Short-term profit or long-term value creation?

Investment with a focus on the long term

Over the past few decades, both listed companies and investors (institutional investors and asset managers) have shifted their focus from the long term to the increasingly shorter term. In the words of Tom Sweet, CFO of Dell, attention is "focused on the ninety-day cycle, on achieving the earnings per share target"[1]. This is partly driven by the use of short-term benchmarks and short-term remuneration structures. The Financial Times defines this 'short-termism' as "an excessive focus on short-term results at the expense of long-term interests"[2]. This perspective restricts the options open to listed companies when it comes to innovation, investment and growth.

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Listed companies are under increasing pressure to demonstrate short-term results. This pressure derives from two sources: from their own management and supervisory boards, which apply a short-term outlook, and from the financial markets. Research shows that 84% of CEOs of listed companies around the world experience pressure to achieve financial targets within two years[3]. Moreover, 78% of CEOs postpone investment under pressure from their shareholders.[4] After all in the short term, investment can have a negative impact on quarterly figures. This leads to companies focusing less on investment for the long term and on the opportunities this provides to create value. Research shows that small and medium-sized listed US companies only invested 2.2% of their capital in the period 2002–2011, while the percentage at their non-listed counterparts was 9.4%[5]. This 'underinvestment' affects the company itself negatively, leads to lower long-term returns for investors and to lower macro-economic growth.

Back to the long term

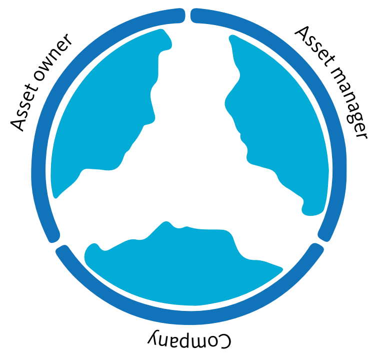
It is not just companies that are increasingly focusing on short-term objectives. The same trend is visible in the investment industry. Since the 2008 crisis, there has been a growing call for shifting the focus back to the long term. Various international organisations have addressed this issue: in 2011 the World Economic Forum published a report entitled 'The Future of Long-term Investing', which contains recommendations for both investors and regulatory authorities to remove obstacles to long-term investment and increase the positive impact of a long-term investment strategy[6]. In 2013, the IMF published a report entitled 'Procyclical Behavior of Institutional Investors During the Recent Financial Crisis: Causes, Impacts, and Challenges'[7] that examined the reasons behind this pro-cyclical behaviour. Its conclusion was that 'behaving in a manner consistent with long-term investing would lead to better long-term, risk-adjusted returns and, importantly, could lessen the potential adverse effects of the procyclical investment behavior of institutional investors on global financial stability'.

Focusing Capital on the Long Term (FCLT) was set also set up in 2013; this is an initiative of Dominic Barton, CEO of McKinsey, and Mark Wiseman, CEO of the Canada Pension Plan Investment Board. Since then, over one hundred pension funds, asset managers and companies have signed up to it. The joint mission is to promote a focus on the long term among investors and businesses and to improve the dialogue between these stakeholders[8].

Three actors need to change their behaviour

On a public equity market, investment in listed companies involves three parties: firstly the companies in which investment is being made, in other words the assets themselves. In order to shift their focus to a horizon of more than one, two or three years, they need change to derive from the other two parties. These are the asset managers that conduct the investment and the asset owners, i.e. the pension funds, insurers or private individuals on behalf of which the investment is being made. For the sake of convenience, we will refer to pension funds in the rest of this article.

Figure 1



These three actors have increasingly focused on short-term profits over the past few decades. Pension funds are under pressure from declining funding levels, peer pressure and legislation. For instance, Dutch pension funds are obliged to report their asset mix and funding levels to De Nederlandsche Bank each month. This serves to preserve short-termism. Declining funding levels have often led to the reduction of risk and management in line with short-term benchmarks. Partly as a result of this, many asset managers look no further than a horizon of three years in order to outperform their benchmarks. Shareholders and companies have become caught up in a vicious circle and work from quarter to quarter. In addition to the abovementioned three actors, legislators and regulatory authorities need to adjust their thinking and actions more to the long term. Yet how can we alter this behaviour?

An essential precondition for successfully changing behaviour is a greater alignment of interests between the three actors, i.e. pension funds, asset managers and companies. All three need to place their focus on the long term and act accordingly. This will not just happen by itself. If, for example, a pension fund assesses its asset manager on its performance in the short term, then an asset manager with a long-term horizon will get into difficulties as it cannot always demonstrate short-term results. Only if this alignment of interests is supported and laid down in writing by all three actors is it possible to have a change in behaviour that leads to a renewed focus on the long term.

The focus on the short term is fed by the needs of the actors involved. The need to perform and to be rewarded for this: both people and organisations seek control, security and appreciation. This means that we do not automatically seek the best solution (e.g. the long-term solution), but instead that we opt for the familiar and secure route: the short term. At the moment both corporations and investors seem to be rewarded more for achieving short-term results. The question is how we can together achieve a different optimum. One important precondition for this is that the rewards for all parties need to be structured more to the long term. The challenge lies in demonstrating the actual long-term value creation. More and better-quality research is needed on this.[9] One method of achieving this is through asset managers and pension funds sharing knowledge on specific cases with one another at national and international level. Furthermore, perceptions about rewards need to change: it is not just about money but also about your legacy to the world.

How will we achieve this change in behaviour? The process starts with minimising conflicts of interest (see figure 3). Part of the solution lies in formulating the correct investment beliefs. Later in this article we describe what a long-term partnership between pension funds and asset managers might look like.

Figure 2 (FCLT, Long-Term Portfolio Guide, March 2015)

What is being done in the Netherlands?

Since 2013, a group of over fifteen Chief Investment Officers of both pension funds and asset managers have met several times a year to exchange ideas aimed at encouraging both companies and investors to invest with a greater focus on the long term and in a more responsible manner. We recently drew up a joint ambition statement that can serve as a guide for applying a long-term investment horizon to listed equities. We explain the main points of our ambition statement below. The core aspects include clear investment beliefs, a review of risk management and benchmarks, qualitative reports and a new concept for fees.

Formulate joint investment beliefs and lay down governance

As an initial step, we propose that pension funds and asset managers hold intensive discussions on the intention behind their investment agreements. What does the pension fund understand precisely by long term? How does the pension fund aim to create value? This will differ for each pension fund and is related to e.g. the composition and growth of its commitments and its investment style. It is generally accepted and supported that the long-term responsibility of the fund means it is held accountable for the impact on people and the environment: responsible investment. The intention to invest with a long horizon subsequently needs to be translated into clear investment beliefs. In fact, this is a kind of constitution: established principles that are supported by several generations of administrators and therefore not open to discussion at the first sign of a headwind. The pension fund then lays these down in an investment mandate together with the asset manager. The mandate states the long-term objectives and governance in unambiguous terms.

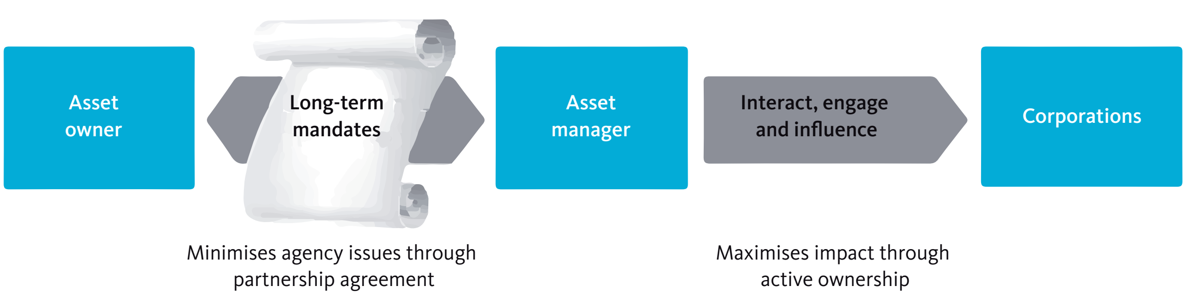
Review of risk management and benchmarks

The measurement of results in terms of risk and return subsequently needs to be brought in line with the long-term philosophy. A review of the use and necessity of the current benchmarks is therefore logical. Benchmarks can be a logical and essential instrument that allow a pension fund to obtain insight into the funding of its commitments and the added value provided by the asset manager. Yet benchmarks can also have an illogical or crushing effect. Blindly following a benchmark can, for instance, lead to the destabilising effects of (market-weighted) index investment and to the wrong incentives in the remuneration policy. A great deal of academic research has been conducted into behavioural finance, including studies in which these pitfalls have been described in detail. A long-term philosophy demands a different method of measuring an investment portfolio's performance, not just the (external) traditional market value-weighted indices as a benchmark, but one chiefly focused on a pension fund's long-term commitments. For instance, a long-term objective and benchmark might be considered that are based on the 20-year swap interest rate + 3% (equity risk premium). Ultimately, a combination of benchmarks is likely to be the most obvious option. The key here is that the asset manager implements the agreed strategy correctly. This is a mainly qualitative assessment. The quality of the performance needs to be assessed over the longer term (e.g. 5-10 years). The process is therefore more important in the short term, in the long term the results.
Current risk management systems can be an obstacle to a long-term horizon given that they are based on traditional short-term risk indicators. This is why long-term risk indicators need to be applied in addition to traditional statistical risk indicators such as volatility, standard deviation or tracking error. Ultimately, these only give a limited idea of the risk inherent to the investments in the long term. An example might be more deterministic scenario analyses that chart the risk of not achieving the long-term objective.
Detailed agreements are needed between asset managers, pension funds and the regulators on the room for uncertainty and how to create interim trust and support in taking up this challenge. At this stage, it will ultimately come down to accepting a specific degree of uncertainty and subsequently establishing as thoroughly as possible how to deal with this uncertainty.

Reports: from quantitative to qualitative

The uncertainty about the short term leads to a requirement for adjusted reporting. In addition to frequent quantitative reports, long-term reports that focus more on qualitative aspects can contribute to a different way of thinking at pension funds,

Figure 3



(FCLT, Long-Term Portfolio Guide, March 2015) asset managers, companies and regulators. Pension funds face financial commitments with durations of up to 30 to 40 years. It therefore makes little sense for the asset manager to report daily, weekly or even monthly on trends in the investment portfolio. Clients that apply a long-term horizon do not need to be worried by temporary fluctuations. This is an essential component of the investment beliefs that the asset manager and client share and need to establish.

The relationship between pension funds, asset managers and companies is even more important in the case of long-term investment, and investors want more than just financial reporting. They require a comprehensive report that describes the strategy, governance, performance and outlook of a company in a cohesive manner. This has consequences for the reporting method. In addition to the traditional monthly reports based on market value and market prices, it is important to have a qualitative report, focused more on the long term, on the growth in the Net Asset Value (NAV) of the companies held in the portfolio. This might include the growth over time of the NAV, the return on equity capital, staff turnover etc. Moreover, transparency towards all the stakeholders is increased by devoting greater attention to the ESG (Environment, Social, Governance) data of the companies in which investment is made. Has one of the companies in the portfolio invested a great deal in reducing harmful emissions or in CO_2 storage? Or have employee rights been improved considerably? Has a radical change taken place in a company's board of management due to a governance issue? Does the remuneration policy provide the correct incentives? Companies need to demonstrate how they create value; value for the stakeholders in the company and value for the sustainable growth of society. Comprehensive reports meet this requirement for increased information by linking a company's ESG activities to its strategy and outlook.

Reports on the transaction volume in the portfolio and the incurred transaction costs are also linked to the intention to operate as a long-term investor. This intention is expressed in portfolios with a relatively low turnover. Where applicable, asset managers need to explain the reasons behind a high turnover. A low turnover translates into lower costs. These in turn lead to a higher chance of an outperformance for the portfolio.

A new concept for fees

Detailed agreements on the mandate and fees are an important component in a sound alignment of interests. On the one hand this involves incentives between the asset manager and the pension fund as the client. An example of this is an asset manager that invests in its own investment funds and in doing so demonstrates its alignment with its clients. On the other hand, how the asset manager applies its remuneration structure is also important: does it reward its fund managers for investing with a long-term horizon, or does it assess its employees on their short-term results? The incentive structures need to encourage a structural change in behaviour. There should be no inappropriate financial incentives for the asset manager with respect to the size of the assets under management, turnover and asset management-related services. We aim to create an internal corporate culture and behaviour with a focus on the long term. Among other things, this should be expressed in the remuneration policy. As with laying down investment beliefs, this requires a customised approach. The time horizon can be an additional factor in determining the management fee. In concrete terms: the longer a mandate runs, the lower the fee paid by the client, with a graduated scale according to duration. Any performance fee can also be dependent on performance in the long term. For instance, the client and asset manager can agree a low basic fee, linked to a performance fee that is only paid at the end of the agreed duration (e.g. after seven years).

Commitment to long-term value creation

A long-term investment horizon is not a direct guarantee of quality and stability. However, we are convinced that a long-term focus can contribute to a better alignment of interests between all the stakeholders in the investment chain. The result of a short-term focus is that companies place too much emphasis on short-term profitability, which creates a sense of false certainty. This causes them to invest less and in fact to perform less well in the long term. This means that both pension funds and society miss out on return and economic growth. Investment with a long-term investment horizon deepens qualitative knowledge of companies and in doing so restricts risk. Equity portfolios become simpler and more transparent. The result is a more responsible investment policy. Pension fund boards and participants become more involved in companies. The capital allocation of companies will improve partly thanks to the increased involvement of long-term shareholders. Asset managers, pension funds and companies would therefore all benefit from structurally improving the dialogue between them. We therefore call on all stakeholders to intensify the national and international dialogue on this topic. Politicians, consultants, regulators and the media also have a role to play here. The dialogue needs to be converted into tangible action aimed at *minimising* conflicts of interest between pension funds and asset managers and at *maximising* the impact on companies through long-term engaged shareholdership. We are committed to taking tangible steps in our own companies with a view to contributing to this over the next few years. Joining forces increases our chance of success in this matter.

Endnotes

1 'CFO Dell: '*Zonder beursnotering kijken we nu vijf jaar vooruit* (Being a private company again means we now look five years ahead)'', Het Financieele Dagblad, 30 July 2015
2 Lexicon.ft.com
3 CPPIB McKinsey Focusing Capital on the Long Term survey 2014
4 CPPIB McKinsey Focusing Capital on the Long Term survey 2014
5 Source: *Comparing the Investment Behavior of Public and Private Firms*, Asker, Farre-Mensa and Ljungqvist
6 *The Future of Long-term Investing*, World Economic Forum, 2011
7 Michael G. Papaioannou, Joonkyu Park, Jukka Pihlman and Han van der Hoorn, *Procyclical Behavior of Institutional Investors during the Recent Financial Crisis: Causes, Impacts, and Challenges*, September 2013
8 See www.FCLT.org
9 Examples of interesting studies on the impact of material sustainability issues in the long-term financial performance of companies: "Corporate Sustainability: First Evidence on Materiality", Mozaffar Khan, George Serafeim and Aaron Yoon, Harvard Business School, March 2015; and "The Impact of Corporate Sustainability on Organizational Processes and Performance", Robert G. Eccles, Ioannis Ioannou and George Serafeim, Harvard Business School, November 2011.