ASSET OWNERS AND A CAPITAL MARKET THAT WORKS

How we can move forward on this issue

SUMMARY

We all want long-term financial performance and the positive sustainability and social outcomes associated with this. However, too often capital markets fail to deliver these. What, if anything, can asset owners and investment consultants do to correct this? What kind of regulatory change is needed?

A roundtable for asset managers, asset owners and investment consultants addressing this question was held on 14 April and was addressed by Professor John Kay and Saker Nusseibeh, CEO of Hermes Investment Management. This proposal for next step actions is based on that roundtable and a series of preparatory interviews conducted ahead of the event.

The following should be priorities:-

- **Passive portfolios**: find ways to finance active engagement with companies by asset managers
- **Active portfolios**: make it easier for asset owners to mandate 'long term' portfolios, for example by standardising metrics and engaging with asset managers more actively
- **Regulation**: develop and advocate the changes needed given the inevitable limits to asset owner action.

Over the coming months we will be discussing with attendees and others how these priorities can be actioned. This document set out the issues and next steps.

BACKGROUND

John Kay, and others, have shown that **capital markets encourage a bias towards short-term objectives** amongst corporate managers, and that this damages returns over the long-term[1] . This is because managers are incentivized to target the **share price,** which primarily **reflects the activity of traders** who try to anticipate other market participants' decisions, **rather than investors** who try to understand companies' prospects. Extensive academic research - for example by Ioannou, Serafeim and Eccles[2] - has also shown that **companies that target sustainability and social outcomes tend to generate better returns** over the long-term.

Kay has called for greater **engagement between companies and investors** to help correct short termism. This should be facilitated by clear and relevant **reporting** with use of appropriate metrics (but at less frequent intervals), corporate and asset manager **incentives** better aligned to long term outcomes, an **investor forum**, and an appropriate **regulatory framework**, including some clarification of **fiduciary duty**. He has drawn particular attention to the deficiencies of **asset manager evaluation**: it is over **too short a time frame** and is based on **performance relative to the market**. These, together with increased fragmentation of ownership, encourage the sale of shares rather than engagement with companies as the preferred means of avoiding loss of value

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[1] "The Kay Review of UK Equity Markets and Long-term Decision Making", www.bis.gov.uk/kayreview, 2012

[2] "The Impact of Corporate Sustainability on Organizational Processes and Performance", I Ioannou (LBS), G. Serafeim (HBS) and R. Eccles (HBS), Management Science, November 2014, 60(11): 2835–2857

DISCUSSION OF THE ISSUES

Objective

The objective is to change company **managers**' incentives so that they take decisions which **maximize returns over the long term**, and not decisions which maximize returns over the short term at the expense of the long term. It is also to ensure that they understand that sustainability and social performance will translate into financial performance over the long term, and that this fact is understood by shareholders.

Two ways of achieving the objective

In principle asset owners can achieve this in two ways: by **engaging** with corporate executives, providing encouragement and criticism, and only voting for incentive schemes that are likely to have the desired effect; and by **buying shares** in companies where the management adopts a long term approach. The latter works in two ways: it helps to maintain the share price of such companies, and it helps ensure a share register of supportive investors.

Passive investors

Engagement is the only route for passive investors – an increasingly large proportion of the total. Where company **management is already** minded to adopt a **long-termist** approach, relatively **low key engagement** can provide moral support and help ensure that management is not distracted by investors with a short term perspective. However some company **management** is not minded to adopt a long-termist approach, for example if they have identified ways of boosting the share price by taking **short-termist** decisions. In this case **engagement has to be active** if it is to be effective, with groups of asset owners acting more like private equity owners (through their asset managers), insisting on appropriate incentive schemes and in extremis dismissing the chief executive.

Active investors

Active investors ***can*** **buy shares in companies** where the management adopts a **long term approach**. They can then protect this investment by engaging in the same kind of **low key engagement** as passive investors. Note that to achieve this they **may not need to put up with likely poor medium term** share price **performance**, for three reasons: first, there may well be sufficient companies where there is no trade-off; second even if there isn't, there may be sufficient long-termist investors to sustain the share price in the medium term; and third, in any case, tolerating medium term pain will not change behaviour - few managers even if appropriately incentivized are likely to tolerate a sustained fall in the share price for fear of corporate raiders and the reactions of investors with a shorter term perspective.

It is **unlikely** that active investors will **want to** engage with companies so as to **actively change behaviour**. It is rational for a long-termist investor to let a company it owns shares in take a 'short term' decision that will boost its share price. For **it can then sell its shares and invest in a second company pursuing a long term strategy**. That way it 'beats the market' twice – when it takes its profit, and when it enjoys the market beating returns of the second company.

Barriers to building long term portfolios and how these can be overcome in principle

While asset managers can assess whether companies are making good long term decisions, it is more **difficult** for asset owners **to assess** whether **asset managers** are building a portfolio that will be successful in the long term – it is easier to assess them based on short term performance. Correcting this is likely to require more active engagement by asset owners with asset managers (as practiced by the Environment Agency Pension Fund for example), standardization of metrics so that portfolio as opposed to company performance can be judged, and new forms of advice from investment consultants – although naturally the latter will only be developed in response to a clear demand.

Limits to action by asset owners and the need for regulatory change

There are two kinds of limit. One may be the **reluctance** of asset owners to **take the initiative** and, where appropriate, act collectively. However the extent to which this is really a limit has yet to be tested, and we propose to join forces with others working in the field to see what can be done. The other limit is the **relative power or impotence of long-termist investors**: do they own enough of the shares to effect the changes we need?

To the extent that the first kind of limit applies, relatively minor regulatory change may be sufficient, for example the nature of fiduciary duty could be changed. To the extent that the second kind of limit applies more radical regulatory change will be needed. This might include measures designed to change executive compensation, or to reduce the relative power of traders as opposed to investors.

ACTION

1. Establish the business case for engagement by owners of passive portfolios, and get a critical mass of asset owners to sign up to providing the necessary resource
2. Continue to work towards standardized long term/sustainability/social performance metrics that can help asset owners assess asset management performance
3. Publicise the kind of engagement with asset managers now being adopted by the Environment Agency Pension Fund and others.
4. Identify the kind of investment consultant product that asset owners may need to assess performance.
5. Assess the limits to asset owner action and develop a set of regulatory reform proposals accordingly.

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