baselining?

You look at eye movement. You look at posture and fidgeting behavior. You look at their hand and leg gestures. You're going to notice the pitch, the speed, the volume at which they speak. You're going to get a sense of their laugh pattern—the style, the duration of their laugh—how they hesitate, how they punctuate their sentences. Most importantly, it's vocal tone and posture that you're going to observe.

Most people already do this unconsciously. We baseline the people we live with. We know them like a book, we know what their norms are, and we know when they are acting abnormally. But if you've just met someone, it's important to spend time building rapport to get a sense of their normal behavior.

What is the A in BASIC?

A is for asking open-ended questions. The goal is getting information through expanded verbal replies. If a computer was stolen from an office, you don't begin with hard questions like, "Did you lock the door?" Instead you might want to ask, "What happened that night?" They'll tell their story, and then at some point you may ask, "Did you lock the door?"

Think of it as a funnel. You start with a very open-ended question, and then you narrow it down to the more and more specific. You're asking lots of questions, but you're also trying to see how someone may be reacting.

You can also propose multiple theories for what you think may have happened. You may empathetically offer a series of possible reasons why the subject may have acted deceptively—then see which ones they respond to. When someone has acted deceptively, they often have a justification for why they did it. Perhaps they were under financial pressure or someone else pressured them or they were covering up for something. If you can touch on that, you may notice—from their body language and vocal tone—which one of those stories they resonate with.

DON'T ACCUSE PEOPLE. THE FIRST THING TO THINK ABOUT WHEN APPROACHING SOMEONE IS THAT IT'S WORTH HAVING RAPPORT. IT'S WORTH GIVING THEM THE BENEFIT OF THE DOUBT.

How does body language tip off deception?

That's the S in BASIC, studying the clusters of deceptive behavior. You may see someone shift their anchor point—their posture may shift significantly in response to a question. With women, this may be a grooming gesture, perhaps twirling the hair or touching the face below the eye. With men, sometimes you see dusting lint from the shoulders. You might observe a slumped or self-protective posture.

Someone may close their eyes, indicating that they're using their imagination rather than memory when they're telling a story. You may notice excessive sweating, finger tapping, or a significant shift in blink rate. You may see what we call post-interview release. If you signal that the interview is over, the person may relax suddenly because they've been so tense. Like the exam is over.

A person may also appear to be unconsciously trying to leave the room. They may slump with their posture and point their feet towards the exit or start to lower their voice.

Remember, it's only the first three seconds after a hard question that's considered scientifically reliable. If you ask someone a question and they're dusting lint from their shoulder or touching their face and they are *still* doing this ten seconds later, it doesn't mean anything. It's only the spontaneous response that's considered reliable.

Do these behaviors always indicate deception?

It's an important question. Often when you see these behaviors, it could simply mean you're not getting the whole story. It doesn't necessarily mean they're lying. It could mean there is a withholding.

There may be information a person hasn't told you. Or perhaps there has been a related development that someone doesn't want you to know. When you see these behaviors, you don't necessarily know what's being withheld. But it will seem like a red flag or like bad weather.

So it's more about discovering a lack of truth than lies?

I teach a very clear method of getting to the truth. It's really not that valuable just to know if someone is lying. Because if you can't get to the truth, what's the point? The last thing you want to do is go around pointing your finger at others saying, "Liar, liar, pants on fire." That doesn't do any good.

When you think someone is being deceptive, if you stay curious, you may find they have good reason to be deceptive—there may be something of real interest beneath the lie. So it's worth keeping a rich, open mind. Keep your curiosity hat on. Don't accuse people. The first thing to think about when approaching someone is that it's worth having rapport. It's worth giving them the benefit of the doubt. Because behind almost every lie is something richer and more meaningful.

What are verbal cues of deception?

A person may use distancing language. Bill Clinton made his famous statement that he "did not have sexual relations with that woman." People will unconsciously distance themselves from their subject. They use language as their tool for doing that.

You may hear a lot of qualifying statements, such as "as far as I know" or "to tell you the truth" or "I certainly do not do that." Someone may question your questions to stall for time. They may repeat your question verbatim to stall for time.

You may observe a non-spontaneous response time or a weak and apologetic tone of voice. You may get an inappropriate amount of detail from someone. In their efforts to convince you that they're being honest (and teenagers do this all the time), people often will just give you way too much detail. But more often than not, when someone is being deceptive, you'll just get very short, clipped answers. Because they're scared to tell you anything.

What else is a tip off?

The person may object to word specifics. "No, no, no. I had the chicken, not the steak, at dinner." They are trying to appear authentic, so they'll object to specifics that are irrelevant. They may be uncooperative. "How much longer is this going to take? I really have to go." There may be a lack of appropriate emotion associated with the story, if they're telling you something really dramatic. If there's no emotion associated with the story, that could be a way that they've distanced themselves from what they did.

The structure of their story may also be an extended prologue, with all kinds of authentic details, where the main issue is just pushed to the end.

Is it true that liars smile?
There *is* an unconscious delight in getting away with a big whopper. It's so unconscious, it doesn't even make sense to people that a liar can smile. But it happens all the time, and you'll start to observe it. And we do see this—we see an unconscious smile at getting away with a whopping lie. This is called "duping delight" and can be associated with deception.

True expressions are usually symmetrical, right?
Most emotions come across the face in a very symmetrical way, when they're real. Often, we'll see a dissonance between someone's words and their body language. Or their words and their facial expressions. We call these "hotspots" when we see this conflict. Someone may say, "I'm dying to do that deal," and then they'll pull their shoulder up. Or they'll say, "You're going to be the best partner ever," and you'll see contempt flash on their face.

What you're looking for in facial expressions is not only the expression itself but how it fits into the whole context of what someone is saying and what their body language is signaling. You're looking for discordance or asynchrony in a person's behavior. When a person is truthful, there is synchrony between their words and their body and their face.

How do you spot a fake smile from a real one?
A real smile is in the eyes. The crow's feet around the corners of the eyes is where true joy is expressed. It's easy to fake a smile of the mouth. If someone is being truly authentic (or they're happy and they love you or they're showing joy), you'll see it in the eyes. I've had people say there's a twinkle in their eye. If you consciously observe their eyes, you'll see a crease where the crow's feet are.

What's the science behind liespotting?
My book is a survey of the research out there. However, like many soft sciences, the research is contradictory. In the book, I've only included studies where the data could be confirmed by more than one researcher. We threw out lots of studies, including some from major research institutions, because we couldn't find another study to confirm the same data.

That's one piece of it, the soft science. The other piece is that lying is actually a gigantic field of practical study. We looked at what we know from police interrogations and what we know from FBI research, as well as how lie detection is taught at the CIA and in the intelligence world. There's something to be learned from every one of those disciplines.

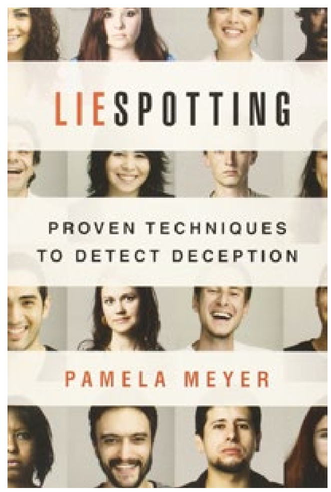
Why do people lie?
People lie for very different reasons. We know that extroverts lie more and persist longer in their lies than introverts [do]. Powerful people lie more. Men and woman also lie for very different reasons. Women lie more to protect other people and to avoid conflict, whereas men tell bolstering lies, where they present themselves as more exaggerated versions of themselves.

Lies fall into many different categories. We do know that lies can be either very practical or they can be bolstering. Often the lies that we're told are to avoid conflict; they're for practical reasons. You might say, "Oh, you don't look fat in that." Or "I'll call you" when you have no intention of calling. Or "I understand" when you're actually thinking "Are you kidding me?" Or [you might be told] "It's not you; it's me" when someone's breaking up with you.

There are high-stakes and low-stakes lies. It's the high-stakes lies that really affect our lives. If you're researching an investment, considering a deal, trying to decide where to work, or even who to date or to marry, it's essential that you know the truth.

If we think we're being deceived, what can we do?
The next step is to *intuit*, the I in BASIC. So you want to ask yourself [questions]. Are there intuitive gaps in someone's story? Is there a gap in their statements between what they claim happened and what the facts indicate? Is there a logic gap?

Are there behavior gaps? Is someone behaving in a way that's different from their baseline? Are there emotion gaps? Are they talking in an incredibly terse way and flashing contradictory facial expressions? If so, you need to trust your intuition and follow up on it.



If you do sense someone is lying (and this is the final C part of BASIC), you have to *confirm*. You need to test your hunches and move toward a conclusion. You cannot just accuse someone, perhaps wrongly. You want to use as many third-party facts or as many additional facts as you can. You need to go back to original sources. You can't just rely simply on your own findings. You need to make sure that you have facts to back it up. I never recommend using a liespotting technique for accusing someone.

What's your method to gain confirmation?
You can ask what are called confirming questions. So you might ask the same question in different ways. Or you may ask, "What should happen if the person who did this is found guilty?" Often a guilty person will respond, "I don't know." They may recommend a lenient punishment, while a truthful person is going to recommend an appropriate punishment, such as removing a person from their position or from the company. You can ask, "Who do you think did it?" The guilty person may not answer the question, while the truthful person is going to cooperate and brainstorm with you.

If someone is being deceptive, they may become passive-aggressive at this point or refuse to talk further with you. They may not completely trust you because you've cut a little too close to the truth. At this point, you need to significantly develop rapport again with the person before you take the conversation further. You really need to have a green light.

How might you get them to open?
You might ask, "How can I be helpful to you? Is there anything else you want to tell me? Do you have any advice for me? What's the pettiest thing that's bothering you about our conversation? What's the pettiest thing that's bothering you about what happened?" You're signaling that you're not going to judge them.

You're saying, "Whatever happened is not morally repugnant to me. I'm not going to be condescending in any way. I'm on your side." When you are really in a place where you have a green light from someone and you sense that kind of rapport, you can then start to ask some of the more difficult questions again, to move toward the truth.

So you actually change your own approach?
I do. I go out of my way to really think through—from the other person's standpoint—how they may be feeling. I want to be curious, especially to who they are as a person. I want to remember that usually someone's life is much richer and much more complex than the one event you may be discussing with them.

This is important, because we're trained by TV culture to accuse and convict. But real life isn't really like that. It's more nuanced.

Can we use these methods to create integrity in our organizations?
I think that's really important, particularly because we're in the midst of, essentially, a deception epidemic. The first thing is to understand ourselves better and make sure we are not self-deceptive. It begins with getting your ego out of the way and knowing where you may be overreacting. There's a lot of personal work to do before we go out in the world and start accusing everyone else of lying. You have to make sure you're not lying to yourself first.

From a management perspective, transparency is key. You want to commit to openly communicating your goals, your concerns, your disappointments, and your expectations with people. You need to have these difficult conversations and not just hand someone an employee handbook or code of conduct (although it helps to have these). You have to demonstrate you're committed. Transparency doesn't mean that you share everything. It means you're transparent about what you are sharing and what you are not sharing.

What about integrity in communication?
It helps to be explicit about our moral code. We can signal to everyone around us that our interaction is going to be honest. There's usually room to be much more explicit about this. It does make a difference.

This means building a habit of honest communication during uncomfortable moments. Many of us sabotage open communication by going behind someone's back, by acting passive-aggressively toward deceitful people via email, or by avoiding conflict all together. That doesn't help. We really need to have these uncomfortable conversations. It's a necessary social skill that mature leaders need to develop now. When they do, this infuses an entire organization with trust.

What's the future of liespotting?
The technology around lie detection is changing significantly. It used to revolve—particularly in the federal government—solely around the polygraph. The polygraph has been the DNA of the intelligence world, and now that is shifting dramatically. I'm on the advisory board of a company called Converus. They have a biometric system that takes several measurements of the eye and tells us, with as much accuracy as a polygraph, whether or not someone is being deceptive.

Measuring the eye reveals lies?
The system takes ocular measurements, among them pupil dilation and autonomic nervous system responses that cannot be controlled. We know that pupil dilation shifts when someone is being deceptive. So this particular technology measures ocular shifts several times a second.

When you're attempting to deceive, to act composed and appear spontaneous, what happens is the cognitive load is so significant on your system that you actually leak indicators of deceit. When the cognitive load is high on the system, it can be seen in the eyes. The brain is essentially overloaded when someone has to think to lie. That's what's being detected.

How relevant are inside threats?
There's a lot of research being done on inside threats. Someone may want to exfiltrate your data, sell it to the competition, and harm your assets. A large percentage of cyber hacks have been accomplished with the help of an insider in the company. This is a very interesting new field, and we're starting to see a lot of new science around this type of deception.

What's the new science behind it?
Carnegie Mellon University has published a number of case studies. So has the Association of Certified Fraud Examiners. They're finding that insiders are often disgruntled at how a conflict has been resolved or are under certain kinds of financial stress. They may have control issues. The indicators for a possible disgruntled insider are different than the indicators for someone who might engage in pure deception.

The sub-science of inside-threat actors is really interesting. Most companies are very far behind in figuring out that piece and therefore very vulnerable to inside-threat actors harming them in some way.

Nathan Jaye, CFA, is a keynote speaker and member of CFA Society San Francisco.

Should RIA Business Models Change?

RECENT MARKET PERFORMANCE COULD BE HIDING PROBLEMS

By Ed McCarthy

There is nothing like solid returns in the financial markets to boost revenues and profits at registered investment adviser (RIA) firms using the assets under management (AUM) model. But will the good times continue? Industry observers cite several emerging trends and results from recent surveys of RIAs that could portend problems. These potential roadblocks include a lack of organic growth for advisory firms, pricing pressures driven by a changing clientele and emerging competitors, and cost pressures as compensation costs grow faster than revenues.

STAGNANT UNDERLYING GROWTH

Gabriel Garcia, managing director of BNY Mellon's Pershing Advisor Solutions in Jersey City, New Jersey, notes that 2017 was a "stupendous" year in the financial markets. Nonetheless, he is concerned about the longer-term trend of advisers' slowing revenue growth. He cites the "2017 *InvestmentNews* Adviser Compensation & Staffing Study," which found only 5% median revenue growth in 2016 among respondents. That result represents a steady drop since 2013, when the reported figure was 16%. Although the financial markets' performance for 2017 certainly will improve advisers' profits, the respite might be short-lived. "My fear is that this tailwind from the market is going to mask and distract advisers from what's happening beneath," Garcia says. "And what's happening beneath is …true organic growth has stagnated."

KEY POINTS

Recent strong performance of financial markets could be masking unfavorable longer-term trends for RIA firms.

The effects of these trends may take years to reach a significant level, but firms that want to be well positioned should start considering strategic planning.

Garcia cites several reasons for the growth slowdown. The average client age for advisory firms is around 62, and older clients are more likely to be in the wealth decumulation phase of their lives. These clients' focus has shifted from increasing wealth to living off their assets and distributing them, which eventually leads to fewer assets supporting the AUM model. "They're gifting their money, they're funding college for their grandkids, they're buying second homes, they're traveling," says Garcia. "There are no more corporate stock options to cash in, no more businesses to sell off, no more incomes to save."

Mathias Hitchcock, vice president of practice management and consulting at Fidelity Clearing and Custody Solutions in Boston, says Fidelity's research also has identified the lack of organic growth as a problem. The firm's 2016 Fidelity RIA Benchmarking Study, which surveys a wide spectrum of advisers, found that organic growth, defined as total AUM growth less any growth driven by investment performance or merger and acquisition activity, was only 6.7% in 2015 (the study's most recently published result). That figure represented a decline of 2.9 percentage points from 2014 and was the lowest level in the past five years. The components contributing to the decline included new assets from new clients (–1.3%), assets withdrawn by departing clients (–0.8%), new assets from existing clients (–0.5%), and assets withdrawn from existing clients (–0.3%).

PRESSURES ON PRICING?

As baby boomers age, advisory firms need to attract younger clients to ensure the firms' sustainability, but that's easier said than done. One problem is that younger generations have different pricing preferences for advisory services. "Generally, we see those other generations being a bit more price sensitive, so they want lower fees," Hitchcock notes. "They're relatively less interested in paying one bundled basis-point fee, so they're interested in more transparency, oftentimes linked to unbundling."

The AUM model also can be a hurdle for younger clients, particularly when firms impose significant minimum asset amounts for new clients. This younger cohort (the so-called HENRYs, or"high earners not rich yet")—often qualifies as RIA clients on the basis of income but not on the basis of investable assets. "They don't have the assets, but certainly many of them value advice and are more than willing to pay for it," says Hitchcock. One possible solution is for RIAs to move away from imposing asset minimums and move toward fee minimums, he suggests.

Hitchcock's suggestion makes sense, but asset-based pricing is a cornerstone of the RIA business model. The 2016 Fidelity RIA Benchmarking Study found that 98% of respondents used an overall basis-point fee based on AUM, with 48% of firms bundling all services into that fee. The use of retainers or fees, which could increase pricing flexibility for younger clients, was much less prevalent:

- Overall annual retainer for multiple services: 8%(of firms).
- Annual retainer specific to individual services: 8%.
- One-time flat fee specific to individual services: 15%.
- Hourly fee: 21%.

The 2016 Fidelity study noted that the overall basis-point fee on AUM model is likely to "come under pressure and trend lower as investment management becomes more commoditized." Part of that commoditization is driven by the emergence of the lower-cost robo advisers, according to Hitchcock, but it's also driven by clients' increased focus on financial planning and other elements of what he calls the "value stack."

"As that planning piece of things becomes a bigger need and then at the same time you've got kind of the direct attack, if you will, on pricing for investment management coming from a lot of those robo advisers, in general that's putting a kind of pressure on pricing models," says Hitchcock.

Asset-based pricing, however, is likely to remain the primary model for the foreseeable future. Participants in the 2016 Fidelity study ranked "changing fees or pricing structure" as one of their least important business initiatives. Forty-four percent were not concerned about the challenges of changing their pricing models because they believed the current models were effective. Apparently, the market isn't clamoring for change yet either. Only 7% of RIAs reported "receiving increasing pressure from our clients to justify our fees"; the number was 10% for pressure from prospects.

Garcia says that although product and service providers to the RIA market face increased competition and pricing pressure, he doesn't see that happening with advisers. Pershing's RIA research shows that prices, as measured by yield on assets under management, have consistently remained in the range of 75–80 bps since the early 2000s. When surveyed in 2016, about one-third of advisory firms reported changing their prices, but two-thirds of those respondents raised their fees. Instead of lowering fees, advisers are working to add value under their current structures, Garcia says. "What we're seeing is an expansion of service and a wealth management offering both in technical specialty and array of services and solutions, and pricing is pretty consistent, if not increasing."

RISING COMPENSATION COSTS

Compensation expenses are another potential pressure on RIA profitability. The 2017 *InvestmentNews* study found that between 2015 and 2017, RIAs' staff salary increases outpaced inflation. At the low end of the increases, salaries for client service advisers rose 11%; lead advisers saw the greatest growth for the period at 23%.

Garcia believes several systemic causes are pushing wages higher. The first is an "acute need for professionals." He cites estimates from Cerulli Associates that the annual attrition rate among US financial advisers is in the 6,000–10,000 range. A second factor is RIAs' growing emphasis on offering clients specialized advice to help differentiate their service offerings from robos. "There's a need for talent, which creates competitive marketplace practices, and there's a need for specialization," Garcia says. "And whenever you have somebody who specializes, that requires obviously an attention to compensation to attract the best talent."

Fidelity's research also found salary growth above the US national average for half the firms that participated in Fidelity's "Insights on 2017 Advisor and Staff Compensation at Large RIAs and MFOs" (multifamily offices) survey. Since about 2013, however, human capital expense, including both RIA owners and nonowners, has remained around 60% of revenue, according to Anand Sekhar, vice president of practice management at Fidelity in Boston.

Still, Sekhar points to tight job markets, such as Boston and San Francisco, where it's easier for front-line staff to find new jobs—a condition that pushes compensation higher. The employee-retention challenge is compounded by the different generations' desires for what they want from their career, according to Sekhar. Salary and bonuses are important, but they're only part of the overall package. Millennials and Generation X employees value a flexible workplace and want their work to inspire them, so they consider factors beyond financial compensation in determining job satisfaction.

More formal compensation planning is one method firms are adopting to manage costs more effectively. Garcia's experience has been that when RIA firms were generally smaller, owners typically paid salaries and perhaps a year-end bonus when business was good. There was no compensation plan; it was more a question of the owner's benevolence. That's changing, he says: "What we're seeing now is a more formal approach with job descriptions, goals, results-based goals especially, that attach to their performance. That then is connected to a very specific incentive plan, and that incentive plan is obviously relative to the position."

Ideally, a compensation package rewards key employees and gives them incentives to remain on the job. Wealth managers understand this: Sekhar reports that his team is discussing long-term incentive plans more frequently with advisers. According to the large RIA and MFO survey, 65% offer one or more long-term incentives, but firms' adoption of the different methods varies. Forty-eight percent used operating company equity, and 21% used phantom equity. None of the survey participants reported using nonqualified deferred compensation, and just over half (52%) offered formal profit-sharing programs.

LOOKING AHEAD

RIAs might not experience a significant impact from these trends and developments for several years, but ignoring them could result in unanticipated problems, particularly if the investment markets reverse course. Garcia believes that wealth advisory firms should avoid dismissing the trends and plan strategically. "The challenge of increases in compensation is not that it's getting more expensive; the challenge is that revenues are not growing fast enough to offset the increase in compensation," he says. "That's what people need to focus on: How do we grow organically, how do we focus on the next generation of clients, how do we manage our costs, and how do we invest for the future?"

Ed McCarthy is a freelance finance writer in Pascoag, Rhode Island, and author of *Foundations of Computational Finance with MATLAB®* (Wiley, forthcoming).

OPINION

Intangible Assets and Share Value

DO ANALYSTS NEED A NEW MODEL FOR VALUING INTANGIBLES?

By Ray Rath, CFA

KEY POINTS

A recent *Financial Analysts Journal* argues that analysts need to change their investment models to capture the value of intangibles.

Analysts and investors need a deeper understanding to gain insights into intangibles because financial reporting standards provide very limited information.

The importance of intangible assets to corporate success is well known and widely accepted. Market capitalizations reflect investment in intangibles, which in the US has exceeded investment in tangible assets since the late 1990s. Given their importance, proper valuation of intangibles becomes even more essential for securities analysts, who face significant challenges in this area. [*For more on recent developments related to intangibles, see the report "Assessing Value in the Digital Economy" in this issue.*]

In the recent *Financial Analysts Journal* article "Time to Change Your Investment Model," Feng Gu and Baruch Lev advise analysts to focus careful consideration on "value-creating strategic assets and their deployment." They also note that EPS is of little use in equity valuation. Gu and Lev essentially suggest that analysts improve how they value intangible assets as well as the business strategies linked with those intangibles. So how can analysts and investors better capture this value?

ACCOUNTING INSIGHTS

The place to start is by examining what kinds of insights analysts can get from the accounting guidance for intangibles. As noted, accounting EPS assessment is of limited value to securities analysts. If anything, the accounting for intangibles increases the variability of reported EPS, which means securities analysts will be busy with adjustments to make EPS more consistent.

Accounting for intangibles is a mixed model on several levels. First, acquired intangibles are capitalized to the balance sheet and typically amortized on a straight-line basis over a finite life. Unlike acquired intangibles, investments in internally generated intangibles are typically expensed as incurred. This difference in accounting treatment leads to EPS inconsistency among otherwise similar companies. To further complicate matters, the amortization of certain acquired intangibles may differ. In global investment bank Houlihan Lokey's "2016 Purchase Price Allocation Study," which looked at 455 qualifying acquisitions that closed in 2016, 49% of acquisitions in the study year had a share of the purchase consideration allocated to trademarks. Of these, 23% of the acquired trademarks were held with an indefinite life and the remaining 77% were being amortized over different estimated lives. The differences in lives assigned relate to the acquired trademarks' perceived durability. These differing assumptions further reduce the consistency of reported EPS.

Accounting standard setters are aware of the challenges that analysts face in valuing intangible assets and have taken steps to improve the relevance of financial reporting by better capturing intangible asset values in financial statements. In 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (FAS) 141, *Business Combinations* (now Accounting Standards Codification 805), requiring the recognition of "individual" acquired intangible assets. FASB also had a project to address internally generated intangible assets. But because audits of valuations of acquired intangibles highlighted the complexities associated with intangible asset valuation, that project did not move forward. In August 2016, the FASB requested comments on whether its future agenda should include a project to assess the accounting for internally generated intangible assets.

GROWTH INVESTMENTS

Investments made by companies can replace existing assets already in place or can be characterized as "growth investments" intended to drive additional revenues and cash flows. Proper valuation of growth investments in intangible assets is also challenging.

In their 2017 *FAJ* article, Gu and Lev use the example of Dell Corporation to highlight the challenges facing analysts. In the years prior to 2013, Dell made significant growth investments to move into the server business (perceived by Dell management as higher growth and higher margin) and away from its declining PC business. The growth investments in developing intangibles related to the server business (such as a skilled workforce, protocols and procedures, and new customer relationships, among others) depressed corporate EBITDA, EPS, and Dell's stock price. Efforts to educate the market on the combined value of the two businesses failed. The market valued Dell mostly as the old PC business with depressed earnings and a poor outlook, affording less value to the growth business than Dell management believed appropriate. Because of the declining share price and belief that the market was improperly valuing the two pieces of the company, Dell Corporation was aggressively marketed for sale and taken private. Despite extensive efforts to educate possible third-party buyers, the highest bid for Dell of $24.4 billion came from Michael Dell and a private equity group in 2013.

Assessment of the Dell transaction suggests that the strategy underlying Dell's growth investment (a move to servers) conflicted with a widely held view that the industrywide move to cloud-based services was putting pressure on the server segment. This case reminds us that the value of intangibles investment is closely aligned with both the value of the strategy and the overall market outlook. Determining a strategy's value requires deep industry knowledge as well as an understanding of how the strategy will play out.

HOW TO GAIN INSIGHTS

For securities analysts, several factors limit the helpful insights available from transactions involving intangible assets. Intangibles rarely trade separately from a business, and market data about them is frequently unavailable.

Sales of patent portfolios (technology intangibles) are increasingly reported, but the insights from these transactions are very limited. Company disclosures are often insufficient for analysts to obtain a clear understanding of the transaction. Perhaps most importantly, patent portfolio sales that occur separately from an operating business typically involve an asset that is not "in use." Many portfolios are acquired for defensive purposes or to enhance a strategic buyer's existing patent portfolio. Despite these limitations, Form 10-K disclosures pertaining to intangible asset valuations as a result of corporate acquisitions do provide some insights—most typically on the mix of value from different intangibles and the useful lives ascribed to various intangibles.

Although intangible assets take multiple forms, three types frequently are the most important intangible to consider in assessing a business: (1) customer relationships, (2) technology-related assets, and (3) trade names. For some industries, a fourth type—enabling licenses—may be a company's most important asset. Enabling licenses include government/regulatory, spectrum, franchise agreements, and certificates of need, among others that provide exclusive operating rights to the holder.

INTANGIBLES DURABILITY

In assessing the durability of competitive advantage associated with an intangible asset, analysts must consider the asset's potential life. Trade names can have a potentially indefinite life and are frequently the most "durable" intangible asset (indefinite lives for customer relationships and technologies are extremely rare). An indefinite life leads to no periodic amortization of an acquired intangible's value but rather periodic impairment testing. Houlihan Lokey's 2016 study of purchase price allocations observed that other intangibles with indefinite lives include license agreements, franchise agreements, and certain content or databases. Acquired trade names can be a significant driver of acquisitions and can be recorded on an acquirer's balance sheet with an indefinite life.

In contrast to trade names, technology-related assets usually have shorter lives because of rapid changes in technology. For example, investors and consumers anxiously await each year's release of the latest iPhone and assess the technology changes. Although software technologies may change rapidly, the significant switching costs associated with a move from many Microsoft software offerings provide the company a stable revenue and profit base until technology changes affect these offerings. The shorter lives of these intangibles increase the uncertainty associated with projecting future financial performance for companies that hold such assets.

A third group of important intangible assets is customer-related assets. Most would agree that the recognition and acceptance of the McDonald's name drives the company's success. Customers continue to visit McDonald's because of its reputation for fast, consistent, economic foods. For many business-to-business companies, brands are a minor component. Without technology or other intangibles that create meaningful switching costs, these businesses must make significant investment in obtaining customers. This customer development effort is frequently in direct sales efforts. Expected customer lives for customer relationships acquired in a business combination are typically disclosed for material acquisitions. Because many customers may stay with a provider longer than a single technology or product/service cycle, customer lives are often longer than technology lives. Customer lives reported in acquisitions cover a wide range based on the facts and circumstances of each acquired business.

RELATIVE RISKS OF DIFFERENT INTANGIBLES

Analysts valuing intangible assets should also note the different degrees of risk associated with different investments. If technology-related assets are defined in broad terms, both software development and investment in early-stage development of cancer treatments could be considered investment in such assets. Any similarity between the two is clearly misleading, however, because the two types of assets carry profoundly different risks. Approval rates for drug formulations that have not received Level 1 FDA approval are miniscule (far less than 1%), whereas the risks of software are much different. In addition, as noted earlier with Dell, the acceptance of technology investment in intangibles can vary with differing perceptions of risk.

Although venture capitalists are recognized as investors in the earliest-stage and highest-risk investments, VC investments reportedly have an extremely high failure rate, with 90% or more frequently judged to be failures. Many of these investments are made prior to a company proving the technical, commercial, or financial viability of its efforts. Although returns from successful VC investments are immense, the high failure rate shows the huge challenges involved with early-stage intangibles. The valuation challenges at this stage are numerous. For new technologies requiring regulatory approval, assessing the probability and timing of approval is immensely challenging. Once an intangible asset crosses this hurdle (many don't make it), projections of the commercial market size and share are difficult to make. Finally, developing financial projections of market share, revenues, and profitability is challenging because of the complexities of assessing a dynamic market subject to the influence of various competitor actions.

Unlike development-stage asset investment, in which capitalization of high-risk intangibles investment is not allowed, some of the investment in intangibles can be capitalized to the balance sheet and subsequently amortized. Subsequent-generation software is an excellent example, because the risk associated with a new version is viewed as very low. There may be little technical risk with completing a new version of existing software. Also, past successful sales likely already established the software's commercial and financial viability. For the investment in updates, accounting rules allow the capitalization of software investment. For many pending updates of existing software, the primary risks may concern whether the new version will be completed on time and on budget.

Another area for analysts to consider is the impact of capital and other resources on the value of intangibles. Some companies use their capital resources as a source of competitive advantage. For instance, Facebook has acquired several companies that represented potentially disruptive competitors. These acquisitions served to protect the value of Facebook's existing customer base, technology, and overall business model. Over the years, Microsoft has also been noted as a company willing to acquire other companies that presented varying degrees of competitive threat to its existing operations. Yahoo also made a significant number of acquisitions over a period of years. Unlike Facebook and Microsoft, which had strong market positions when making defensive acquisitions, Yahoo's market position was weaker than many of its emerging competitors. Its transactions and strategy did not reposition Yahoo to a sufficiently strong market position, and the company was subsequently acquired by Verizon. Competitive use of capital is yet another complex wrinkle for analysts to consider.

Accounting for business combinations provides further evidence of valuation challenges. The release of FAS 141R in 2007 (effective for transactions after 15 December 2008) revised accounting rules. After it went into effect, contingent consideration (CC) elements in transaction structures had to be valued at their fair value and included in the determination of the purchase price paid. Approximately 19% of the business acquisitions included in Houlihan Lokey's 2016 study had CC included in the purchase price. Among the cases included in the study, the median contingent consideration paid was 14% of the total purchase consideration. The inclusion of contingent consideration presumably reflects the inability of a buyer and seller to agree on the value of uncertain intangibles, hence the inclusion of contingent payments in the transaction structure.

Analysts interested in a greater understanding of the recognition and valuation of intangible assets for financial reporting purposes can learn much from several guides released to enhance valuation practice for intangibles. Interested readers are advised that the publications provide extensive discussions and detailed calculations appropriate for financial reporting. The theories and calculations covered may require significant modifications to meet a securities analyst's objectives. (As an important example, future customers do not meet asset recognition criteria for financial reporting. Although a buyer is likely to include some payment for future customers, this value will wind up as a part of the goodwill recorded for the transaction.)

These resources include the following:

- The Appraisal Foundation, Best Practices for Valuations in Financial Reporting: Intangible Asset Working Group, "The Identification of Contributory Assets and the Calculation of Economic Rents," issued 31 May 2010.
- AICPA Practice Aid, "Assets Acquired to Be Used in Research and Development Activities," issued 2013.
- The Appraisal Foundation, "The Valuation of Customer-Related Assets," final document issued June 2016.
- The Appraisal Foundation, "The Measurement and Application of Market Participant Acquisition Premiums," final document issued 6 September 2017.
- The Appraisal Foundation, "First Exposure Draft: Valuation of Contingent Consideration," 28 February 2017.

Another resource pertaining to intangibles valuation as well as business and securities valuation is the Mandatory Performance Framework (MPF) developed by Corporate and Intangibles Valuation Organization. The MPF sets forth minimum required procedures for certain financial reporting fair value estimates and includes detailed requirements related to intangible assets.

Note that various bodies, including the SEC, have noted that the overall quality of fair value measurements could stand improvement. These observations led to the release of a Certified in Entity and Intangible Valuations (CEIV) credential for financial reporting. Also, guidance on minimum valuation procedures to perform and document was set forth in an MPF document and related Application of Mandatory Performance Framework published by the Corporate and Intangibles Valuation Organization in 2017.

CONCLUSION

Intangibles are and will continue to be an important driver of corporate value. Identification and valuation of intangibles requires informed judgment and the full range of business valuation skills. Early-stage, high-risk intangibles are very difficult to value. Although venture capitalists are some of the brightest minds in business strategy, finance, and their industries of focus, studies suggest that the vast majority of VC investments (as high as 90% in some studies) are unsuccessful. In addition, our assessment of Dell suggests that the strength (or perceived lack thereof) of corporate strategy will drive the valuations. Analysts will need to develop better tools to recognize and capture valuation creation from intangibles and the related corporate strategies. Given the dynamic nature of intangibles and markets, models will require frequent updates and significant insights and informed judgment.

Ray Rath, CFA, is a managing director with Globalview Advisors LLC, an independent valuation services firm.

Our Future Is Up to Us

By Paul Smith, CFA

During the past year, one of my primary goals was to visit and connect in person with as many CFA Societies and members as possible. I had the opportunity to visit 60 societies and talk with more than a thousand society leaders and members. There is just something so valuable and insightful about face-to-face visits, and these interactions really are one of the great privileges of my role as CEO. I want to take this opportunity to thank all of the society leaders who worked so hard to make me welcome and to ensure that my visits were productive for them and their members.

What I learned was remarkable. Regardless of geography, years of industry experience, or charterholder tenure, we are all facing many of the same challenges and, thankfully, opportunities.

As you know, our industry is witnessing major global changes—a drift in the advisory business toward passive investing, fee compression, robo-advice, a complex and shifting regulatory environment, technology disruptions, and demands for more transparency. A decade after the economic downturn, there remains concern among investors around the world about how much value we provide and how trustworthy we really are. These are serious challenges, and our industry's future will largely be determined by how we rise up to meet them.

As an organization, however, we are thriving. In fiscal 2017, we saw record exam administrations and increased brand awareness and value in the eyes of regulators, employers, and the general public worldwide. Our reserves are at an all-time high and challenge us to work out how we can invest them productively. We are on track to position CFA Institute incontrovertibly as the professional membership organization for the global investment management industry in the coming years. Despite this success, we are planning some incredibly demanding but very exciting transformational projects in the immediate future. These projects include how we deliver CFA exams, revamping continuing professional development, and positioning CFA Societies to be the primary delivery agents of member value (what we are calling Societies 2.0).

If we stand still in a rapidly changing world, we fear we will lose our leadership position. We believe now is exactly the right time to embark on these endeavors and make changes from a position of strength with the ultimate aim of protecting—and increasing—the value of the CFA charter.

We still have much work to do to raise professionalism in the industry and restore the credibility and trust that has been lost among investors. The general public and society demand a high standard of competence, ethics, and best practice from doctors, architects, and engineers. In return, society accords these occupations the status of professions. It is up to us to earn our place among these respected professions by demonstrating that we always place our clients' interests above our own. You cannot self-declare professional status.

So, what changes lie ahead as we seek to help shape the future and what is your role? CFA Institute aspires to lead a global professional body. We can make an impact globally only if we make an impact locally. Strong, impactful societies are the way in which we will raise standards and professionalism worldwide.

A DECADE AFTER THE ECONOMIC DOWNTURN, THERE REMAINS CONCERN AMONG INVESTORS AROUND THE WORLD ABOUT HOW MUCH VALUE WE PROVIDE AND HOW TRUSTWORTHY WE REALLY ARE. THESE ARE SERIOUS CHALLENGES, AND OUR INDUSTRY'S FUTURE WILL LARGELY BE DETERMINED BY HOW WE RISE UP TO MEET THEM.

We envision a future state when you will no longer differentiate between CFA Institute and CFA Societies because you will derive the full spectrum of member benefits in a global organization through the single interface of your local society. You will receive the highest levels of professional development locally, advocate locally for a fair and transparent industry, and enjoy all the networking and career development opportunities that a strong local society can provide.

To achieve this vision, we need to better equip and empower societies to deliver greater benefits and value than they are able to do today. The new Members App is the key delivery mechanism for this. If you haven't already downloaded and used it, please do. You will be impressed. In 2018, you will begin seeing a transformational change to our services. We will create a vastly improved continuing professional development (CPD) experience delivered exclusively through societies. A robust CPD program is key to raising professionalism in the industry and proving to both clients and regulators that CFA charterholders are the best of the best.

The second most important service a professional body can deliver is advocacy—working with regulators and policymakers to improve overall market conditions. In 2017, we formed society-led advocacy councils in both the US and EU to drive a member-led agenda forward. We also helped CFA Societies Canada come together to hire a new managing director, Chris May, whose duties focus on advocacy, among many other responsibilities. Under this umbrella, we also pushed forward our thought leadership projects and delivered the ground-breaking Future State of the Investment Profession report under the guidance of Roger Urwin. Please download this report from our website and help carry forward this debate in your businesses. [*For more on the FSIP report and the future career implications, see the article "Career Tracks to the Future" in this issue.*]

We are also shifting our relationship management delivery to a one-relationship approach that coordinates all external interactions, allowing us to improve our relationships and influence in each society location. Further, as part of our efforts to advance professionalism, we are developing Credentialing 2030, a process that takes a 10-year-view of the credentialing and exam trends ahead, including meeting the needs of the millennial generation, technology changes, and shifting perceptions of lifelong learning. Look for much, much more on this as 2018 develops.

We are laying the groundwork for this transformation through infrastructure and technology. Several multi-year, multi-phase projects are underway to improve systems and internal efficiencies. This effort is already coming to fruition through technology, such as the Members App, with many more developments on the horizon.

We have a lot of plans in the works, but we can't do it alone. Join your local society if you haven't yet and get engaged. This is your chance to make an impact in your own community where it matters to you most, to get the maximum from your membership, and to make a contribution to our work on a global scale. We are on the move. Please get on board and help us accelerate. We are making a difference and we are measuring up to our responsibilities. Each of us has a role to play.

I hope to meet and talk with many more of you during my society visits again this year. As always, I want to hear your feedback, ideas, and concerns. Our agenda and goals are ambitious, and if we're going to be successful, we need each of you to get involved. I look forward to what we can achieve together.

Paul Smith, CFA, is president and CEO of CFA Institute.

Brexit: A Difference of Opinion

By Rhodri Preece, CFA

With less than one year to go until the United Kingdom formally exits the European Union in March 2019, CFA Institute sought to gauge market perceptions of Brexit in its latest member survey. The results, published in March, reveal continued concern among investment professionals about the implications of Brexit for the UK investment management industry, including its impact on investment returns and market competitiveness. Further afield, respondents were more sanguine in their assessment of Brexit, with the results suggesting cautious optimism over ensuing trade negotiations. As a barometer of sentiment, the survey is a reminder that opinion remains divided within and across countries and regions, reflecting ongoing uncertainty over the Brexit end-state.

The survey, the third conducted by CFA Institute on Brexit, was carried out in February 2018, approximately one year after our previous survey. We received 974 responses, of which 24% were from the UK, 24% from other European Union (EU) countries, and the remaining 52% from the rest of the world (ROW).

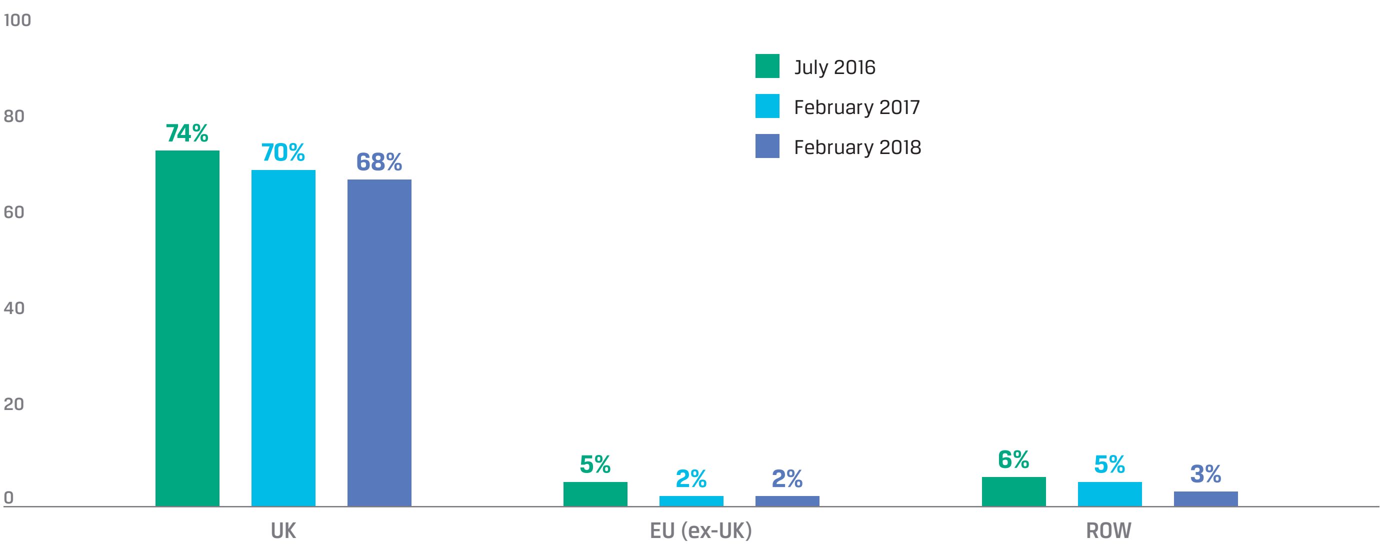
In regard to the impact of Brexit on market competitiveness, two-thirds of respondents in the UK said that Brexit has caused the competitiveness of their market to deteriorate, exhibiting a slightly downward trend from prior surveys, as shown in **Figure 1**. Elsewhere, respondents from the EU (ex-UK) and the rest of the world generally thought Brexit had caused the competitiveness of their market to increase or stay the same **(Figure 2)**.

A factor influencing market competitiveness is the ability of a financial centre to attract top talent. On this score, members in the UK were equally pessimistic, with 64% of respondents expressing the view that Brexit will hurt the ability of investment firms to hire the best talent. Correspondingly, 67% of respondents in the UK expected their firms to reduce their UK presence (up from 62% in 2017). This number rises to 76% of those polled in the EU (ex-UK), as shown in **Figure 3**.

Members in all regions believe that Brexit will hurt investment returns in the UK, but views are mixed about the impact of Brexit on EU (ex-UK) investment returns. As shown in **Figure 4**, more than three quarters of respondents think Brexit

FIGURE 1

% of UK respondents indicating the Brexit process has caused the competitiveness of the UK market to deteriorate

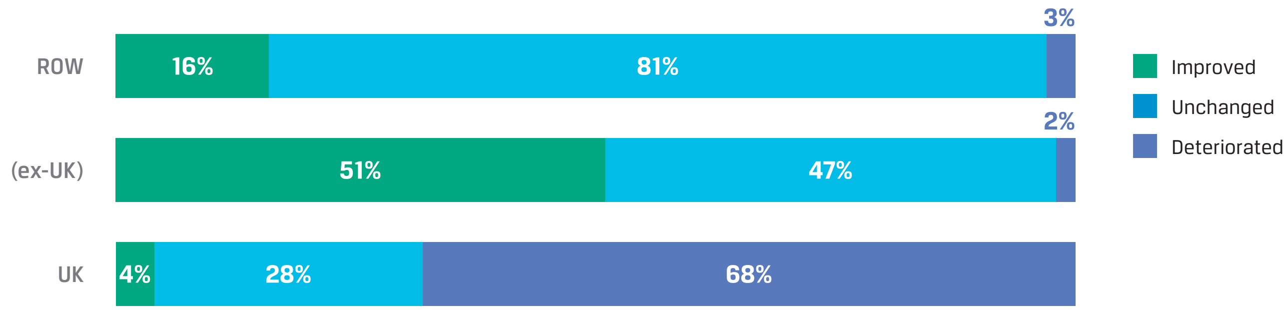


Question: What impact, if any, has the Brexit process had so far on the competitiveness of [respondent's market] as a financial center?

Note: Results shown exclude "don't know" responses

FIGURE 2

% of EU (ex-UK) respondents indicating the Brexit process has caused the competitiveness of their market to deteriorate



Question: What impact, if any, has the Brexit process had so far on the competitiveness of [respondent's market] as a financial center?

Note: Results shown exclude "don't know" responses

will negatively affect investment returns in the UK, rising to 90% among EU (ex-UK) respondents. UK respondents are more likely to believe that EU (ex-UK) investment returns will be hurt as a result of Brexit than their counterparts in the EU and ROW.

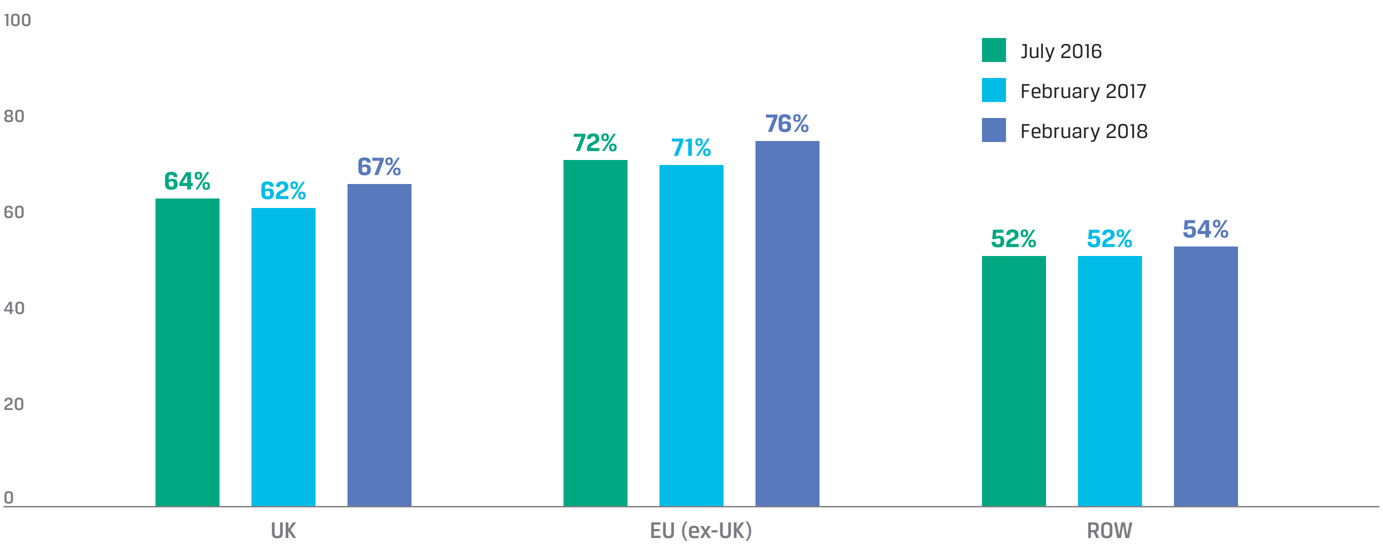
The survey results reveal a degree of confidence among members over the outcome of trade negotiations between the UK and EU. Globally, almost half of respondents expect Brexit negotiations to result in either a comprehensive trade deal covering both goods and services (25%) or a goods-only deal (24%), as illustrated in **Figure 5**. There is also a perception among UK members that the UK will not engage in a regulatory race to the bottom to attract business after leaving the EU, a view expressed by 51% of UK respondents and 41% of respondents globally (a plurality). This result likely reflects the view that future market access between the UK and EU will be conditional upon there being a regulatory level playing field.

The results also reveal concerns among members that any potential restrictions on delegation arrangements (in which portfolio management is delegated by a fund to a manager in a different jurisdiction) would be detrimental **(Figure 6)**. Delegation arrangements are common and are typically used by fund structures to allow assets to be managed most efficiently, often (in the European context) with a fund entity delegating portfolio management to a London-based manager.

The survey also suggests that sentiment is strengthening on political stability in the EU. Globally, 34% of respondents think

FIGURE 3

% of respondents expecting firms in their local market with a strong UK presence to reduce their presence in the UK as a result of Brexit



Question: How do you expect firms in your local market with a strong UK presence to react to Brexit?

Note: Results shown exclude "don't know" responses

FIGURE 4

How do you think investment returns over the next 3–5 years will be affected as a consequence of Brexit?

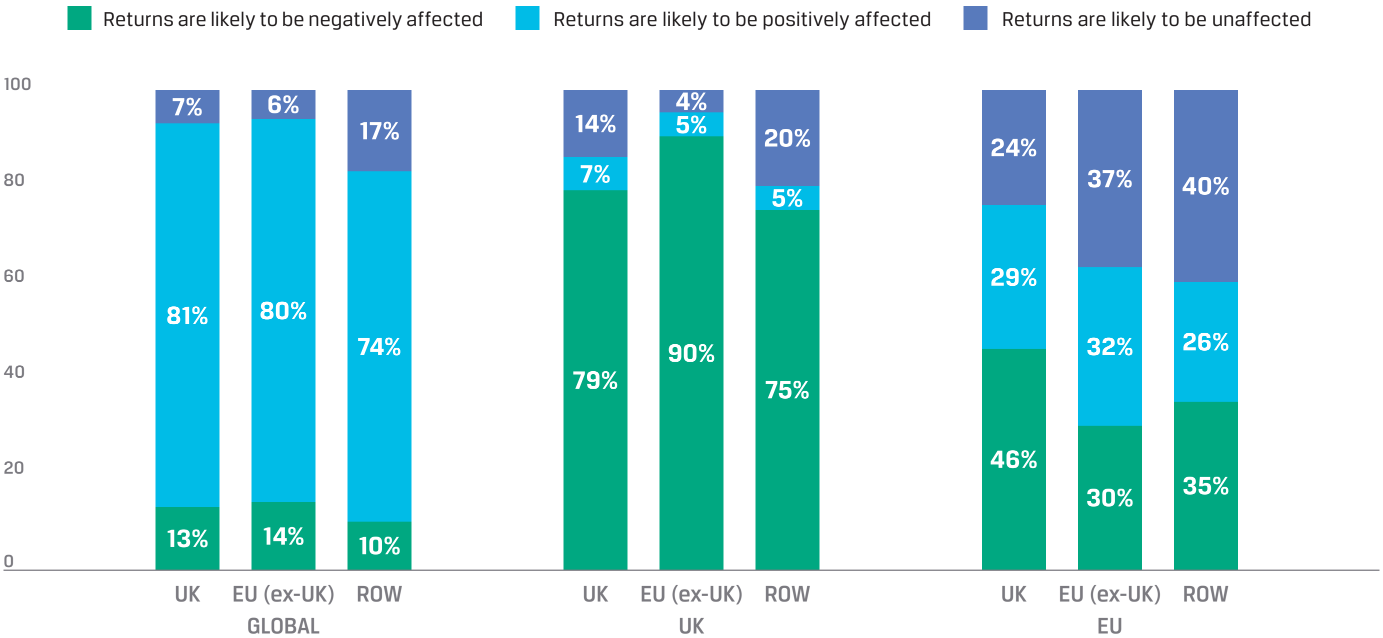
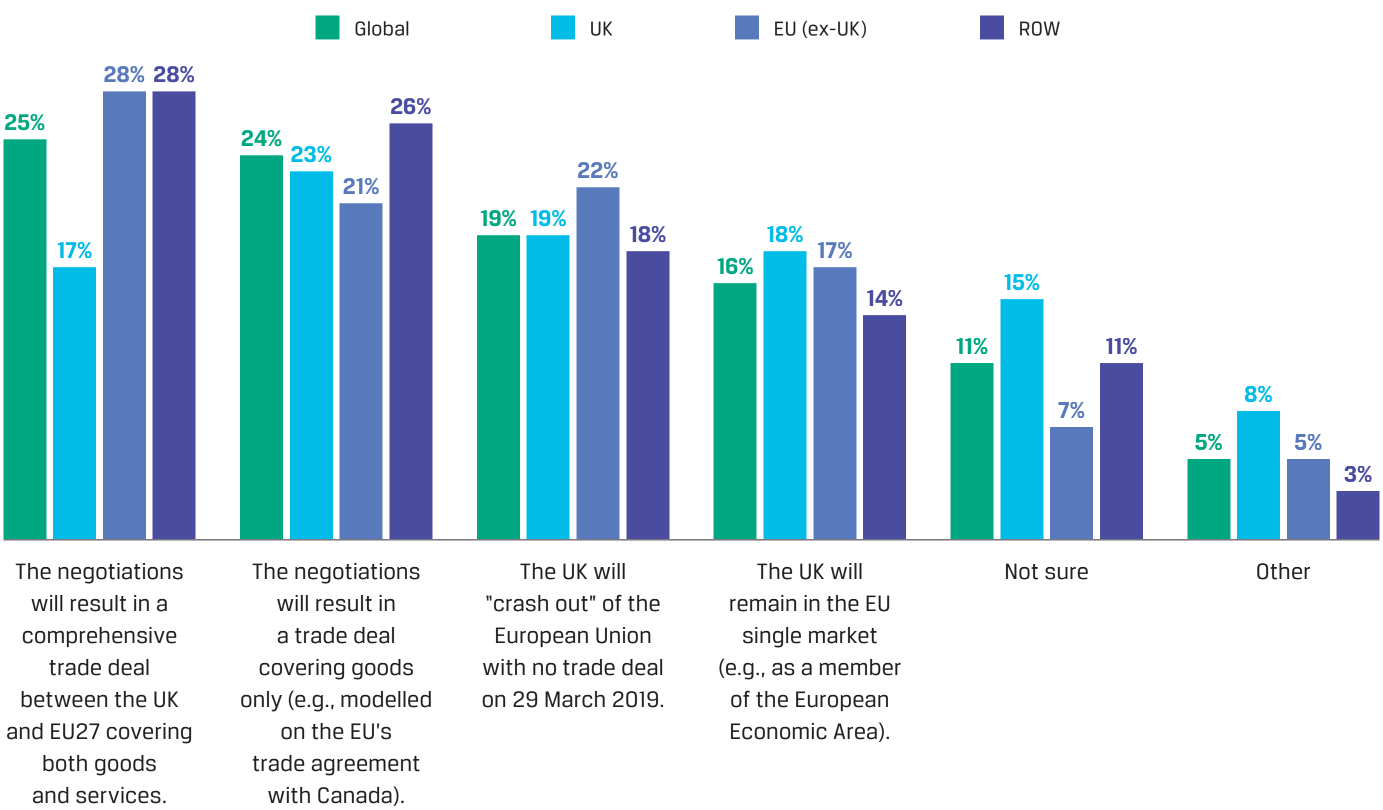


FIGURE 5

One year ahead of the United Kingdom's exit from the European Union (29 March 2019), what do you think is the most likely outcome of the Brexit negotiations?



that EU strengthening is likely, compared with 13% in 2017, and far fewer respondents now anticipate more EU exits to follow the UK's departure (30% in 2018, down from 59% in 2017). Additionally, fewer imagine Brexit will spur UK fragmentation (41% down from 53%). However, uncertainty that Brexit will go ahead has also risen, with 15% of respondents now thinking it likely that Brexit will not happen, up from 5% in 2017.

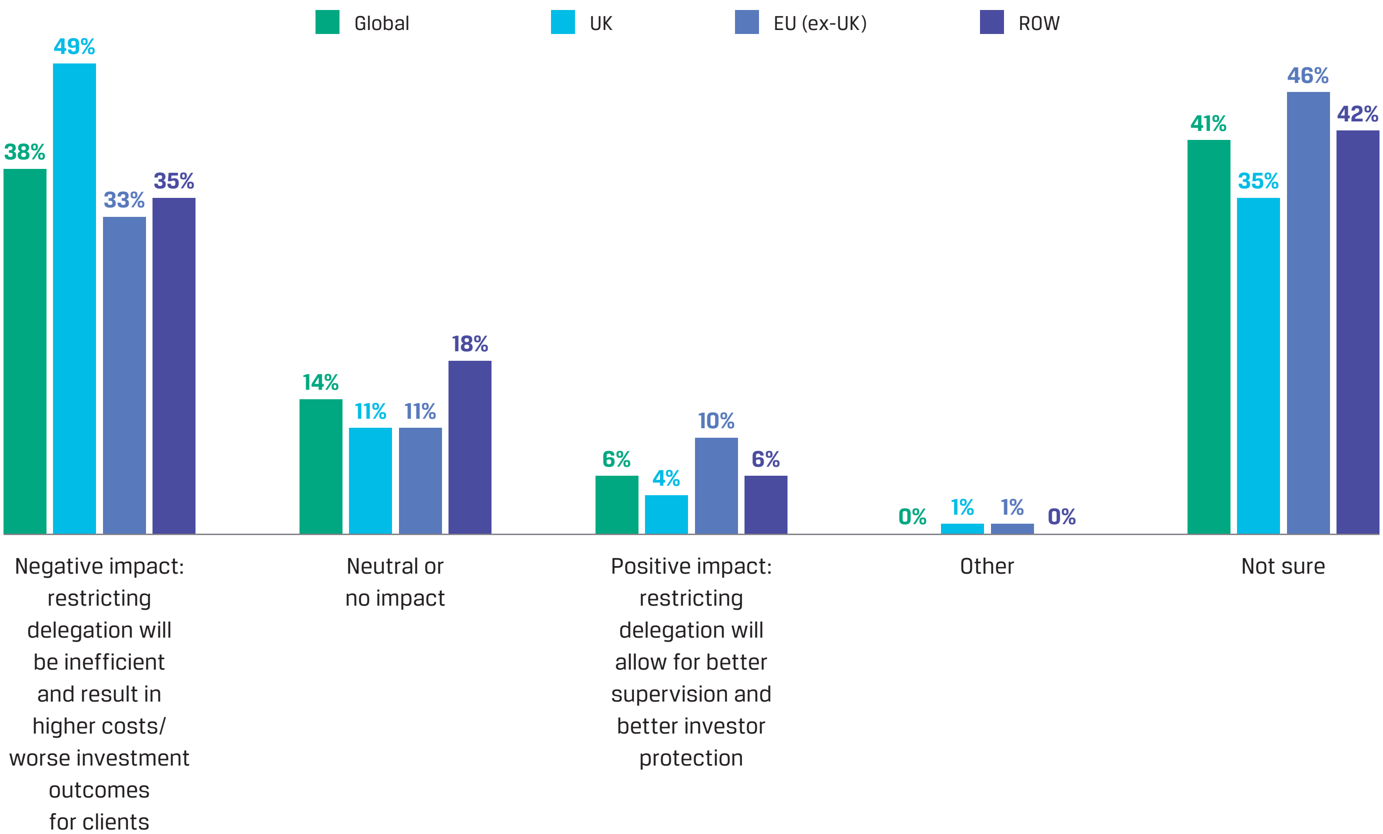
In other results, the survey identifies Frankfurt as the most likely winner from Brexit, followed by Paris, Dublin, Luxembourg, and Amsterdam. Paris is the biggest mover on this score, up 13 percentage points from 2017.

Since the survey was conducted, the UK and EU agreed to a transitional period of 21 months following the UK's departure on 29 March 2019, which would provide continued access for the UK to the EU single market through December 2020. Whilst the transitional period provides some needed time for firms to adjust operations, it provides no guarantees over the future state. With the adage that "nothing is agreed until everything is agreed" underpinning the negotiations, investment professionals will have to live with Brexit uncertainty for some time yet.

Rhodri Preece, CFA, is head of industry research at CFA Institute.

FIGURE 6

If delegation arrangements are restricted as a result of Brexit, what impact, if any, do you think such restrictions will have on investor outcomes?



CFA Institute China 2.0

By LJ Jia

Two years ago, we embarked on the journey we call CFA Institute China 2.0, which is aimed at building the foundation and capability to sustain our growth and better support our members. Our growth in China is underpinned by an investment management industry advancing "at a furious pace that no other market has been able to replicate," according to Casey Quirk & Associates. China's GDP is expected to reach US$17 trillion by 2030, a six-fold increase in just under 15 years. China is projected to become the second-largest asset management market in the world next year and to employ 150,000 people in core job functions as defined by CFA Institute.

CFA Institute China 2.0 is a blueprint focused on pioneering a new type of professional community. The initiative is built on a commitment to professional excellence and participation, sustained by trust and teamwork and inspired by future opportunities. We have prioritized our resources to focus on building the brand, relationships, and infrastructure. And we are developing and delivering impactful programs for our members in partnership with societies and volunteer groups, incorporating cultural aspects and themes. Fostering a culture of volunteerism and lifelong learning will help us build a sustainable business in China for the years to come.

EXPANDING THE SOCIETY NETWORK

We have established new societies in Shenzhen and Chengdu, and together with CFA Society Beijing and CFA China, these groups serve more than 5,000 members, one-fifth of the total Asia-Pacific membership. Meanwhile, we are also supporting other volunteer groups to form societies in China.

STRENGTHENING PARTNERSHIPS

Effectively managing government relationships is also an important focus for CFA Institute China 2.0. We have a well-established relationship with the Ministry of Human Resources and Social Security (MOHRSS), which regulates international credentialing, including the CFA Program. MOHRSS has played a key role in supporting its China Talent Association work as a member of the Financial Talent Advisory Council. CFA Institute has also joined the China Green Finance Committee (affiliated with the People's Bank of China) as an international institutional member (along with the United Nations Development Programme and the World Bank), and it plays a key role in jointly organizing events and promoting socially responsible investing and has jointly launched the CFA China Green Finance Fellowship.

Our collaborations with financial industry associations also enable us to organize events and training that showcase our expertise and know-how. These partnerships will grow and expand to other areas, including research, advocacy, corporate social responsibility, investment foundations, and more. iPart's key employers list is the who's who of the leading financial institutions in China, and we will continue to expand this network with a focus on deepening and widening C-suite engagement.

NEW PLATFORMS

We have also created a series of platforms and programs to more effectively deliver our global mission in China, including the following:

- CFA China Society Leadership Council.
- CFA China Senior Member Engagement and Early Member Engagement.
- CFA China Financial Talent Summit/Pudong Financial Talent Leadership Dialogue.
- CFA China Leadership Dialogue/China Investment Conference.
- CFA Institute China Academy.

Constant innovation and improvement are also essential. Looking ahead, we will partner with local governments and industry leaders to create more broad-based ownership and activities associated with the Talent Summit. China Academy is complementary to continuing professional development and encourages senior members to create subject-matter expert groups to deliver programs across China (groups have already been formed around equity, fixed income, asset-backed securities, risk management, and hedge funds). We also organize professional networking sessions at key events.

These are exciting times to be in China, a market where CFA Institute enjoys strong recognition of its brand, with a growing number of professionals leading the transformation of its investment management industry. CFA Institute is uniquely positioned to capitalize on this momentum, and we see exciting opportunities ahead. In 2018, we will accelerate programs in China, with 10 major events expected this year.

LJ Jia is country head, China, at CFA Institute.

SUMMARY SUSPENSIONS

On 28 September 2017, CFA Institute imposed a **Summary Suspension** on **Alfred C.T. Hung (Hong Kong)**, a charterholder member, automatically suspending his membership and right to use the CFA designation. Because he did not request a review, the Summary Suspension became a **Revocation** on 26 October 2017.

From 1997 until 2012, Hung was employed by the Sino-Forest Corporation, a Canadian company. In August 2011, the Ontario Securities Commission (OSC) suspended trading of the shares of Sino-Forest, stating that the company had engaged in practices they "knew or should have known perpetuated a fraud." That same month, the OSC filed a lawsuit in Toronto against Sino-Forest and its five senior executives, including Hung. In March 2012, Sino-Forest filed for bankruptcy protection.

The OSC trial started in 2015, and in July 2017, the Hearing Panel rendered its decision, finding the following: 1) As an officer of Sino-Forest, Hung permitted Sino-Forest to make materially misleading or untrue statements with respect to ownership of assets, revenue recognition, and internal controls, contrary to subsection 122(1)(b) of the Securities Act; 2) Hung engaged in deceitful or dishonest conduct related to Sino-Forest's standing timber assets and revenue that he knew constituted fraud, contrary to subsection 126.1(b) of the Securities Act; and 3) Hung misled OSC staff during its investigation, contrary to subsection 122(1)(a).

Subsections 122(1)(a) and (b) state that a person who makes a materially misleading or untrue statement in information submitted to the OSC or in any required document filed under the securities laws is guilty of an offence and on conviction is liable to a fine of not more than C$5 million or to imprisonment for a term of not more than five years less a day, or to both. Hung was summarily suspended because he was convicted of a crime punishable by more than one year in prison. His conviction is currently on appeal.

CFA Institute imposed **Summary Suspensions** on the following people who failed to cooperate in separate investigations conducted by Professional Conduct. The investigations were opened because it appeared they may have been misusing the CFA designation, either while their memberships were "lapsed" or because they had not been awarded the right to use the designation, in violation of Standard VII(B). Because they failed to cooperate, no determinations could be made. When they did not request hearings, their suspensions automatically became **Revocations** of their opportunities for membership and to use the CFA designation. Professional Conduct may rescind a summary suspension and reverse the resulting revocation if the person comes forward and agrees to cooperate in its investigation.

Laurence Lau (New York)

Jialiang Xu (Shanghai)

Zilin Tang (Beijing)

Matthew Mosteiro (New York)

Timothy Ju-Tsung Pi (Westborough, Massachusetts)

Todd Allen Lee (San Francisco)

C. John Schumacher (Toronto)

Mohit Bhargava (Dubai)

PROHIBITION

Effective 31 October 2017, CFA Institute imposed a **Prohibition** from Participation in CFA Institute Exam Programs on a **Postponed Level I Candidate**. CFA Institute found that the candidate violated the CFA Institute Code of Ethics and Standards of Professional Conduct: I(C) – Misrepresentation; and VII(B) – Reference to CFA Institute, the CFA designation, and the CFA Program (2014).

Professional Conduct found that from March 2013 to June 2017, the candidate misused the CFA designation and misrepresented to others that he was a CFA charterholder on his company's website and on company newsletters. The candidate admitted that by misrepresenting himself as a CFA charterholder, he would gain an advantage over his competition for employment. Once he was hired for the position, the candidate continued the misrepresentation to his employer and clients.

The candidate confessed to misusing the CFA designation in his response to Professional Conduct. The candidate stated that he wanted to come clean about his misrepresentation to his employer years ago but failed to do so out of fear of possible consequences.

TIMED SUSPENSION

Effective 19 October 2017, CFA Institute imposed a **Six-Month Suspension** of membership and of the right to use the CFA designation on **Jack Jason Trueman (Kingston, Ontario)**, a charterholder member. A Hearing Panel found that Trueman violated the CFA Institute Code of Ethics and Standards of Professional Conduct: I(A) – Knowledge of the Law, IV(A) – Duties to Employers – Loyalty, IV(B) – Additional Compensation Arrangements, and VI(A) – Disclosure of Conflicts (2014).

Trueman has been employed as a registered representative and portfolio manager at Cumberland Private Wealth Management since January 2014. While employed at Cumberland, Trueman continued to conduct a separate, undisclosed financial planning business that he called True Growth Private Wealth Management to advise friends and family members. In addition to financial planning, he advised and assisted his True Growth clients in making and managing investments.

Trueman had True Growth's clients open and maintain investment accounts in their own names with various large, discount brokerages in Canada. These firms processed the trades and provided the clients with confirmations and account statements. In total, there were 31 clients with 54 accounts and assets under management of approximately C$1.4 million.

Between January 2014 and February 2015, Trueman advised clients of True Growth without notifying Cumberland, his employer. He placed trades in his True Growth clients' accounts from the computer assigned to him at Cumberland and used the computer to create and store documents related to his outside business. He also conducted outside business on behalf of his True Growth clients during regular business hours, as well as during his personal time.

On 30 January 2014, Trueman signed an acknowledgment in which he agreed to follow the guidelines and rules in Cumberland's Compliance Manual. The Manual specifically prohibited his participation in any "outside activity" without prior firm approval and required that any "pro" (proprietary) accounts, including those in which he had trading authorization, be maintained at Cumberland.

Also on 30 January 2014, and again on 10 February 2015, Trueman signed Cumberland's Annual Employee Disclosure Forms in which he was required to disclose any outside business activities or involvement in pro accounts. He did not disclose his outside business activities, receipt of fees from outside clients, or possession or use of discretionary trading authority on behalf of his clients at True Growth.

The matter was also investigated by the Investment Industry Regulatory Organization of Canada (IIROC), which has Member Rules that: (1) require that registered representatives disclose all outside business activities to their employer and obtain prior approval and (2) prohibit registered representatives from accepting remuneration from any party other than their employer for securities-related activities. In August 2016, IIROC accepted Trueman's offer of settlement. In doing so, the IIROC hearing panel noted that Trueman had answered his firm's compliance questionnaire and falsely stated that he was not involved in any outside business activities. In settling with IIROC, Trueman agreed to pay a fine of C$25,000 along with costs of C$2,500 and to complete the chief compliance officer's Qualifying Examination.

Trueman's actions deprived his firm of the opportunity to supervise his outside business activities, including the receipt of fees from clients for investment-related activities, and clients of the separate business were not properly protected by the securities regulatory system, such as oversight by IIROC.

RESIGNATIONS

Effective 28 November 2017, **Brian de Wit (Victoria, Canada)**, a lapsed charterholder, **Permanently Resigned** his membership in CFA Institute in the course of a Professional Conduct investigation. The investigation was related to an indictment issued in 2014 by the US Attorney's Office for the Eastern District of New York, which alleged that de Wit and others allegedly engaged in securities fraud, tax evasion, and money laundering.

On 9 November 2017, **Michael Chasan (Weston, Massachusetts)**, a charterholder member, **Permanently Resigned** his membership in CFA Institute and in any member societies and his right to use the CFA designation during a disciplinary proceeding brought by Professional Conduct.

The investigation arose because, in October 2015, Chasan agreed with the Securities Division of the Commonwealth of Massachusetts to a Consent Order making findings that, from 2005 to 2015, he violated state law by: failing to register as an investment adviser and investment adviser representative; failing to have proper written agreements with clients; and failing to document, or maintain a process to verify, whether clients were "qualified clients" before charging them a performance fee.

Under the Consent Order, Chasan agreed to: register; pay a fine of US$300,000, plus US$3,500 in unpaid registration fees; offer rescission of more than US$1.2 million in asset management and performance fees paid by his advisory clients; and hire an independent consultant. In addition, his sole proprietorship was permitted to and did become registered in Massachusetts as an investment adviser under its current name, Chasan Capital Management.

Chasan accepted referrals from friends and began to advise and manage investments for others through their retail accounts at Fidelity. Clients granted him discretionary trading authority, which he then used to make stock purchases and sales in their accounts. By 2015, Chasan managed the accounts of 22 people with total assets of more than US$9 million. Chasan charged his clients a fee of 1% of their assets under management plus a performance fee that varied from 15% to 20%.

Among other things, the investigation concerned allegations about: the receipt of illegal compensation from individuals who were ineligible to pay performance fees; and the making of trades in clients' accounts without knowing or considering the clients' overall financial circumstances, investment objectives, and risk tolerances.

On 25 January 2017, **Zachary D. Scheidt (Kennesaw, Georgia)**, a lapsed charterholder member, **Permanently Resigned** his membership in CFA Institute in the course of a disciplinary proceeding.

In Memoriam

By Paul Smith, CFA

On behalf of the CFA Institute Board of Governors, I regret to inform you of the passing of Lynn Stout, a member of our Board of Governors, on 16 April following a long battle with cancer.

Lynn had served as a Governor since 2014 and was a major contributor to our deliberations; she was a source of great wisdom and guidance to those of us who knew her. She was an internationally recognized expert in corporate governance, financial regulation, and moral behavior—all of which are core to our organization and our industry.

Lynn was a scholar of corporate law, a prolific writer, and accomplished speaker. Throughout her career, Lynn was known as a passionate teacher and mentor. In her professional life, Lynn most recently served as the Distinguished Professor of Corporate and Business Law at Cornell Law School. She authored many articles and books. Her last book, *The Shareholder Value Myth*, was named 2012 Governance Book of the Year by *Directors and Boards* magazine.

In addition to her service on the CFA Institute Board of Governors, she served as a member of the Advisory Committee to the Office of Financial Research in the U.S. Treasury, as a member of the Board of Advisors for the Aspen Institute's Business & Society Program, as an executive adviser to the Brookings Institution Project on Corporate Purpose, as an adviser to the Conference Board, and as a research fellow for the Gruter Institute for Law and Behavioral Research.

We are truly grateful for her contributions to our organization and for her work on our Board. Lynn will always be remembered at CFA Institute, and we will miss her leadership.

Paul Smith, CFA, is president and CEO of CFA Institute.

CFA Institute

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