PARADIGM SHIFT TO LONG-TERMISM

Action Plan for the Australian Finance Sector

Final

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Prepared by

Institute for Sustainable Futures

For

Total Environment Centre

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Disclaimer

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Summary of recommendations

Overarching recommendations

We recommend:

- **that Australia take a leadership position and develop a sector-wide process for promoting long-termism, building on international research and initiatives. This would include a finance sector-led in-depth review of Australian market short-termism, involving wide consultation with finance sector stakeholders. The review should propose specific mechanisms for advancing long-term thinking in the finance sector. The most likely driver of this development would be superfund agencies such as the recently formed Regnan or ACSI.**
- **that the Federal Government expedites a re-review of the case for mandatory disclosure of extra-financial performance; and**
- **that the finance sector-led review specifically examines the case for mandatory disclosure of extra-financial performance and the need for amendments to current earnings disclosure requirements.**

Recommendations for structural change

We recommend:

- **that the finance-sector led review includes review of the current regulatory framework and an assessment of the need for new or amended legislation to:**
    - **incentivise long-term investment; and/or**
    - **discourage short-termism in the finance sector, particularly through reform of capital gains tax; and**
    - **adequately account for externalities.**
- **that the finance sector-led review considers the concept of an accreditation scheme to recognise organisations demonstrating a long-term focus.**
- **that investors and investee companies work together to:**
    - **create fora for more open and regular dialogue on environmental, social and governance (ESG) issues and long-term strategies and value; and**
    - **identify opportunities for collaborative initiatives to promote long-term thinking.**
- **that Australian institutional investors support the international Enhanced Analytics Initiative and/or consider establishing an Australian version of the fund.**
- **that companies regularly supply information to the market and media on long-term strategy, targets, objectives, value drivers and risks including material extra-financial issues. Risk assessment should include sensitivity analysis. Mechanisms for provision of information include:**

- **annual reporting of sustainability issues using reporting frameworks such as the Global Reporting Initiative (GRI), and inclusion of extra-financial performance measures in annual reports;**
- **participation in rating schemes, such as the Corporate Responsibility Index (CRI), which help benchmark performance; and**
- **traditional disclosure vehicles such as prospectuses.**

- **that industry associations, such as the Investment and Financial Services Association (IFSA), review the results of the Corporations and Markets Advisory Committee (CAMAC) inquiry and consider the need for additional guidance on disclosure of extra-financial factors (in the absence of mandatory disclosure).**
- **that ESG analysts and long-term institutional investors engage actively with the business media and provide information to improve media understanding of the importance of analysing and reporting on extra-financial issues and long-term value.**
- **increased uptake, by all members of the investment community and companies, of tools already in existence for measuring extra-financial performance.**
- **research to identify information gaps and development of new tools to fill the gaps, particularly tools to enhance risk assessment through evaluation of material extra-financial and long-term factors. Research and tools development requires funding and this could be provided by industry associations or government.**
- **continuing dialogue between companies and analysts to understand how information on extra-financial issues can be provided in a format that can be incorporated into mainstream analysis.**
- **provision of finance sector-led learning opportunities, on sources of long-term value and risk, for superfund trustees and advisers. This could be provided by industry associations such as the Australian Securities and Investment Commission (ASIC).**
- **continuing research by governments to investigate how best to improve general financial literacy, for example, through school curricula.**
- **implementation by governments of appropriate measures to improve general financial literacy.**
- **research by institutional investors to better understand the motivations and objectives of superfund beneficiaries.**
- **drawing on the research, enhanced communication by superfunds to beneficiaries to improve understanding of the benefits of a long-term investment approach.**
- **that providers of education for financial analysts incorporate teaching on extra-financial (ESG) and long-term analysis in curricula.**
- **that organisations providing continuing professional development for corporate executives, such as professional associations and the Australian Institute of Company Directors, provide learning opportunities in sources of long-term risk and value, including extra-financial factors; and**
- **that all providers of primary business/financial education (business schools and faculties, professional associations etc) incorporate ESG issues and long-term strategy development into curricula where they are not already incorporated.**

- **that the finance sector-led review investigates the issue of lack of venture capital for commercialisation of Australian technologies with long-term value potential.**

Recommendations for links in the investment chain and stakeholder groups

Institutional investors

We recommend:

- **that more Australian institutional investors and industry associations join the growing list of those who are already signatories to the United Nations Principles for Responsible Investment (UNPRI).**
- **that Australian UNPRI signatories implement the principles in investment activities.**
- **that institutional investors actively encourage companies to improve performance on extra-financial issues of long-term importance.**
- **that institutional investors investigate the application of the PRI shareholder Engagement Clearinghouse concept in the Australian finance sector.**
- **that large Australian institutional investors consider setting up funds, similar to the Hermes focus funds, to assist under-performing Australian companies with long-term value potential to improve performance.**
- **that long-term investors implement performance assessment and remuneration structures for fund managers that encourage long-term investment decisions.**
- **that Australian institutional investors reflect commitment to long-term performance by adopting long-term mandates.**
- **that long-term investors collaborate to establish guiding principles for long-term investment**

Analysts

We recommend:

- **further uptake of ESG analysis by mainstream analysts to meet growing market demand.**
- **research to identify a viable business model for analysts selling high-quality research with a long-term focus**

Corporate sector

- **We recommend that companies clearly articulate their vision and strategy for long-term value creation, including consideration of material extra-financial issues.**

- **We recommend that the finance sector-led review investigates the feasibility and effectiveness of a scheme to incentivise long-term investment by rewarding longer-term shareholding through additional dividends.**

We recommend that companies:

- **implement remuneration and performance assessment structures that reward performance (financial and extra-financial) over the long-term. Deferred bonus and deferred option schemes have been suggested as a viable option with maximum deferral up to 5-7 years.**
- **provide greater disclosure of remuneration and performance assessment schemes.**

Other stakeholders

Government

- **We recommend that the finance sector-led review involves government and considers the role of government in addressing finance sector short-termism beyond legislation, for example through public education, research and tools development.**

Finance sector bodies

- **We recommend that the finance sector-led review considers the role of finance sector associations and professional bodies in addressing finance sector short-termism through provision of services such as fora for dialogue, research and learning opportunities.**

Unions

We recommend that unions and their members:

- **participate in the finance sector-led review.**
- **campaign to inform and raise awareness and to encourage the finance sector to take action on short-termism.**
- **help to improve understanding among their members of the benefits of long-term investment through superfunds.**
- **in their role as superfund trustees, promote long-term investment.**
- **engage directly in dialogue with industry superfunds about long-term investment strategy.**

NGOs

We recommend that NGOs/not-for-profit organisations:

- **participate in the finance sector-led review.**

- **campaign to inform and raise awareness and to encourage the finance sector to take action on short-termism.**
- **partner with government and business to provide research and analysis of the problem and feasible solutions.**

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Abbreviations

ASFA	Association of Superannuation Funds of Australia
ASIC	Australian Securities and Investment Commission
ASX	Australian Securities Exchange
CAMAC	Corporations and Markets Advisory Committee
CRI	Corporate Responsibility Index
EAI	Enhanced Analytics Initiative
ESG	Environmental, social and governance
GRI	Global Reporting Initiative
ICGN	International Corporate Governance Network
IFSA	Investment and Financial Services Association
ISF	Institute for Sustainable Futures
ISO	International Organisation for Standardisation
NAB	National Australia Bank
NGO	Non-governmental organisation
PCA	Property Council of Australia
TEC	Total Environment Centre
TUC	Trades Union Congress
UNPRI	United Nations Principles for Responsible Investment
UTS	University of Technology, Sydney

1 Introduction

1.1 The project

Short-termism has been identified as a significant barrier to achieving corporate sustainability, both in Australia and globally. The Total Environment Centre's (TEC) Green Capital Program has instigated a project to consider the problem of short-termism with the following objectives:

- To raise the issue of short-termism as a barrier to corporate sustainability
- To identify causes and solutions to short-termism
- To promote the uptake of solutions in Australian business

Green Capital has commissioned The Institute for Sustainable Futures (ISF) to research causes of, and solutions to, short-termism in the finance sector. The research involves desktop review of literature and two focus groups with selected stakeholders of the Australian investment community.

The outputs from this research project are: two discussion papers - one covering causes of short-termism and the other covering solutions to short-termism; and the Action Plan. The purpose of the discussion papers and Action Plan is to stimulate debate about short-termism and to lay the foundations for addressing short-termism in the Australian finance sector.

This paper, the Action Plan, provides recommendations for steps that the finance sector and finance sector stakeholders can take to begin to address the problem of short-termism. It should be read in conjunction with the two discussion papers *Causes of Short-termism in the Finance Sector* and *Solutions to Short-termism in the Finance Sector*.

The recommendations in this paper are drawn from solutions identified in the literature and the views of participants in the focus groups. In this paper, the focus groups are referred to as "the project focus groups".

1.2 Summary of the short-termism problem

In the paper *Causes of Short-termism in the Finance Sector*, we defined short-termism as "a preference for actions in the near-term without due consideration of the long-term consequences" [1] and we considered a timeframe of less than three years to be short-term.

The literature broadly agrees that short-termism is a significant problem for the finance sector. Reports generated by the finance sector confirm the results of academic research and theory. Internationally, high level investment community symposia have acknowledged the problem of short-termism, and influential market participants, such as members of the Marathon Club[1], are making serious attempts to find solutions. A report by The Conference Board Global Corporate Governance Research Center (The Conference Board) concludes

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[1] *The Marathon Club is a direct follow-up project to the competition run by USS Ltd and Hewitt (with support from FTfm) entitled "Managing pension funds as if the long-term really did matter". The Club is comprised of approximately 18 members including institutional fund trustees, senior executives and senior specialists who have a proven track-record in playing a relevant leadership role in public and private institutional funds and endowments. (www.marathonclub.co.uk)*

that short-term performance pressure on companies inhibits longer-term corporate growth. Such pressure can cause corporates to lose sight of strategy, compromising global competitiveness. The report cites the need to restore investors' confidence and the credibility of global capital markets [2]. In his address to the International Corporate Governance Network (ICGN) Annual Conference in Washington in 2006, Peter Butler noted that investor disinterest in long-term ownership issues “threatens to undermine the model of value creation and accountability of directors to owners” [3].

The project focus group participants agreed that short-termism is the dominant paradigm in the finance sector. They noted, however, that a short-term outlook is not *ipso facto* problematic. Indeed, a degree of short-termism is needed for market liquidity. Good decisions can be made from a short-term perspective and not all decisions made from a long-term perspective are good decisions. The problem with the short-termism paradigm is that it restricts the ability of long-term investors and corporates to take decisions based on principles of long-term value creation rather than short-term performance expectations. These concerns are supported by empirical evidence suggesting that corporate managers make decisions that sacrifice long-term value creation in order to meet short-term earnings expectations [4]. Short-term investor behaviour therefore appears to drive short-term business management. In focusing only on the short-term, however, the market is potentially missing sources of value, misallocating capital, reducing investment returns and underestimating the long-term risks of issues like climate change.

Good decision-making relies on good information. There are gaps in the information available to the market to inform long-term investment decisions. The present focus on narrow short-term financial indicators undermines the ability of all market participants to make sound decisions, and is a key contributor to short-termism.

From the perspective of organisations like TEC, and indeed anyone concerned about long-term prosperity and well-being, the current paradigm in the financial sector is problematic because it undermines economic, environmental and social sustainability. Short-termism favours immediate financial returns. The long-term costs of unsustainability therefore tend to be ignored in favour of minimising short-term costs and maximising short-term profits. There is no imperative to account for externalities. This is equivalent to “keeping a ledger recording income but not expenses” [5]. In the long-run, this could lead to society- and economy-wide destruction of value.

The economic logic of the ‘tragedy of the commons’ suggests that in the absence of a regulating authority, self-interested independent agents will seek short-term personal gain at the expense of the long-term welfare of all. Theory is now playing out in reality at a global level, with the increasingly evident present day impacts and projected future costs of climate change, and economic disasters such as the collapse of commercial fisheries. The Conference Board report neatly summarises the problem thus: short-termism “encourages opportunistic behaviours by a few to the detriment of the many” [2].

It is clear that a wholly short-termist approach creates public costs. We believe however, that short-termism also impacts negatively on private gain. One such impact is experienced through the ‘universal owner’ effect. The impacts of externalities (costs that are not paid for by participants in a transaction) can be cumulative and are often experienced only in the long-term. Failure to account for them can lead to long-term value destruction and economy-wide resource inefficiency. If an investor has a highly diversified portfolio (i.e. is a ‘universal owner’), as in the case of large institutional investors, then effectively they have a stake in the economy as a whole. So if an individual investee company creates externalities, in the long-term they will affect the diversified investor’s portfolio to some degree. A more direct risk arises from the depletion of long-term corporate value. For institutional investors, such as superfunds with long-term liabilities, this could result in a mismatch between future assets and liabilities.

1.3 Benefits of long-termism

In our view, the costs and risks of short-termism, at a societal level and for long-term investors, are compelling enough reasons to address the issue. This is the preventive aspect of risk management. The other aspect of risk management is forward-looking and opportunity-identifying [6]. This aspect encourages a broader and longer-term approach as a positive value-creator. The business case for long-term corporate sustainability is now well-rehearsed. The Conference Board's Centre for Corporate Citizenship and Sustainability identifies corporate sustainability as inextricably linked to [7]:

- Brand reputation and goodwill
- Customer demand
- Employee and community relations
- Government regulation
- Profitability and market valuation

The Centre sees corporate sustainability as a necessity for competitiveness, increased profitability and market valuation in the long-term. This is illustrated with examples of corporate sustainability in practice, such as DuPont's sustainability efforts, which are expected to yield US+$6 billion in revenues by 2015 [8]. Fiskel et al discuss how sustainable business practices contribute to shareholder value by: reducing operating costs and insurance premiums and strengthening brand equity, reputation, human capital and alliances [9]. In explaining National Australia Bank's (NAB) recent decision to go 'carbon neutral', Darren Clarke, NAB's Head of Sustainable Development and Planning, cited the following reasons: the concerns and aspirations of NAB's people; community awareness and attitudes; growing business momentum; understanding risks and opportunities; and the emerging regulatory framework [10]. On the question of regulation, as issues such as climate change are increasingly brought under the mantle of regulation, those forward-looking companies that have actively taken steps to minimise their exposure to carbon risk should be least negatively affected by it. And on the flipside, the companies that have identified the opportunities in carbon markets should be successful in the long-term. The Conference Board states that "Companies with foresight and a desire to create value, address tough societal problems as new business opportunities, and generate sustainable business models, will be the companies that succeed" [11]. Those investors with a long-term outlook are therefore also more likely to profit in the long-term if they have invested in these companies.

The Conference Board identifies recently emerging drivers that make action on short-termism now seem feasible. These include: active engagement of institutional investors with the companies in which they invest; investigation by institutional investors of longer-term investment opportunities; international convergence on accounting principles, particularly focused on true value drivers and reporting of extra-financial performance measures; major empirical research linking sustainability and improved stock prices and shareholder value; and efforts by regulators, intermediaries and institutional investors to focus research on long-term value [2]. This drive for change is reflected in the current international sector-led efforts to deal with the problems.

Despite the compelling reasons presented by the identified costs of short-termism and the opportunities of long-termism, the current drivers for change, and the evidence of efforts by market participants to address short-termism, there are still those who would argue that without specifically constructed long-termism incentives, investor behaviour will not change. Further, although a recurring theme from the literature and project focus groups is the need for improved understanding and awareness of the issues across the board, Lawrence E Mitchell, writing for the Ethical Corporation, notes that learning is essentially a long-term process, while the need for business to address short-termism and grow in a healthy and sustainable way is pressing [12].

1.4 A paradigm shift is necessary

This research project provides a starting point for action. The discussion papers summarise relevant literature and provide valuable perspectives from finance sector stakeholders. The Action Plan and discussion papers aim to foster engagement with the issues.

Short-termism is a complex and multi-faceted issue. It is not possible within the scope of this project to properly do justice to the complexity of the problem, to provide highly detailed solutions, or to undertake widespread stakeholder consultation. Our conclusion at the end of the project is that a paradigm shift is necessary and is already brewing. We concur with the Conference Board conclusion 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]. The finance sector must refocus on long-term value, break free from short-term thinking and promote long-term thinking. This requires a concerted effort by all market participants to adjust the system and its values as a whole. An appropriate starting point for the paradigm shift, therefore, is an across-the-board, in-depth, finance sector-led review.

That being said, action on short-termism should not be deferred until a review is undertaken and all-embracing cooperation is achieved. This paper provides recommendations for what could be done at different levels and by different finance sector stakeholders to promote long-term thinking, in the hope that at least some of these will be taken up and developed in the near-term. The recommendations present options for those participants who are willing to take voluntary action and who recognise the potential benefits in doing so, both in the short-term and as a longer-term enterprise. We acknowledge however, that ultimately voluntary action may not be sufficient. We therefore also recommend further exploration of the need for investor incentives through regulation and other mechanisms. The issue of incentives for other links in the investment chain is addressed primarily through recommendations for restructuring of performance assessment and remuneration. We recognise that the recommendations in this paper are necessarily high-level and would benefit from further analysis and development beyond this project. We specifically recommend further research on complex issues. Much more could be achieved through a collaborative finance sector-led initiative.

Members of the finance sector are already actively championing the importance of long-term value and we hope that this project will give them information and encouragement. For the many stakeholders who are not yet engaged with the problem, we hope the project outcomes will bring it into focus for them and will encourage them to consider the significance of short-termism and prompt them to devise their own actions to promote long-termism. Principally, we hope this project will catalyse a concerted effort by the Australian finance sector to cultivate a longer-term perspective and move away from short-termism in all its guises.

2 Recommendations

2.1 Overarching recommendations

2.1.1 Finance sector-led process and in-depth review

We believe that the issue of short-termism in the Australian finance sector is worthy of a sector-led process to address it, including development of specific mechanisms to promote long-termism. The starting point in the process would be an in-depth review (referred to hereafter in this paper as "finance sector-led review"). Similar reviews have already been undertaken overseas.

In July 2005, The Conference Board 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 output from the summit was a report analysing the short-termism issue and how it might be resolved. In the US, beginning in September 2005, the CFA Centre for Financial Market Integrity (The CFA Institute) and the Business Roundtable Institute for Corporate Ethics co-sponsored the "Symposium Series on Short-Termism" to examine the issue of short-termism from a unique cross-group perspective. The participants are described as thought leaders from the corporate issuer, analyst, asset and hedge fund manager, institutional investor, and individual investor communities [13]. The output from the symposium series is a report that gives recommendations on how the investment community can refocus on long-term value. Following the symposium report, the CFA Institute has issued further recommendations and a template to improve quarterly reporting.

To date, there has not been such a review in Australia. The overseas models could be applied here. Ideally, the review would be led by influential players in the investment community - leading super fund agencies, such as the recently formed Regnan or the ACSI. The purpose of the review would be to:

- Raise awareness and understanding of the issue;
- Analyse and agree on the problem;
- Analyse and agree on what is/is not working in the finance sector;
- Examine the impact of societal short-termism on the finance sector and vice versa;
- Articulate the preferred future for the finance sector;
- Define the steps to achieve the preferred future; and
- Propose mechanisms for shifting the finance sector to a longer-term, sustainable foundation.

We believe that a review is necessary to:

- Allow for adequate investigation, analysis and understanding of the issue and solutions i.e. a rigorous examination of the institutional, cultural and behavioural factors that bias the Australian market towards short-term investments and how these can be addressed;
- Achieve industry-wide buy-in to solutions;
- Bring together key players to share knowledge and experience and engage them in solutions that are appropriate to the Australian context; and
- Bring the Australian finance sector up to date with international trends.

The review should include stakeholders from beyond the finance sector including government, business, academics and NGOs.

- **We recommend that Australia take a leadership position and develop a sector-wide process for promoting long-termism, building on international research and initiatives. This would include a finance sector-led in-depth review of Australian market short-termism, involving wide consultation with finance sector stakeholders. The review should propose specific mechanisms for advancing long-term thinking in the finance sector. The most likely driver of this development would be superfund agencies such as the recently formed Regnan or ACSI.**

2.1.2 Disclosure requirements

ASX listed companies are required to announce earnings for the past period every 6 months. Companies also provide guidance on future earnings. In the absence of other measures of performance and alternative sources of information, the market is highly sensitive to short-term earnings announcements. This reactivity impacts on corporate management decision-making. Meeting earnings targets becomes an overriding objective for many companies, restricting their ability to take long-term value-creating decisions.

Annual reporting also focuses on purely financial, short-term metrics. There is no requirement to disclose extra-financial measures of performance – although recent changes to the Companies Act (s299A) may encourage greater disclosure by requiring companies to report on business strategies and prospects for future years. Despite there being no mandatory disclosure of extra-financial factors, a growing number of companies are voluntarily disclosing this information. A 2005 KPMG survey found, for example, that 24% of Australia's top 500 companies now produce sustainability reports [14]. In comparison with financial reporting, extra-financial reporting is at an early stage of development. Consequently there are no reporting standards (other than voluntary initiatives such as the Global Reporting Initiative (GRI)). This can make interpretation and understanding of extra-financial reporting, and comparability between companies, difficult.

A recent Federal government-led review of corporate responsibility concluded that there is no need to further amend disclosure requirements [15]. This conclusion was met with disappointment by those in favour of mandatory disclosure of extra-financial performance, who see it as a missed opportunity to bring rigour and clarity to disclosure practices. There remains, however, strong resistance from certain sectors of the business community to additional reporting requirements.

There are examples of recent regulation designed to improve annual reporting overseas. 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 [15]. The UK regulation is considered to be progressive in promoting forward-looking disclosure. Arguably, Australia risks being left behind internationally if new reporting requirements are not implemented.

It is likely that awareness of the importance of extra-financial performance and long-term value, and hence demand for information, will continue to grow. As demand for information grows, so too should support for mandatory disclosure and standards to provide clarity and enable comparison. To some extent, this is already happening - the Property Council of Australia (PCA) is, for example, calling for mandatory disclosure of building energy performance. While we welcome support for mandatory disclosure, it would be preferable to implement regulation in a holistic, rather than a piecemeal fashion. Any comprehensive consideration of mandatory disclosure should assess both the costs and benefits of implementation.

We recommend:

- **that the Federal Government expedites a re-review of the case for mandatory disclosure of extra-financial performance; and**
- **that the finance sector-led review specifically examines the case for mandatory disclosure of extra-financial performance and the need for amendments to current earnings disclosure requirements.**

This paper provides further recommendations identified during the project from the literature and focus group discussions. We look at actions at the level of structural change and at the level of finance sector stakeholders and individual links in the investment chain (as described by the Conference Board Summit [2]:

- The investor link
- The analyst link
- The corporate link

We recognise that the descriptive links above do not capture all market participants. There are significant players, including credit rating agencies, consultants and advisers, industry associations and professional bodies, whose role we have not been able to examine in detail in this project. This reinforces the necessity of an all-inclusive review. Recommendations for structural adjustments, nonetheless, are of relevance to, and would impact on, all market participants.

2.2 Recommendations for structural change

Our paper *Causes of Short-termism in the Finance Sector* identifies that the dominant paradigm in the finance sector is problematic because it inhibits long-term investment. Effectively, all players in the market are subject to short-term performance pressure and long-term investors conform to the short-termism paradigm, although they acknowledge that is not in their best long-term interests. This conformity impacts on other links in the chain and ultimately results in pressure on companies to make economically perverse decisions to meet short-term performance expectations. At a system-wide level, changes are needed to support long-term investment and to give corporate executives the latitude to make long-term value-enhancing decisions. These changes can be realised through voluntary initiatives and/or through changing the architecture of the system via regulation.

2.2.1 Regulation to incentivise long-term investment

The scale of the problem and the dominance of the short-termism paradigm, support a case for regulatory measures to incentivise long-term investment and/or discourage short-term investment. Measures that have been suggested include incentives for long-term investors, such as enhanced voting rights, higher dividends and lower capital gains tax and restrictions on short-term investors, such as limits on trading. Lawrence E. Mitchell, writing for Ethical Corporation, makes the case for creating incentives for long-term investment through taxation. In the US stock is taxed at long-term capital gains rates if it is held for more than one year. Mitchell points out, however, that one year is not long in the life cycle of a business. He therefore proposes reform to capital gains tax to create meaningful incentives for long-term investment - punitive taxation of profits from short-term trading and tax forgiveness for long-term holdings via a sliding scale of declining taxation. Definitions of long- and short-term would rest on the establishment of sectoral industry averages and there would be exemptions from punitive taxation for those who could demonstrate a necessity to sell early due to hardship[12].

The project focus groups discussed the impact of a move from defined benefits to accumulation super funds and member choice. Super funds are concerned about losing members if short-term performance is poor. Accumulation funds have shifted risk, or at least made it more obvious who are the ultimate risk-bearers – fund beneficiaries. This was identified as a major factor in increasing short-term performance pressure on superfunds. It was suggested, perhaps controversially, that superfund competition could be restricted to ease short-term performance pressure.

Regulation and market instruments have also been proposed to address externalities – for example, putting a price on carbon through introduction of carbon trading or a carbon tax. This is currently the subject of a Federal Government review.

It is beyond the scope of this project to review current legislation and proposals and make detailed recommendations for amendments. However, the finance-sector-led review should assess in detail the case for regulatory changes to encourage long-term investment and to account for externalities.

- **We recommend that the finance-sector led review includes review of the current regulatory framework and an assessment of the need for new or amended legislation to:**
  - **incentivise long-term investment; and/or**
  - **discourage short-termism in the finance sector, particularly through reform of capital gains tax; and**
  - **adequately account for externalities.**

2.2.2 Accreditation

The project focus groups discussed 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. However, there is no scheme specifically for long-termism, so there is an opportunity for Australia to take a leadership role. The concept of an accreditation scheme requires much further thought and development beyond this project.

- **We recommend that the finance sector-led review considers the concept of an accreditation scheme to recognise organisations demonstrating a long-term focus.**

2.2.3 Measures to improve information flows and risk assessment capability

In the absence of mandatory disclosure requirements, there is nonetheless an identified need for increased availability of information to better support long-term investment decisions and risk assessment. Traditional financial reporting is insufficient to provide investors with the information they need about a company's long-term risks and opportunities, including extra-financial factors. Sustainability factors are, "outside the boundaries of what's visible through the lens of financial reporting" [16]. The narrow, myopic spectrum of traditional reporting omits potentially material sources of risk that can fundamentally impact a company or industry sector's long-term viability and value. It omits exposure to, for example, carbon risk, water risk, stakeholder relations and reputation. Without such information, risk assessment is incomplete and can result in misallocation of capital.

Information flows can be enhanced through a mix of dialogue, incentives, voluntary disclosure and tools development:

Investors and companies engage in dialogue on extra-financial issues and long-term value and collaborate to promote long-termism

There is a need for enhanced regular dialogue between investors and companies. This would enable long-term investors to communicate their interests to companies, providing support for long-term value-creating decision-making at the company level. It would encourage greater discussion, and promote understanding of, environmental, social and governance (ESG) issues and long-term value. Dialogue could create opportunities for collaborative investor/company efforts to advance long-term thinking through initiatives such as the Australian Business Roundtable on Climate Change. Such collaboration could help to raise awareness and challenge the barriers to long-termism. It would enable corporate managers to identify and nurture long-term investor relations and it would give participating organisations the opportunity to influence and shape the debate. Dialogue is encouraged at the level of individual investor/company interactions and/or through broader collaborative initiatives.

- **We recommend that investors and investee companies work together to:**
    - **create fora for more open and regular dialogue on ESG issues and long-term strategies and value; and**
    - **identify opportunities for collaborative initiatives to promote long-term thinking.**

Investors incentivise extra-financial and long-term analysis

Analysts will provide extra-financial and long-term analysis when they perceive a demand for it in the market. Therefore, it is incumbent upon investors to encourage and reward research and analysis of long-term issues and extra-financial measures. A recent initiative designed to do so, is the Enhanced Analytics Initiative (EAI). The EAI, an international collaboration established by a major group of institutional investors, pools a percentage of broker commissions and directs it towards extra-financial research. The EAI members regularly 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 develop a broader and longer-term view of companies [17].

- **We recommend that Australian institutional investors support the international Enhanced Analytics Initiative and/or consider establishing an Australian version of the fund.**

Increase availability and explanation of information on extra-financial factors and long-term value drivers

Many analysts largely base their analyses on information provided to them by companies. Therefore, the information that companies communicate also helps to shape the market. Presently, information flows are impeded both by companies that are unwilling to disclose extra-financial information and a perceived lack of interest in the information in the market. Nonetheless, as noted, many companies are now reporting on extra-financial issues and are actively grappling with the issue of how best to communicate their long-term value drivers, risks and opportunities (such as future political or regulatory changes, the alignment of management and board with long-term company value, the quality of human resources management, governance structure, the environment, branding, corporate ethics and stakeholder relations [18]).

It seems apparent that in order to nurture long-term investor relations, companies should provide information about issues of long-term importance. Corporate executives therefore have a role in sharing with, and explaining to, investors and analysts, information about extra-financial issues of material importance. The greater the understanding of these issues, the more likely that demand for information will increase. Influential industry associations are also taking note of the need for better disclosure - in 2006 ASIC issued guidelines on the preparation of better prospectuses, including improved risk disclosure. Until such time as extra-financial disclosure is mandated, additional disclosure guidance could be beneficial. Guidance already exists through initiatives such as the GRI, and government and industry association guidelines. New guidelines should draw on existing guidance.

Media reporting of business performance contributes to the short-termism paradigm. In a 24-hour news culture, there is insufficient time for rigorous media analysis and in-depth understanding of underlying issues and drivers. Conversely, increased media coverage, if well-directed, 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. A specific initiative suggested by the project focus groups would involve a coalition of superfunds preparing a report to challenge the negative concept of the short-term costs of sustainability versus the benefits of long-term value-creation and maintenance.

We recommend:

- **that companies regularly supply information to the market and media on long-term strategy, targets, objectives, value drivers and risks including material extra-financial issues. Risk assessment should include sensitivity analysis. Mechanisms for provision of information include:**
    - **annual reporting of sustainability issues using reporting frameworks such as the GRI, and inclusion of extra-financial performance measures in annual reports;**
    - **participation in rating schemes, such as the Corporate Responsibility Index (CRI), which help benchmark performance; and**
    - **traditional disclosure vehicles such as prospectuses.**
- **that industry associations, such as the Investment and Financial Services Association (IFSA), review the results of the Corporations and Markets Advisory Committee**

(CAMAC) inquiry and consider the need for additional guidance on disclosure of extra-financial factors (in the absence of mandatory disclosure).

- **that ESG analysts and long-term institutional investors engage actively with the business media and provide information to improve media understanding of the importance of analysing and reporting on extra-financial issues and long-term value.**

Use existing mechanisms and develop new mechanisms to measure and assess risk of extra-financial factors and long-term value

At present, factors that are not systematically monetised are assumed to have no value and important sources of risk are overlooked. Despite the growing number of companies reporting on extra-financial performance, it is unclear how much prominence such measures are given by mainstream analysts. To encourage analysis and understanding of long-term strategy and extra-financial issues, companies need to provide information in a format that analysts and investors can interpret.

There is therefore a need to develop mechanisms for translating extra-financial issues into terms that demonstrate their value and that the investment community can understand and use to inform investment decisions. Analysts are beginning to help companies understand what information is useful through processes such as stakeholder feedback on companies' sustainability reports. New information tools that provide a more complete assessment of a company's performance are constantly being developed and some are already in use, such as the Balanced Scorecard and the Corporate Performance Statement. Alternatives to earnings guidance that have been proposed include discounted cash flow, condensed balanced sheets and more frequent and higher quality operating data, such as monthly data provided via company websites.

We recommend:

- **increased uptake, by all members of the investment community and companies, of tools already in existence for measuring extra-financial performance;**

- **research to identify information gaps and development of new tools to fill the gaps, particularly tools to enhance risk assessment through evaluation of material extra-financial and long-term factors. Research and tools development requires funding and this could be provided by industry associations or government; and**

- **continuing dialogue between companies and analysts to understand how information on extra-financial issues can be provided in a format that can be incorporated into mainstream analysis.**

2.2.4 Measures to improve understanding

This project has identified that although short-termism is widely recognised as problematic, the requisite skills and experience to adjust to an alternative paradigm may be lacking. Learning and development is needed at each link in the investment chain and beyond.

Institutional investors

The CFA Institute identified that not all superfund trustees have the financial knowledge and skills to support long-term investment decision-making.

- **We recommend provision of finance sector-led learning opportunities, on sources of long-term value and risk, for superfund trustees and advisers. This could be provided by industry associations such as ASIC.**

Individual investors

Globally, levels of financial literacy are generally low. Research is needed to explore how best to improve levels of financial literacy in society. The Federal government is already investigating this issue. It is likely that since the introduction of compulsory superannuation in Australia, popular understanding of how financial markets operate has increased. Nonetheless, superfunds feel much more progress must be made before fund beneficiaries fully understand the benefits of a long-term investment approach. Research would be beneficial to understand the motivations and objectives of individual investors.

We recommend:

- **continuing research by governments to investigate how best to improve general financial literacy, for example, through school curricula;**
- **implementation by governments of appropriate measures to improve general financial literacy;**
- **research by institutional investors to better understand the motivations and objectives of superfund beneficiaries; and**
- **drawing on the research, enhanced communication by superfunds to beneficiaries to improve understanding of the benefits of a long-term investment approach.**

Analysts

In order to be able to interpret extra-financial information and understand long-term drivers, analysts also need to be provided with appropriate learning opportunities to develop the necessary skills.

- **We recommend that providers of education for financial analysts incorporate teaching on extra-financial (ESG) and long-term analysis in curricula.**

Corporate Managers

Corporate leaders (CFOs, CEOs, Directors) need to better understand how the market values their company and what information long-term investors are looking for. Current corporate leaders must develop understanding of how extra-financial issues impact on business success and long-term value.

Future leaders also need to understand these issues. Finance education should incorporate ESG considerations to broaden the perspective of future executives. Leading business schools have recognised the importance of considering extra-financial issues for some time - the Balanced Scorecard was developed by members of the Harvard Business School in the early 1990s. Internationally, there are now Green MBAs (for example, Dominican University of California), and overseas and in Australia, business schools and faculties (such as the School of Management at UTS) already incorporate consideration of extra-financial issues.

We recommend:

- **that organisations providing continuing professional development for corporate executives, such as professional associations and the Australian Institute of Company Directors, provide learning opportunities in sources of long-term risk and value including extra-financial factors; and**
- **that all providers of primary business/financial education (business schools and faculties, professional associations etc) incorporate ESG issues and long-term strategy development into curricula where they are not already incorporated.**

2.2.5 Provision of venture capital

The project focus groups identified that there is a lack of funding in Australia for commercialisation of technologies with long-term value potential. Therefore there is insufficient structural support for long-term economic development. An example of this is the inadequate support for solar technology development over time that has resulted in Australian solar businesses moving offshore. In the absence of public funding for commercialisation of such technologies, there may be a greater role for the finance sector to provide venture capital for emerging businesses that have long-term potential.

- **We recommend that the finance sector-led review investigates the issue of lack of venture capital for commercialisation of Australian technologies with long-term value potential.**

The above recommendations for structural change include actions of relevance to individual links in the investment chain. Below we make further recommendations applicable to links in the chain and stakeholder groups.

2.3 Recommendations for links in the investment chain and stakeholder groups

2.3.1 Institutional investors

Institutional investors have a key role to play in creating change. The signals that fund managers and companies receive from investors about what matters to them is a fundamental cause of short-termism. Therefore the signals need to change to enable a paradigm shift. Long-term investors should formally incorporate commitment to long-term performance into their policies and practices.

Practise active ownership

The concept of active ownership takes dialogue to the next level. Active shareholders proactively encourage companies to address issues of importance to them, and in some cases lend financial support. Long-term investors could, for example, encourage companies to implement executive remuneration and performance assessment structures that reward long-term performance. They can also support companies in making long-term value building investment decisions, such as investing in sustainability initiatives.

The UN Principles for Responsible Investment (UNPRI) encourage the concept of active ownership. They provide a framework for investors to consider ESG issues. Principle 2 specifically commits signatories to active ownership and incorporation of ESG into ownership policies and practices. Single institutional investors may be reluctant to confront companies on ESG issues, but groups of investors may be more willing to do so. The UNPRI initiative has established the PRI Engagement Clearinghouse. This is described as "the first global collaborative forum for investors to work together and share knowledge and resources to take action on ESG issues" [19]

In the UK, the institutional investor Hermes (which is owned by the BT pension scheme, Britain's largest pension scheme) has set up "focus funds" aimed at helping under-performing companies to turn around their performance through working with management.

We recommend:

- **that more Australian institutional investors and industry associations join the growing list of those who are already signatories to the UNPRI;**
- **that Australian UNPRI signatories implement the principles in investment activities;**
- **that institutional investors actively encourage companies to improve performance on extra-financial issues of long-term importance;**
- **that institutional investors investigate the application of the PRI shareholder Engagement Clearinghouse concept in the Australian finance sector; and**
- **that large Australian institutional investors consider setting up funds, similar to the Hermes focus funds, to assist under-performing Australian companies with long-term value potential to improve performance.**

Implement fund manager remuneration and performance assessment structures that recognise long-term performance

Many institutional investors outsource investment decisions to fund managers. The way in which investors assess the performance of, and remunerate, fund managers, is critical to the messages fund managers receive about what matters to investors. Fund manager performance assessment and remuneration should be structured to encourage longer-term investment. David Blood and Al Gore's Generation Investment Management is an example of an investment company that bases performance fees on long-term performance.

- **We recommend that long-term investors implement performance assessment and remuneration structures for fund managers that encourage long-term investment decisions.**

Adopt long-term mandates

Long-term mandates are frequently proposed as a mechanism for encouraging long-term investment. In the UK the Marathon Club is championing long-term mandates. Responses to a Marathon Club consultation paper revealed the following factors thought to be important to success of long-term mandates[20]:

- Articulation of trustee investment beliefs;

- A shift away from a focus on short-term performance;
- Reform of governance structures and appropriate trustee understanding;
- A focus in periodic review meetings on the development of the portfolio's investments and the underlying characteristics of the portfolio based on factors other than share price; and
- Multi-criteria performance evaluation.

Beyond adopting long-term mandates, long-term investors could design guiding principles for long-term investment to promote wider application.

We recommend:

- **that Australian institutional investors reflect commitment to long-term performance by adopting long-term mandates; and**
- **that long-term investors collaborate to establish guiding principles for long-term investment**

2.3.2 Analysts

In a market where interest in long-term value and extra-financial issues is increasing, there is an opportunity for skilled analysts to differentiate themselves on the basis of high quality analysis and direct research. Recent 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. BT Governance Advisory Service provides an investment risk management overlay service. Greater integration and understanding of extra-financial issues and long-term analysis may ultimately reduce reactivity to earnings announcements, thereby changing the signals that companies receive. Research is needed to identify a viable business model for analysts selling high-quality research with a long-term focus [2].

We recommend:

- **further uptake of ESG analysis by mainstream analysts to meet growing market demand; and**
- **research to identify a viable business model for analysts selling high-quality research with a long-term focus.**

2.3.3 Corporate sector

The impact of finance sector short-termism upon the corporate sector is critical. Implementation of recommendations in this paper should ultimately begin to change corporate behaviour and ease corporate short-term performance pressure by changing the signals that are received from the finance sector by corporate boards and CEOs about what matters. However, companies should be actively involved in creating the paradigm shift. Companies need to plan for, and invest in, the long-term, and provide long-term incentives for investors and employees.

Long-term vision and strategy

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, there is no framework within which executives and directors can make long-term investment decisions. Lack of long-term direction can result in resource inefficiency.

- **We recommend that companies clearly articulate their vision and strategy for long-term value creation, including consideration of material extra-financial issues.**

Investor incentives

Companies could encourage long-termism by providing direct long-term shareholder incentives. In his 2006 ICGN Conference address, Peter Butler described a proposal for rewarding long-term owners with a small additional dividend. Butler drew a parallel with the UK Standard Life flotation where the terms provided that owners who retain their shares for one year will receive an additional 5% of shares. He proposed a scheme whereby "owners who neither sell their shares nor stock lend for a period of say, one year should receive a small extra cash dividend" [3]. Safe guards would be needed to limit the size of the dividend and rules for the scheme should be established upfront. Butler believes such a scheme would create a virtuous circle that "gives directors some control over the balance on their share register between short-termists and those who are responsible owners whose primary concern is the generation of long-term value" [3]

- **We recommend that the finance sector-led review investigates the feasibility and effectiveness of a scheme to incentivise long-term investment by rewarding longer-term shareholding through additional dividends.**

Executive remuneration

Executive performance assessment and remuneration are key drivers of behaviour. To ensure value-creation and long-term performance, organisational incentives need to drive long-term outcomes. Reward programs should be aligned with long-term sustainability. Deferred bonus and options schemes can provide long-term incentives. The Shareholder Association has encouraged a move to options-based reward systems that reward performance over the long-term. The project focus groups noted that the Macquarie Bank model provides long-term rewards over periods of up to 10 years (although it should be noted that there are also critics of the Macquarie Bank model). It is important that companies disclose details of reward structures to enable investors to assess alignment with their long-term interests.

We recommend that companies:

- **implement remuneration and performance assessment structures that reward performance (financial and extra-financial) over the long-term. Deferred bonus and deferred option schemes have been suggested as a viable option with maximum deferral up to 5-7 years; and**
- **provide greater disclosure of remuneration and performance assessment schemes.**

Other stakeholders

2.3.4 Government

Government's primary role in addressing short-termism in the finance sector is to provide the appropriate framework for long-term investment. We have recommended the need for a review of legislation. Governments themselves seem to be locked in a short-term paradigm. The most effective response to the issues is likely to be achieved through government and business working collaboratively to find solutions. Beyond legislation, governments can promote long-termism by improving public understanding of financial markets and awareness of the importance of long-term investment. Governments can fund research and tools development. Importantly, governments can also lead by example by demonstrating long-term thinking in policy development.

- **We recommend that the finance sector-led review involves government and considers the role of government in addressing finance sector short-termism beyond legislation, for example through public education, research and tools development.**

2.3.5 Finance sector bodies

Finance sector bodies, such as the ASX Corporate Governance Council, are already taking a leadership role in trying to address some of these issues. It is important that other finance sector and professional bodies engage with the problem of short-termism. Beyond leading a review process, these organisations can further encourage long-term investment through provision of enabling services. This could include, for example, commissioning further research on specific issues identified by this project and the sector-led review; providing fora for sectoral dialogue; and providing public financial information.

- **We recommend that the finance sector-led review considers the role of finance sector associations and professional bodies in addressing finance sector short-termism through provision of services such as fora for dialogue, research and learning opportunities.**

2.3.6 Unions

In the UK, the Trades Union Congress (TUC) investigated the short-termism issue and prepared a report including recommendations on how to address it [17]. The TUC was prompted by the recognition that union members are vulnerable to an insufficiently long-term approach in management of their super funds. We believe that unions in Australia should also engage with this issue. There are opportunities for unions to improve understanding of the importance of long-term investment among their members. Union members who are trustees of superfunds can use their influence in these positions to promote long-termism.

We recommend that unions and their members:

- **participate in the finance sector-led review;**
- **campaign to inform and raise awareness and to encourage the finance sector to take action on short-termism;**
- **help to improve understanding among their members of the benefits of long-term investment through superfunds;**
- **in their role as superfund trustees, promote long-term investment; and**
- **engage directly in dialogue with industry superfunds about long-term investment strategy.**

2.3.7 NGOs

NGOs and non-profit groups in Australia who have an interest in long-term economic, environmental and social welfare should also engage with the short-termism issue. NGO involvement could include campaigning to raise awareness and encourage a shift to long-term thinking. NGOs could provide original research and analysis. Many of the voluntary initiatives that aim to mainstream extra-financial issues, such as the GRI, CRI and AA1000 framework, have arisen from the not-for-profit sector. TEC is doing much to address short-termism through its Green Capital program and most directly by commissioning this project. We commend them for doing so and encourage others to join them in calling for action.

We recommend that NGOs/not-for-profit organisations:

- **participate in the finance sector-led review;**
- **campaign to inform and raise awareness and to encourage the finance sector to take action on short-termism; and**
- **partner with government and business to provide research and analysis of the problem and feasible solutions.**

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