SOLUTIONS TO SHORT-TERMISM IN THE FINANCE SECTOR

Discussion paper

Final

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Prepared by

Institute for Sustainable Futures

For

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Disclaimer

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Abbreviations

ACSI	Australian Council of Super Investors
ASIC	Australian Securities and Investment Commission
BT	British Telecom
CAMAC	Corporations and Markets Advisory Committee
CFA Institute	Chartered Financial Analyst Institute
CII	Council of Institutional Investors
CSR	Corporate Social Responsibility
DCF	Discounted Cash Flow
EAI	Enhanced Analytics Initiative
ESG	Environmental, Social and Corporate Governance
FRS	Financial Reporting Standard
G100	Group of 100
GRI	Global Reporting Initiative
IR	Investor Relations
LTIP	Long Term Incentive Plan
LTLO	Long Term Long Only
M&A	Merger and Acquisition
NGO	Non-government Organisation
SEC	Securities and Exchange Commission
TBL	Triple Bottom Line
TUC	Trades Union Congress
UNEP FI	United Nations Environment Programme Finance Initiative
UNPRI	United Nations Principles for Responsible Investment
USS	Universities Superannuation Scheme

1 Introduction

> *So, who is going to make the first move? If it is a question of perception then the perception is in the whole circle. We think we are being measured on a short-term basis and board directors think that is what investors want of them so in fact their remuneration arrangements are getting shorter and shorter term, with all their LTIPs [long term incentive plan] running off annual bonuses, because that is what they think shareholders want, so they operate on that basis. Who is going to break that chain? (Skipper, 2006 cited in [1] page 49)*

This is the second of two discussion papers prepared by the Institute for Sustainable Futures (ISF) for the Total Environment Centre's Green Capital program. Green Capital has commissioned ISF to undertake research into the causes of, and solutions to, short-termism in the finance sector. This paper discusses solutions and should be read in conjunction with the first discussion paper *Causes of Short-Termism in the Finance Sector* and the Action Plan *Paradigm Shift to Long-termism*. Comments from the project focus groups are incorporated in this paper. The focus groups are referred to hereafter in this paper as "the first/second project focus group".

Our analysis of the causes of short-termism shows that they are multi-faceted, complex and spread across the investment chain. They are also, in many respects, interdependent. A difficulty in addressing short-termism is in identifying where and how to intervene in the system for greatest impact.

Views expressed in recent reports, surveys and consultation exercises suggest that system-wide change is needed and all parties in the investment chain need to be involved in change. In July 2005, The Conference Board Global Corporate Governance Research Center held a Corporate/Investor Summit in London that convened some of the most distinguished representatives from the corporate and investment worlds, to explore the debate on market short-termism. The report from the Summit concluded that:

> *…short-termism is so embedded in the way the stock market functions that any attempt to tackle it piecemeal will fail…aspects of the entire system must be adjusted* all at the same time *for there to be change [2].*

What is needed, therefore, is a concerted effort by all market participants to adjust the system as a whole.

There appears to be growing and widespread consensus on the need for change. Numerous analyses argue that short-termism is not in the best interests of the majority. A small number of investors may benefit through vehicles such as hedge funds, but the market and economy as a whole lose out when myopia leads to allocative inefficiency.

The kind of change that is necessary is not likely to be easily achieved. A recent report by the Trades Union Congress (TUC) in the UK states that what is needed is "a significant cultural change in attitudes to performance"[1], in which fund managers and analysts take account of long-term economic, environmental and social challenges. As the TUC report notes: "Such fundamental change, in structures or values, may be difficult, if not impossible, to achieve." [1]. In a 1996 UK House of Lords debate on wealth creation and social cohesion, one speaker said, "I do not believe there is one single cause or a simple solution to short-termism…Above all, attitudes will have to change, and few things are more difficult [3].

Despite the recognition that change may be difficult, there are serious attempts from within the industry to address the issue of short-termism. Recent conferences, studies and reports have yielded valuable information and suggestions as to how reform might be achieved. The remainder of this paper summarises the ideas that have been put forward to date.

2 Systemic solutions to short-termism

2.1 Reporting and communications

As identified in the discussion paper on causes of short-termism, reporting and disclosure requirements and practices are key factors driving a short-term focus. Correspondingly, there are calls for changes in reporting and disclosure. A 2006 report, by the CFA Institute, Centre for Financial Market Integrity (CFA Institute), recommends that company reporting such as annual reports, should provide more meaningful information about strategy and long-term vision. The study suggests that:

> *…one of the most important responsibilities of company executives is to communicate and act on their corporations' values and to embed those values in the long-term strategy and "value proposition" of the company [4].*

In Australia, the Group of 100 (G100) believes that companies should provide shareholders with regular communication that focuses on long-term shareholder value creation and how current performance reflects progress towards long-term objectives. The G100 also considers that Australian companies should not move to reporting more frequently than allowed for by the current reporting regime [5].

2.1.1 Annual reports

Annual reports tend to have a narrow financial focus and include mainly backward-looking outcome data (lag indicators), rather than information about the activities that drive performance (lead indicators) and future prospects. The Conference Board delegates discussed the need for improved quality of information flow on corporate assets to enable projection of strategic and investment decisions on a longer timeline. Reporting should focus on communicating the fundamental business drivers underlying long-term performance – these can include intangible factors such as human resources management, governance arrangements, risk management, branding, corporate ethics and stakeholder relations. Many companies are already attempting to report on intangibles. For example, 52% of the Global Fortune Top 250 companies now report on sustainability factors [6].

The Conference Board cites its own research into long-termism as demonstrating the importance of companies having an organisation-wide process for selecting appropriate financial and extra-financial measures of business performance [2]. Warren Buffet, the former CEO of Berkshire Hathaway, successfully provided insight into the state of his company and its long-term outlook in annual reports [4].

There are examples of recent regulation designed to improve annual reporting both in Australia and overseas. As reported in the Corporations and Markets Advisory Committee's (CAMAC) December 2006 report on corporate social responsibility (CSR) in Australia, the UK's recently enacted *Companies Act 2006* includes the requirement for all companies, other than small companies, to include in their directors' report a business review. This review, (similar to an operating and financial review) should cover the company's principal risks and uncertainties, including (for listed companies) environmental, employee, social and community issues [7]. The UK Department of Trade and Industry sees the Act as promoting "forward looking narrative reporting by companies" (Source: Press Release, 8 November 2006, cited in [7]). Several other recent initiatives aim to improve reporting, such as the Enhanced Business Reporting Initiative in the US and the European Union's Accounts Modernisation Directive [2].

CAMAC reports on a recent amendment to the Australian Corporations Act (s299A) that they believe, "provides a general framework for the disclosure of relevant non-financial

information" and "an appropriate basis for reporting about environmental and social issues relevant to a company's business" [7]. The new provision is applicable to annual reports of listed companies since 2005 and the CAMAC report recommends extending the reporting obligations to all listed entities, not just listed public companies. The CAMAC report lists the requirements of s299A as follows: "Listed companies must include in the directors' report any information that shareholders would reasonably require to make an informed assessment of:

- the operations of the company
- its financial position, and
- the company's business strategies and prospects for future years" [7]

In the CAMAC Committee's view, the requirements of s299A rest on "an investor protection rationale" [7].

Section 299A appears to be a positive step towards encouraging disclosure of longer-term value drivers, including extra-financial information. It may be expected, for example, that a company reporting on operations and prospects for future years would discuss the company's exposure to risk associated with the introduction of a price on carbon. Work to calculate and disclose carbon risk is already underway through the Carbon Disclosure Project, although this is a voluntary initiative. It is hoped such disclosure will enable investors and analysts to better assess the company's long-term value-creation and risk-management strategies.

The s299A requirement to cover prospects for future years should facilitate a shift from a short-term performance focus. It remains to be seen, however, how s299A will be interpreted and applied. There are already worrying indications that the interpretation may be narrow. A group of influential Australian business leaders has recently rejected a proposal by the ASX Corporate Governance Council that companies report to shareholders about all the risks, including extra-financial risks, which they are facing. They have also rejected moves to make it compulsory for listed companies to report on corporate social responsibility or sustainability measures [8].

2.1.2 Alternatives to earnings

The current obsession with short-term performance measures, primarily earnings, has been identified as contributing to myopic behaviour. Reports such as the CFA Institute report are calling for a phasing out of the practice of earnings guidance, which is provided quarterly in the US and UK, and every 6 months in Australia. A survey by the CFA Institute found strong support among its members for changes to earnings guidance and some companies in the US, such as Intel, McDonalds, Motorola and Pfizer are signaling plans to scale back focused earnings guidance.

Much has been written about the effects of quarterly reporting on behaviour in investors, fund managers, analysts and corporations. To address this, the CFA Institute promotes a shift to provision of "supplemental shareholder value information for investors". The report discusses alternative performance metrics such as discounted cash flow (DCF), condensed balanced sheets and more frequent and higher quality operating data, such as monthly data provided via company websites – in other words, a move towards publication of high quality data that is already used for internal monitoring and decision-making. This, the report argues, would enable company executives to educate analysts on the company's true business drivers [4].

Alfred Rappaport, of Northwestern University Kellogg Graduate School of Management, has developed an alternative reporting tool, the "Corporate Performance Statement". A Corporate Performance Statement would:

- "Separate cash flows and accruals
- Classify accruals by levels of uncertainty
- Provide a range as well as the most likely estimate for each accrual
- Exclude arbitrary, value-irrelevant accruals
- Detail assumptions and risks for each line item" [9]

The statement would be accompanied by a 'management discussion and analysis' section in which management presents "the critical assumptions supporting each accrual estimate and its business model along with performance indicators, such as customer-retention rates, time to market for new products and quality improvements that drive value." [9] Rappaport claims that the Corporate Performance Statement deals directly with the uncertainty inherent to current reporting by separating real cash flows from subjective assumptions about the future (accruals). By contrast, the Statement provides "a more straightforward picture of a company's results" [9]. Rappaport argues that no single-period performance measure can substitute for detailed analysis of the industry and company strategies. The Corporate Performance Statement does not present a bottom line because "no single number can reasonably encapsulate a company's performance." [9].

A further beneficial effect of the Corporate Performance Statement could be that it would make it easier to base executive remuneration on long-term value rather than short-term earnings. Rappaport believes that the information necessary for the Corporate Performance Statement should already be available for internal purposes and therefore the learning curve for implementing this approach should not be steep. However, "The forgetting curve, the time it takes to shed old habits and ways of thinking, will be more challenging." [9]

Leading executives are already beginning to adopt alternative conceptual frameworks such as Economic Value Added, Cash Flow Return on Investment, Triple Bottom Line (TBL) and the Balanced Scorecard. Conceptual frameworks underlie decision-making. For the most part, they are so deeply ingrained that they operate at the sub-conscious level and are assumed to be truths or reality or 'worldviews'. The importance of TBL and Balanced Scorecard is that they attempt to challenge conventional worldviews by introducing additional qualitative elements into decision making; qualitative elements that are foreign to existing measurement systems. Given that TBL and Balanced Scorecard are now accepted systems, they can be adapted to include measurements that are long-term and not short term. Greater use of tools such as these would encourage a move away from over-reliance on earnings-based measures and would provide investors with more meaningful information on which to base investment decisions.

Existing metrics of performance were created in an earlier industrial age that focussed on the tangible value of capital. Wealth creation is now driven by "thinking-intensive talent" rather than capital. In the knowledge-intensive digital age, new performance metrics need to be developed which take into account intangibles such as the returns on the talents of people within companies. One such metric is performance per employee, which can act as a good proxy for earnings on intangibles. It can provide an effective insight into the return on talent and "requires no adjustment from accounting conventions" [10]. Researchers are also investigating measurement of employee commitment, reputation, attraction and retention rates. In Australia, the Society of Knowledge Economics is working on the measurement of knowledge capital. Further research is needed both on extra-financial performance metrics and on their market appreciation and use [2].

The CFA Institute report recommends use of plain language in disclosures rather than legal language and "boilerplate" (standardised) analysis. The report suggests that integration of Investor Relations (IR) and legal departments within firms would help to avoid the disconnect between information emanating from different departments, which can be confusing for investors and analysts.

The first project focus group discussed the need for better information to underpin decision-making, whether those decisions are about short or long-term investments. It was also suggested that while different information and analysis is needed in the market, it would not necessarily be wise to eliminate current sources of information, such as earnings guidance, which do perform a useful function for some sectors of the investment community. One participant proposed that companies provide a reasonable earnings guidance range, as an improvement on current guidance practices. Another participant commented that overall, solutions on disclosure should be "more about encouraging longer-term investment rather than …cutting off information to short-term investors". Companies need to talk to markets about both short-term issues and longer-term issues to cater for everyone. Therefore, an information flow specifically tailored to one investor type may not be appropriate.

2.1.3 Additional disclosure

There is a need for greater disclosure of incentive and performance metrics of both fund managers and corporate executives [4]. Such disclosure would enable all parties to make more informed assessments of whether the appropriate mechanisms are in place to promote a long-term outlook and to encourage change where necessary. In the US, regulation is moving in the direction of increased mandatory disclosure. For example, in 2006, the Securities and Exchange Commission (SEC) proposed executive compensation disclosure reform that would include, among other requirements, that public companies include in their annual reports a comprehensive "executive compensation plan" [2]. As noted above, more sophisticated measures of productivity and commitment are being developed.

In summary, what is needed is more dialogue and improved communications between the investor community and the companies in which they invest, with a focus on the true long-term business drivers of investee companies. Companies need to clarify for investors their long-term value proposition. However, the communication of longer-term and extra-financial factors alone is unlikely to be sufficient to cause the market to take a longer-term perspective. Indeed, in the worst-case scenario, in the absence of regulated standards, reporting of 'soft' information may simply create opportunities for further market distortions.

2.2 Regulation

There may well be a role for new or different regulation to encourage a more long-term approach to investment. The Marathon Club and The Conference Board both note that some existing regulation and accounting principles (such as the accounting standard FRS17 in the UK, and the requirement to expense investment in intangibles) unduly apply short-term pressure. As noted above, changes to regulation in some countries are already yielding positive results.

The paper on causes identifies investor short-termism, driven by human behavioural factors, as a fundamental driver of market short-termism. Investors can make good money out of short-termism. Unless investors are incentivised to look beyond short-term profit maximisation, all other attempts to overcome short-termism may be ineffective. Regulation may be necessary to address the problems of market failure, specifically existence of externalities like climate change impacts, and over-exploitation of common resources. The

CFA Institute recommends consideration of regulated incentives for long-term investors, such as enhanced voting rights, higher dividends or lower capital gains tax. There are now widespread calls for pricing of externalities, particularly carbon pricing through a carbon tax or trading scheme. The Government could also play a role in encouraging long-term mandates, as advocated by the Marathon Club. From an investor perspective however, the long-term can be seen as a series of short-terms, so even lengthening of mandates may not be enough to shift the short-term focus. Ultimately, more direct measures, such as limits on trading [1] or re-evaluation of superannuation taxation [11], may need to be considered. Such measures could help to curb speculation, which has also been identified as contributing to short-termism in the market.

One project focus group participant expressed the view that the finance sector alone will not be able to address short-termism in isolation from the rest of society. Specifically the sector needs to link in with governments, who have a key coordinating role to play in setting appropriate policy frameworks. The focus group discussed the need for internalisation of externalities and more signals and prices on various resources so that they can be disclosed and factored into decision-making. This could include disincentive measures, such as polluter's taxes, and incentive regulation, such as differential capital gains tax. Regulation need not be heavy-handed. High-level dialogue between sectors is also needed to find ways to reward innovation at the same time as protecting the environment.

The TUC has advocated a UK Government enquiry into the issue of short-termism and how it can be resolved. While this paper and the Action Plan that follows lay the foundations for addressing short-termism, and provide useful analysis of work already underway, to really get to the roots of the problem and to design innovative solutions, a finance sector-led in-depth review with government participation will be necessary. Such a review should consider the role of regulation: whether current regulation acts as a disincentive to long-termism and whether new regulation is necessary to incentivise long-term thinking and behaviour in the finance sector.

2.3 Active ownership

A long-term approach would require shareholders to act like owners, to hold shares for longer, trade less and exercise stewardship [4]. The UN Principles for Responsible Investment (UNPRI) encourage the concept of active ownership. The Principles provide a framework for investors to consider environmental, social and corporate governance issues (ESG), driven by the view that such issues can affect the performance of investment portfolios. Principle 2 specifically commits signatories to active ownership and incorporation of ESG into ownership policies and practices. Advocates of the Principles believe that shareholder engagement with businesses on issues of concern holds huge potential for impact and that investors are becoming more confident in influencing companies.

In Australia, the BT Governance Advisory Service provides an investment risk management overlay service. Companies like VicSuper use this service to address portfolio exposure to corporate, social and environmental governance risks via research and dialogue with companies. VicSuper's CEO Bob Welsh says of the service, "It engages with companies, identifies behaviour change we are seeking and reports back to us…We see this not as a passive share-holding, but active ownership" [12]. Despite innovations such as the BT service, there remains a need for greater shareholder activism in Australia, perhaps supported and encouraged by a strong NGO sector.

The first project focus group discussed the idea that either the short-termist signal coming from analysts has to be fixed, or long-term asset owners need to be empowered to get their signals through to companies. The idea of a shareholder engagement clearing house was

suggested. This would be a mechanism for enabling asset owners to talk directly to company boards, to 'trump' the signals coming from analysts about what is important to investors. It was also suggested that fund managers should be forced to disclose how they vote on issues of corporate governance.

The Conference Board report also suggests that institutional investors can be major advocates of long-term growth and sustainable corporate performance [2].

> *Specifically, institutional investors are in the position to seek a constructive dialogue with management and communicate their desire that the business be truly run in the long-term interest of shareholders*
>
> (Raj Thamotheram, Senior Adviser to Universities Superannuation Scheme (USS), quoted in [2]).

In the US, changes in regulation are accredited with improving this dialogue by enabling greater use of shareholder proposals [2]. There are already Australian signatories to the UNPRI in all three categories of signatory – asset owners, investment managers and professional service partners. Many Australian organisations do not yet subscribe to the principles and should be encouraged to do so. Organisations such as the Australian Council of Super Investors (ACSI), a UNPRI signatory, can play a significant role in encouraging greater industry engagement with frameworks such as UNPRI.

In the UK, the institutional investor Hermes (which is owned by the BT pension scheme, Britain's largest pension scheme) is demonstrating active ownership. Hermes has set up "focus funds" aimed at helping under-performing companies to turn around their performance through working with management. Hermes articulates its ownership expectations to investee companies through the Hermes Principles – 10 principles designed to create "common understanding between businesses and their owners of the goals of a public company"[1]. Large US public pension funds are actively advocating sound corporate governance as a means to improve long-term value [2]. Funds such as Telstra Super (Australia's largest corporate super fund) could take a similar leadership role and emulate the positive long-term stewardship demonstrated by UK and US pension funds. However, the cost-effectiveness of such a strategy needs to be considered.

The focus group discussed the concept of the universal owner. This recognises that there can be a divergence of interest between an individual company and diversified investors with a stake in that company. If an investor has a highly diversified portfolio, as in the case of large institutional investors, then effectively they have a stake in the economy as a whole. Therefore, if an individual investee company creates externalities, they will affect the diversified investor's portfolio in some way. This is a concept worth investigating and developing further as an aid to improving understanding of the impacts of externalities.

2.4 Merger and Acquisition procedures

Merger and acquisition (M&A) procedures have been identified as a possible contributor to short-termism. A report by the business think-tank, Tomorrow's Company, in the UK recommends reforms to M&A procedures, specifically suggesting that executive directors obtain independent advice on proposals and that companies carry out independent reviews of acquisitions to assess their contribution to shareholder value (*Restoring Trust: Investment in the 21st century*, Tomorrow's Company, June 2004, cited in [1]). The TUC report recommends employment of the 'precautionary principle' in relation to M&As, given their poor success rate in creating value [1].

2.5 Accreditation

The second project focus group raised the possibility of an accreditation scheme for organisations demonstrating a long-term focus. Such a scheme could be used to enhance branding and improve consumer awareness of the issues. It should be aspirational and rigorous, with reporting to support progress tracking and accountability. Factors to be measured could include human resources, stakeholder relations, governance and environmental management. It was noted that the International Organisation for Standardisation (ISO) is currently developing a standard on corporate social responsibility, although there is no scheme specifically for long-termism.

2.6 Education

The paper on causes identifies lack of adequate financial education, both of market participants, such as pension fund trustees, and at a societal level, as a significant factor contributing to short-termism. For improved communications to have the necessary impact, there is a need for better education of investors:

> *…more financially educated individual investors who better understand the consequences of focusing on the short term to the detriment of the long term would help alleviate the short-termism problem. A more knowledgeable investor would be better equipped to understand long-term business and investment strategy and could reinforce a focus on long-term horizons by corporate leaders, fund managers, and institutional investors. [4].*

Corporate executives need to achieve a better understanding of how the market values their company. Companies, in turn, need to educate investors and analysts on the long-term value-creating drivers of their business and on the consequences of short-termism. Newly educated analysts need to be open-minded about alternative valuation methods, and for that to happen, change is needed at the level of analyst education [2]. The first project focus group discussed the value in taking a longer-term perspective to identify opportunities early on. Taking a longer and broader view of companies' results in better outcomes. This is the message that analysts need to receive from investors who want to encourage a longer-term outlook. The CFA Institute report emphasises the need for better education of trustees of pension funds in particular and encourages pension fund to take up available education programs and materials.

Media reporting of business performance can contribute to the short-termism paradigm. However, if well directed it can also improve communication flows. It is important therefore, that companies, analysts and investors provide information and analysis to the media that promote greater understanding and awareness of factors contributing to long-term risk and value.

Financial education can be implemented from school level upwards, with basic financial literacy programs in schools. Professional bodies can take a leadership role in sponsoring educational seminars and including relevant metrics, such as DCF, in curricula [4]. In Australia, organisations such as ASIC could be active in promoting financial education of the investment sector. Corporate sustainability case studies could be used as teaching cases in accountancy and finance courses. Educational changes are needed across the investment community. Already some universities and business schools are leading the way with introduction of corporate sustainability issues in curricula and sustainability-focused business courses, such as Green MBAs, that have a long-term focus. Research shows that if long-term sustainability considerations are integrated into existing programs, such as Accountancy majors, students see the issues as more relevant and important [13].

2.7 Role of others

The discussion paper on causes of short-termism identified that the finance sector does not operate in isolation from the rest of society. There are broad societal and human behavioural causes of short-termism that are particularly difficult for a single sector, organisation or individual to influence. There is therefore a need for consideration of the issue from many sectors of society, not only the finance sector.

In the UK, for example, the TUC has taken a leadership role in addressing short-termism by commissioning its own review of the issue. The report noted that unions can play a role in dealing with short-termism by exercising their responsibilities as fund trustees, "Trade union members who are trustees can play a vital role in implementing any necessary reforms" [1]. It is in the interests of unions to be involved in addressing short-termism because it is union members who are vulnerable to an insufficiently long-term approach to management of their super funds. In the UK, most shares are owned by "collective investment vehicles representing the capital of millions of working people. The public are in large part the owners of British business. The very victims of corporate short-termism are the providers of the capital invested in those companies" [1]. A 2004 Australian Securities Exchange (ASX) study found that 55% of the Australian adult population, or approximately eight million people, owned shares directly or indirectly (via a managed fund or self-managed superannuation fund) [14]. There is therefore a strong case for unions in Australia to take a similar leadership role in order to protect the long-term interests of its members.

At a societal level, a shift in values could instigate change. As environmental pressures such as climate change and water shortages mount, we may begin to see a shift in societal beliefs and values towards a longer-term outlook. Use of conceptual frameworks such as TBL and Balanced Scorecard are representational of the interweaving of existing business practice with external expectations of business practices and are therefore arguably representative of changes already taking place in the external values of the world beyond business boundaries. This may increasingly impact business and the financial sector, via changing consumer demand and calls for regulation. To consciously accelerate a shift in values would require a great deal of effort, including strong support from the NGO sector.

2.8 Leadership

A theme emerging from the CFA Institute report is the need for strong leadership across all sections of the finance industry. Leadership is required to provide the necessary support for analysts, fund managers and corporate executives to develop a long-term approach. Effective governance of a company's Board is a key method by which to inject long term horizons into top management's consciousness [15], given its role in providing strategic direction for the organisation. As leaders have a strong influence on the actions of others, it is critical that leadership is supportive of measures to address short-termism.

This paper provides examples of leadership across the industry such as encouragement of extra-financial analysis through the Enhanced Analytics Initiative discussed below, active ownership by institutional investors such as Hermes, development of new tools for performance measurement, companies seeking their own solutions through changed reporting regimes and even outstanding individual leadership as demonstrated by Warren Buffet. There are already leaders within Australia, such as the UNPRI signatories and companies that are calling for action on long-term extra-financial issues like climate change through initiatives such as the Australian Business Roundtable on Climate Change. However, this project challenges the Australian investment community to consider individual and collective leadership in actively seeking solutions short-termism. Initiatives

such as the Conference Board Summit series provide models that the Australian finance sector could adopt to begin to do so.

The remainder of this paper discusses proposed solutions to address short-termism at the level of the individual links in the investment chain:

- The investor link
- The analyst link
- The corporate link [2].

3 Solutions to short-termism at the level of links in the chain

3.1 The investor link

3.1.1 Individual and institutional investors

As discussed above, the issue of how to incentivise investors away from a focus on short-term profit maximisation is fundamental to overcoming short-termism in the finance sector. Some form of regulated incentives may be the only feasible solution.

There are measures that investors can take however, to reduce short-term pressures in the investment chain. Long-term investors should formally incorporate commitment to long-term performance into their policies and practices. Institutional investors have a role to play in the education of individual investors. Institutional investors need to communicate their long-term investment strategies to beneficiaries [4]. Super funds in Australia could, for example, issue long-term investment statements to beneficiaries to enhance understanding of how their funds are being managed for the long-term.

Long-term mandates

A commonly proposed solution to short-termism is that institutional investors such as pension (super) funds, award long-term mandates to ease the short-term pressures on fund managers. This is articulated by Will Hutton in *The State To Come*, p69, 1997, cited in [1]):

> *Ownership is a serious business, and those charged with discharging the ownership responsibilities of the bulk of British business need themselves, to be given the architecture in which they can take a far-sighted view.*

There is surprising consensus on the issue of long-term mandates. For example, Tomorrow's Company recommends that "Mandates should be established on the assumption that they are for the long term, ideally seven to ten years, with a regular review cycle" (*Restoring Trust: Investment in the 21st century*, Tomorrow's Company, June 2004, cited in [1]). A report by the consulting firm Watson Wyatt suggests that "'Ten-year Mandates' offer one possible solution" (*Remapping our investment world*, page 2, Watson Wyatt, October 2003, cited in [1]). Respondents to a 2005 survey into investment beliefs by the Marathon Club, thought that the most important way to improve corporate behaviour and performance is to lengthen the investment horizon [19]. Long-term mandates should give fund managers more freedom to make long-term decisions. However, long-term mandates would need to be issued in tandem with changes to remuneration and performance assessment [1].

In 2006, the Marathon Club issued a consultation paper setting out proposed characteristics of a long-term, long-only (LTLO) mandate. The Marathon Club defines LTLO investment as

> *…a fundamental, research oriented investment approach that incorporates the variables that explain business success and has a focused discipline of optimising positive absolute returns over the long-term business cycle [16].*

The consultation paper identifies key features of an LTLO mandate including: aims, such as positive absolute returns over the long-term and capital preservation bias; investment strategies based around research emphasising business fundamentals and extra-financial factors, low portfolio turnover and promotion of long-term ownership; and fund managers with a strong commitment to continuous improvements in research processes and investment models [16]. A key component in implementing long-term mandates is the manager selection process. The Marathon Club believes that more time needs to be dedicated to selecting fund managers to fully investigate and understand their approach to investment.

Responses to the Marathon Club's consultation paper revealed the following key themes [17]:

- Articulation of trustee investment beliefs is thought to be critical to the success of LTLO mandates and should be undertaken in conjunction with advisors and fund managers;
- There needs to be a shift away from a focus on short-term performance (discussed further below);
- Reform of governance structures and appropriate trustee understanding are also thought to be essential to a long-term view; and
- Periodic review meetings should focus on the development of the portfolio's investments and the underlying characteristics of the portfolio based on factors other than share price.

Consensus was reached on the objectives of LTLO mandates as "efficient allocation and preservation of capital and risk protection." [17] Responses further suggested that multi-criteria performance evaluation is needed for LTLO mandates and a balanced scorecard approach may be appropriate. Detailed suggestions were made on the characteristics of LTLO mandates such as the suggestion that a LTLO mandate would allow cash holding until appropriate investment opportunities become available. Responses also suggest a need for trustees to delegate more authority to specialist advisors to assist with researching LTLO investment opportunities and monitoring performance [17].

The TUC report urges trustees to consider long-term mandates and also notes the potential for Government to encourage the implementation of LTLO mandates [1]. The Conference Board has called for a group of leading institutions committed to long-termism to design and disseminate a set of "best practice" principles for long-term investment [2]. Australian fund trustees should consider whether an LTLO approach is appropriate for their portfolio management and the Australian investment community could work collectively to establish guiding principles for long-term investment.

The first project focus group discussed the need for the market to cater to different types of investors – short-term traders and long-term investors. The factors that are considered in investment decisions should be consistent with the investor's investment pathway. Superannuation funds, with a lifetime timeframe, should be looking at long-term factors. A potentially controversial suggestion is the idea of limits on superfund competition to ease short-term performance pressure (arising from superfund customer choice). It was noted that rationalisation of super funds could also make it more difficult to incorporate ESG factors.

Education of young investors was also suggested as a strategy. There was some discussion about the need for education of superfund customers – to persuade beneficiaries that a short-term performance approach is not necessarily the best thing for their longer-term wealth creation. It was noted that such education faces the challenge of overcoming the overwhelming societal short-termist consumerism messages.

The group discussed limits on disclosure of fund manager and superfund performance to ease short-term performance pressure. Five-year rolling average performance disclosure was suggested.

3.1.2 Fund managers

Assessment of fund manager performance is an important contributor to short-term behaviour in the finance sector. The Conference Board report cites evidence from a UN report showing that most jurisdictions do not support "a single-minded pursuit of profit maximisation by asset managers" (*A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment*, cited in [2]). Changes in how fund managers are assessed and managed by investors are seen as a key factor in moving towards a more long-term approach.

Firstly, the time horizon for assessment of fund manager performance should be increased. A UK Treasury review of institutional investment, the Myners Review, put forward the following solution to the problem of short-term decision-making:

> *…clarify the understanding between fund managers and their clients about time horizons and the length over which performance would be measured. Ultimately, clients should not terminate mandates before the end of the assessment period on performance grounds alone. (cited in [1]).*

The CFA Institute report suggests tying fund manager incentives to multi-year performance. A 2004 European Morningstar survey also suggested that fund manager bonuses should be linked to longer-term performance measures (cited in [18]). The first project focus group commented that super funds need to assess fund managers' performance on a longer term basis. This signal would also impact on analysts. Al Gore and David Blood's Generation Investment Management model was cited as an example.

Secondly, incentives should aim to align the interests of the fund manager with the interests of shareholders and promote long-term investment strategies. Fund managers could be encouraged to commit a meaningful proportion of their own funds to the funds they manage, with a view to aligning client and manager interests [4]. Marathon Club consultation revealed that performance related fees are not thought to be positive for manager behaviour, and indeed could lead them to take more risks. A more popular solution is co-investment. This may be difficult in practice however, as the objectives of the fund manager may differ from the objectives of investors. Deferred bonuses are seen as good way of aligning investor and fund manager interests [17].

Finally, to combat high fund manager turnover, which is costly and hampers performance evaluation, a KMPG report recommended that "large fund houses set up boutique-style departments in order to provide staff with the unconstrained and "free thinking" environment that attracts them to hedge funds", such as the structure in place at AXA Investment Managers (cited in [18]).

3.2 The analyst link

The short-termism chain can only be broken if securities analysts are also involved in the process [2]. In a market where investors are more interested in the long-term value-creating drivers of a business than its short-term performance, there is an opportunity for highly skilled analysts to differentiate themselves on the basis of high quality analysis and direct research. David Blood and Al Gore of Generation Investment Management have discussed the need for better analysis as follows:

> *…analysts need to take account of factors that are not routinely monetised on balance sheets – including sustainability issues – as opposed to solely focusing on short-term returns. This means analyzing the implications for shareholder value of long-term economic, environmental and social challenges. They include future political or regulatory risks, the alignment of management and board with long-term company value, quality of human resources management, risks associated with governance structure, the environment, restructurings/mergers and acquisitions, branding, corporate ethics and stakeholder relations.* (Financial Times FTFM, 2005, cited in *[1]).*

Respondents to the 2005 Marathon Club survey expressed a strong preference for mainstreaming of good corporate governance and corporate responsibility practices into buy / sell decisions, rather than managing against a specialist index, or using a specialist team of analysts. The report suggests that issues such as training therefore need to be given further consideration [19]. Research is needed to identify a viable business model for analysts selling high-quality research with a long-term focus [2].

The CFA Institute describes the need to shift to a market in which "the hard work, expertise, and independent assessment of the best analysts are rewarded" [4]. To help create such a market, a major group of institutional investors has established the Enhanced Analytics Initiative (EAI). This initiative pools a percentage of broker commissions and directs it towards extra-financial research. On a 6-monthly basis, the EAI members award commission to those analysts deemed to have provided the highest quality analysis incorporating long-term, extra-financial and intangible performance measures. The purpose of the fund is to incentivise more of this type of research and to encourage analysts to take a broader and longer-term view of companies [1]. Such initiatives need reinforcement to encourage analysts focused on long-term valuation and to create "a community of leaders" in the field [2]. Trustees in Australia could encourage long-term and extra-financial investment analysis by supporting the EAI or creating a similar Australian-centred scheme.

Recent analyst initiatives are mainstreaming analysis of corporate governance issues. The Global Equity Unit at Deutsche Bank has developed a framework to analyze corporate governance issues and explore their relationship to stock market risk and corporate performance. The framework aims to integrate the metrics into investor portfolio management processes. Deutsche Bank's research supports a link between corporate governance standards and equity risk [2].

A plethora of rating systems is emerging, that claim to assess the performance of companies based on financial and extra-financial measures. These include indices such as the Dow Jones Sustainability Index, Business in the Community, the Corporate Responsibility Index and Reputex. While these ratings systems are not without problems and critics, they are arguably an important contribution to the wider recognition of the importance of extra-financial analysis and disclosure. The Global Reporting Initiative (GRI), which provides a framework for reporting of extra-financial measures, is also making easier the work of analysts wishing to take a broader view of performance drivers. There is evidence that analysts who are provided with more comprehensive business information tend to issue more positive recommendations on the company's securities [2]. Progressive Australian companies are already reporting against the GRI framework, although there is still resistance to such disclosure.

Despite evidence of the link between sustainability issues and long-term shareholder value, research indicates that such issues are peripheral for young financial analysts. There remain significant cultural barriers to change [2]. A 2005 study by United Nations Environment Programme Finance Initiative (UNEP FI) and the World Business Council for Sustainable Development was conducted "in the belief that financial analysis can be a significant enabler or inhibitor of change in corporate practice, and that young analysts may be key agents of change within financial institutions" (*Reality Check. Young Financial Analysts' Views on Environmental, Social and Corporate Governance Issues*, United Nations Environment Programme Finance Initiative-World Business Council for Sustainable Development (Young Managers Team), Geneva, January 2005, cited in [2]). The study found that young analysts are largely disengaged from ESG issues. The findings underline the need to broaden the scope of analyst education. Attitudes to sustainability may well be determined more by world view than age, so it is likely that analysts already working in industry also need to be educated on these issues.

3.3 The corporate link

The first project focus group discussed the idea that it is not the finance sector itself that is of most importance in the discussion, but rather the finance sector's impact upon the corporate sector. Therefore, the focus of outcomes should be on changing corporate behaviour and easing corporate short-term performance pressure. What matters are the signals that are received from the finance sector by corporate boards and CEOs about short-termism.

In return for shareholders exercising their responsibilities as owners and adopting a long-term investment approach, companies should seek out those investors who will form a long-term shareholder base. As noted above, executives have a responsibility to educate investors about the value in long-term investment and to communicate the company's long-term strategic objectives and benchmarks. Berkshire Hathaway is cited as an example of a company that has been successful in doing so and has profited from retaining a core shareholder base that has supported it in implementing long-term value-creation strategies (it should be noted however that Berkshire Hathaway's success is unusual and largely attributable to outstanding leadership).

Although many companies are now reporting on extra-financial performance, very few companies have clearly articulated their long-term vision and strategy for sustainable performance and value building. Without a long-term vision and strategy, it is difficult for executives and directors to make long-term investment decisions. A sound long-term strategy conversely can "act as a beacon to senior executives and board directors, permitting them to weather either natural economic downturns or temporary negative externalities" [2]. Like any other facet of business life, investment can be influenced by current fads, for example, the recent investment by Australian banks in Chinese financial institutions. However, despite potential short-term negative effects of resisting these fads, by following an explicit set of values and communicating effectively with its stakeholders, an organisation can ride through these short-term effects in the interests of the longer-term strategy [20]. Companies that have successfully communicated their long-term strategies to investors could be identified as a means of inspiring other investors [2].

The Conference Board recommends widespread adoption of an enterprise risk management framework as a means of bringing clarity to and communicating long-term strategy [2]. Developments in the field of risk management mean there are numerous sophisticated tools available to assess risk. As noted, initiatives like the Carbon Disclosure Project are helping to identify and communicate extra-financial risk such as exposure to carbon risk. In 2006 ASIC issued guidelines on the preparation of better prospectuses, including improved risk disclosure incorporating sensitivity analysis. Improved risk management techniques increase opportunities for long-term investment by reducing future uncertainties.

Remuneration and performance assessment

Executive remuneration is seen as a primary area for change. As with fund manager remuneration, there is a need for executive remuneration to be linked to long-term shareholder value. There has been much discussion of the effect on behaviour of remuneration through options and how this can promote short-term behaviour when compared to other remuneration options.

Instead of options, manager compensation could be linked in a meaningful way to shareholder value to align long-term corporate goals and strategies with long-term shareholder interests [4]. The Tomorrow's Company report recommends a greater level of remuneration in shares (*Restoring Trust: Investment in the 21st century*, Tomorrow's Company, June 2004, cited in [1]). Plender, a UK Financial Times columnist, favours straight equity over options with executives locked into it for longer periods. Plender's preferred solution, however, is a return to a greater emphasis on basic pay with equity awards used only to reward outstanding performance (*Going off the rails: Global Capital and the Crisis of Legitimacy*, Plender, p263, cited in [1]). Alfred Rappaport, on the other hand, argues that a move away from share-based remuneration could make directors risk averse and instead recommends that options are structured to reward long-term performance (*The Economics of Short-Term Performance Obsession*, Rappaport, pages 72-74, Financial Analysts Journal, 1 May 2005, cited in [1]). The Shareholder Association has encouraged a move to options-based reward systems that reward performance over the long-term.

The focus group discussed corporate executive remuneration. It was suggested that deferred remuneration and bonuses would encourage a longer-term perspective. The maximum deferral period was thought to be around 5-7 years. Longer than this, could lead to perverse outcomes such as nationwide talent loss. Macquarie Bank was cited as an example of a company with successful deferred remuneration programs. The Macquarie model provides long-term rewards over periods of up to 10 years. The group also noted the need for greater disclosure of corporate remuneration structures.

Research by Henderson Global Investors found that rewards for directors' performance in relation to extra-financial issues were also linked to short-term incentives, although these issues are by their nature, long-term [1]. In the UK, the USS has signalled its intention to include extra-financial measures of performance in their discussions with investee companies on their remuneration arrangements [2]. As remuneration is an important behavioural incentive, structures should be reviewed to ensure they encourage desirable outcomes for investors and companies [1].

Investors and fund managers could play a role in encouraging the companies in which they invest to develop processes to ensure that companies award executive compensation on a long-term basis. What is required is a holistic approach to compensation, going beyond a focus on CEOs and including other industry players including analysts and fund managers [4].

4 Indicators of change

There are positive signs of change. Initiatives such as the EAI and the work of the Marathon Club demonstrate that there is acknowledgement of the issue of short-termism and the first steps are being taken to address the underlying causes. Graeme Davies, Chairman of the Marathon Club sums up the incentive for change thus: "Improving the long-term financial and qualitative buying power of fund beneficiaries should be our primary goal. It is not enough to secure an individual's pension and then fail to consider our collective impact on the factors affecting the quality of that pensioner's retirement."[16].

The Conference Board report identifies the drivers for change as [2]:

- the need to restore investor confidence in the wake of corporate scandals;
- the active engagement of institutional investors with the companies in which they invest, including advocating accountability, enforcement of shareholders rights and adoption of higher standards of business integrity. And the investigation by institutional investors of longer-term investment opportunities;
- active encouragement of companies by investors to review compensation structures and performance metrics and devise schemes based on financial and extra-financial indicators;
- international convergence on accounting principles, particularly focused on true value drivers and reporting of extra-financial performance measures;
- research linking sustainability and improved stock prices and shareholder value, the most notable of which is the UNEP FI Materiality Project report of June 2004. Data in the report shows that "long-term protection of shareholder value rests upon the rigorous integration in the corporate strategy of policies on climate change, internal governance and openness to shareholder proposals, innovation and scientific research, labor rights and public health" [2]. This is a highly complex area and quantification of value remains challenging [21]. There is a need for more meta-analysis of research studies in this area [13]; and
- efforts by regulators, intermediaries and institutional investors to focus research on long-term value, through projects such as the Enhanced Analytics Initiative.

5 Conclusion

Overcoming the structural, behavioural and cultural barriers to long-termism in the finance sector will not be easy. Encouragingly though, there is recognition of the positive drivers for change and a growing consensus on the need for change. Change is needed across the investment chain and all parties in the chain must be involved – investors, analysts and investee companies. An effective national response will require action from corporate Australia, sections of the media, and fund managers [11]. The Government must also be involved. Numerous positive examples exist of progressive individuals and organisations within the investment community internationally who are taking the lead on initiatives to address short-termism. Nevertheless, much more needs to be done, and the problem of how to shift investors away from a focus on short-term profit maximisation remains. The Australian investment community as a whole must begin to engage more fully in the effort to address short-termism.

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