The AMBACHTSHEER Letter

Sustainable Pension Design • Effective Pension Management

January 2017

OUR JOURNEY TOWARDS 'LONG-TERMISM':

GETTING TO A 'TIPPING POINT'

"In the end, 'Tipping Points' are a reaffirmation of the potential for change and the power of intelligent action."

From "The Tipping Point" (2000)
by Malcolm Gladwell

"Under what circumstances is collective action among asset owners and managers realistic and potentially effective?"

From "Tipping Point 2016"
By Burckart, Lydenberg, and Zeigler

Tipping Points

A review said Gladwell's now 16 year-old book was "an elegant exploration of how social epidemics work……it reaffirms that human beings are profoundly social, influenced by, and influencing other human beings, no matter how much technology we introduce into our lives." SCIENCE Magazine article "Social Norms as Solutions" examines the Tipping Point idea from a different perspective.[i] It asserts: "Many global challenges pose major collective action problems. A group benefits from a certain action, but no individual [or organization] has sufficient incentive to act alone." Defining a social norm as "predominant behavior within a group", the article suggests collective action in the form of legislation and regulation may be needed to create Tipping Points for beneficial changes in collective behavior. The cited "Tipping Point 2016" article makes the same point from systems thinking perspective.[ii]

This *Letter* examines the global challenge of shifting the investment of retirement savings from processes driven by short-term thinking to processes driven by long-term thinking. In short, how can we create virtuous dynamics that would accelerate such shifts? Is it more assertive voluntary forms of individual and collective action? More muscular forms of legislation and regulation? A more activist approach to using the courts? Or some combination of all three approaches?

The Benefits of 'Long-Termism'

Most readers of this publication understand the benefits of 'long-termism' in the investment of retirement (and other long-horizon) savings. For example, my 2015 article "The Case for Long-Termism" asserts that without it, we would still be hunters and gatherers living in caves. Fast-forwarding to modern times, the article reviews JM Keynes' pro long-termism arguments in his famous Chapter 12 of "The General Theory" (1936) and backs these arguments with subsequent research findings.[iii] However, Bank of England Governor Carney's recent climate change speech "The Tragedy of the Horizon" forcefully describes the grip 'short-termism' continues to exert today in corporate, governmental, and investment decision-making processes.[iv]

Happily, the empirical case for 'long-termism' in corporate and institutional investing continues to strengthen. New research findings summarized in last year's August and December *Letters* powerfully validated the logical connections between good fund governance, good corporate governance, long-termism-focused decision-making, and superior corporate financial results. Importantly for investors, short-term-focused financial markets continued to be surprised by these superior financial results (e.g., higher innovation productivity, higher dividend payouts, lower sales/costs/earnings volatility, and higher profitability). This in turn means that long-horizon investing, expertly executed, continues to generate material excess investment returns.[v]

Barriers to Long-Termism

If Long-Termism in investing is such a great thing, why is it still not the dominant investment paradigm today? There are three mutually-reinforcing barriers:

1. Convention: for lay people and even most professional investment people 'investing' continues to fit Keynes' 1936 'beauty contest' description of it. It is a game where the goal is to outsmart other investors by beating them to the acquisition of investment opportunities 'the market' will think most beautiful sometime over the course of the next 12 months. This convention continues to be re-enforced on a daily basis in the electronic and print media, and on a quarterly/annual basis through the agendas of the vast majority of investment committee meetings and investment conferences. Measured in terms of entertainment value, 'short-termism' beats 'long-termism' hands down. On top of all this, most compensation schemes continue to reinforce 'short-termism' conventions.
2. Exploitation: George Akerlof received the 2001 Nobel Prize in Economics for setting out the economic consequences of 'asymmetric information' in market outcomes. Market participants with superior information will 'win' at the expense of participants with inferior information. Arguably, the largest 'asymmetric information' market in the world is the market for financial/investment services. At both the retail and wholesale levels, the buyers of these services generally know less about what they are buying than the sellers know about what they are selling. As a result, buyers pay too much….and the sellers earn too much for exchanges of too little value. Short-termism has played an important role in this game of exploitation, as sellers work hard to convince buyers that they can beat their competitors in a variety of investment beauty contest games.
3. Information Dysfunction: a powerful Peter Drucker dictum is that "what gets measured gets managed". So not surprisingly, in a short-termism world, corporate and investment performance measurement systems have short-term orientations. For example in the corporate world, the 'quarterly earnings guidance' game has taken on a life of its own despite the resulting short-term numbers being largely noise rather than signal. So it is in the investment world, where at least 10 years of high-quality return information is needed before any serious conclusions should be inferred about management quality. Ironically, longer-term information that is actually material to assessing corporate and investment management quality and sustainability has seldom been either demanded or provided.

The good news is that a growing body of research is fostering a clearer understanding of these three barriers to 'long-termism' and their societal costs. This clearer understanding has in turn triggered a series of initiatives to turn the tide towards a more productive and fairer investment paradigm based on 'long-termism'. A brief summary of these initiatives on a barrier-by-barrier basis follows.

Breaking the 'Convention' Barrier

Malcolm Gladwell's book offers a number of examples of how individuals, groups, or events can trigger changes in what people think and do in such diverse fields as health, education, crime, and transportation. The investment field has its share of events, people, and groups acting as catalysts to change its short-termism conventions. The writings of individuals like Keynes, Graham, Buffett, Samuelson, Sharpe, Swensen, Kahneman and Tversky, Lo, Shiller, and Lewis come to mind. The Global Financial Crisis triggered the formation (or expansion) of new collaborations like the FSB, UNPRI, FCLT, IRRI, and ICPM. At the same time, organizations like the WEF, OECD/G20, IMF, World Bank, CFA Institute stepped up their efforts to redirect conversations about investing away from beauty contests, and towards its role in sustainable wealth-creation.

These combined individual and collective efforts are moving the 'convention' yardsticks at the wholesale level of the investment field (e.g., pension funds, endowment funds, sovereign wealth funds, insurance funds, investment managers). Under such banners as sustainable investing, responsible investing, ESG investing, the investment horizons of a growing numbers of these funds are lengthening. Funds with scale and strong governance functions are leading the way. ICPM and the Rotman School of Management have been offering a board effectiveness program since 2011. Collaborations such as UNPRI, IRRI, and FCLT are creating protocols which integrate the key activities that make up sustainable/responsible long-term investment processes.[vi] Key elements in these protocols are feedback loops which permit ongoing monitoring of what <u>should</u> be happening versus what is <u>actually</u> happening.

Where does progress on breaking the 'convention' barrier go from here? The question is easier to answer at the wholesale level of investing than at the retail level. It should include ongoing sponsorship of academic research which addresses a list of relevant governance and investment questions, as well as a material expansion of sharply-focused, strategic governance and investment education efforts. At the same time, a continuous, integrated 'outreach' strategy involving organizations like the 11 listed above is critical. As to 'outreach' targets? The print and electronic media should be high on the list, as should other 'impact' bodies such as international and national government, regulatory, and industry agencies.

Breaking the 'Exploitation' Barrier

The asymmetric information problem continues to redirect billions of dollars out of retirement savings and other long-horizon investment pools into the pockets of a global network of intermediary agents. For example, large-sample performance studies of actively-managed retail mutual funds continue to show average net return shortfalls of -3%/year versus comparable market indexes, compared to average positive net return outcomes for pension funds.[vii] Why such materially different outcomes? Because pension fund sectors around the world operate under fiduciary mandates while retail mutual fund sectors do not.

As in the 'convention' space, there is significant barrier-breaking progress underway in the 'exploitation' space. Legislators and regulators are severing the link between giving financial 'advice' and receiving sales commissions from mutual fund manufacturers. Such legislation/regulations are already in place in Australia and the UK, and are being put in place in Canada and the USA. Another powerful 'exploitation' barrier breaker is mandatory participation in workplace pension plans (e.g., in northern European countries, Australia, Singapore, and recently, the UK). As these plans operate with fiduciary mandates they must act in the best interest of their members, rather than exploit them. The more workers save through these vehicles, the less they have need of expensive Pillar 3 retirement savings options built on asymmetric information foundations.[viii]

Where could 'exploitation' barrier-breaking initiatives go from here? A remaining opportunity is the reorganization of workplace pension plan sectors around the world into fewer, larger-scale pension management organizations with strong governance functions. As empirical evidence of the value-creating powers of scale and good governance continues to mount, the stronger the case becomes that the sponsors and trustees of pension organizations which lack these two attributes are failing the legal 'reasonable expectations' test, and are therefore in breach of their fiduciary duties.[ix] The Dutch and Australian regulators are already moving in this 'more scale/stronger governance' direction. A few well-selected 'breach of fiduciary duty' legal actions would accelerate the transition towards long-termism and fiduciary capitalism.

Breaking the 'Information Dysfunction' Barrier

Peter Drucker defined information as "data endowed with relevance and purpose". By this standard, much of the data disclosed by the corporate and investment sectors does not pass the genuine information test. Once again, the good news is that a number of collaborative efforts have been underway for some time to change this situation. Notable examples are the International Integrated Reporting Council (IIRC), the Sustainable Accounting Standards Board (SASB), Accounting for Sustainability (A4S), and the Financial Stability Board's Taskforce on Climate-related Financial Disclosures (TCFD).[x]

‘Sustainability’, ‘integration’, and ‘materiality’ are key concepts in breaking the ‘information dysfunction’ barrier. Assessing organizational sustainability is impossible without information ‘endowed with relevance and purpose’ that looks beyond the next quarter, year, or even 3-year period. Integration is an essential discipline that connects an organization’s purpose to its governance culture, its many forms of capital, its strategic plan, and to a series of metrics that convey progress signals rather than just noise. Materiality requires judging what information is important, and what is not. These realities are equally relevant for corporate and investment organizations.

Again, the question is: where do these promising ‘information dysfunction’ barrier-breaking efforts go from here? An important consideration is that the barrier-breaking efforts to date have led to voluntary disclosure protocol recommendations. Is not the logical next step to translate the good works of IIRC, SASB, A4S, and TCFD into mandatory requirements enforced by the globe’s reporting rules setters, securities regulators, and stock exchanges?

Getting to a ‘Tipping Point’

The *Letter* introduction asked how we could create a ‘Tipping Point’ to accelerate the shift to ‘long-termism’ in corporate and institutional governance and investing. Five mutually-supporting strategies were identified:

1. Accelerate the sponsorship of academic research relevant to fostering effective corporate and fund governance and investing.
2. Expand the integration of ‘long-termism’ into governance and investment education programs.
3. Expand and integrate ‘long-termism’ messaging to the media, and to key governmental, regulatory, and business agencies.
4. Promote the expansion of workplace pension plan coverage, and of effective pension delivery organizations with fiduciary mindsets. Explore if/how legal action and the courts could help.
5. Translate the voluntary disclosure protocols developed by IIRC, SASB, A4S, and TCFD into a coherent set of mandatory rules promulgated by the globe’s reporting rules setters, securities regulators, and stock exchanges.

Now we need a global plan and the resources to actually implement these five ‘Tipping Point’ strategies……

Keith Ambachtsheer

Endnotes:

i. *“Social Norms as Solutions”, SCIENCE Magazine, October 2016.*

ii. *“Tipping Point 2016” was published as part of the “The Investment Integration Project” by the Investor Responsibility Research Institute…..28 a*sset owners and 22 investment managers participated in the project.

iii. My “The Case for Long-Termism” article can be accessed through a variety of sources. Just google it.

iv. *Carney’s “The Tragedy of Horizon” speech can be accessed through a variety of sources. Just google it.*

v. *The two new research studies reviewed in the August and December Letters were “Corporate Sustainability: First Evidence of Materiality” by Khan, Serafeim, and Yoon (2015), and “Do Long-Term Investors Improve Corporate Decision-Making?” by Harford, Kecskes, and Mansi (2016). In both studies long-term excess returns in the 3%/yr. area were shown to be feasible targets.*

vi. *For example, FCLT put out a 54-page “Long-Term Portfolio Guide” in 2015. It covered five key areas: Investment Beliefs, Risk Appetite, Performance Benchmarking, Financial Incentives, and Investment Mandates.*

vii. See, for example, Bogle (2014) “The Arithmetic of ‘All-In’ Investment Expenses”, FAJ, Jan-Feb., and Beath (2015) “Value-Added by Large Institutional Investors Between 1992-2013”. CEM Benchmarking Inc. website.

viii. *Well-designed workplace pension plans have separate long-term investment and payment safety pools.*

ix. *See Chapter 11 of my book THE FUTURE OF PENSION MANAGEMENT titled “The Evolving Meaning of Fiduciary Duty: Is Your Board of Trustees Keeping Up?*

x. *”Detailed information on all four reporting/disclosure initiatives can be accessed through googling their names.*

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