The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

February 2021

STRETCHING THE TIME-HORIZONS OF CAPITAL USERS AND CAPITAL SUPPLIERS: A DEBATE

*Last month's Ambachtsheer LETTER was titled "**Measuring Short-Termism: Is the FCLTGlobal's New Study Using the Right Metrics?**". The Study in question was titled "FCLT Compass", which attempted to measure the decision time-horizons of capital users (i.e., corporations) and capital suppliers (i.e., households, pension funds, insurance cos, SWFs, endowments/foundations). It calculated a 6yr. Horizon for corporations and two weighted average horizons for capital suppliers: an actual 5yr. Horizon vs. an intended 13yr. horizon. The Study concluded there was a material 8yr. 'intention/allocation' time-horizon gap among capital suppliers.*

The LETTER agreed that there likely were 'intention/allocation' time-horizon gaps in both capital user and supplier decision-making, but that the metrics used in the Study to reach that conclusion were problematical. We argued there are better ways to measure the extent of the problem, and to address it. At my invitation, FCLTGlobal's Ariel Babcock and Sarah Keohane Williamson responded to what I wrote last month. Their response is set out below, with some concluding observations by me on Page 4.

Keith Ambachtsheer

FCLTGlobal's Response to the January *LETTER*

FCLTGlobal is a non-profit organization whose mission is to rebalance capital markets to support a long-term, sustainable economy worldwide. We tackle this mission three ways:

1. Continuously making the case that taking a longer-term approach to business and investment-decision making adds value over time;
2. Developing practical, evidence-based tools to help capital markets participants stay focused on the long term and overcome short-term pressures; and
3. Identifying and developing key metrics linked to long-term value creation.

Our FCLTCompass project, the focal point of January's *LETTER*, is a new measurement of the amount and time horizons of capital on a global scale. Bringing more attention to this project and engaging in robust dialogue with thoughtful readers and constructive critics is an integral part of the process. We are grateful to Keith Ambachtsheer for catalyzing this dialogue and inviting us to guest write this February *LETTER*.

FCLTCompass tracks capital flows from savers, through various investment vehicles, to the companies that use it. The data shows that there is a significant "intention-allocation gap," of upward of eight years on average, between the expected investment horizon of a typical saver and the actual time frame that capital remains committed to a particular investment opportunity. This is not altogether unexpected, as noted in last month's *LETTER*. The more critical aspect, however, is that it is being measured at all – we know of no other effort to measure the disparities between the objectives of savers, investors, and companies. These gaps in investment horizons are a fundamental driver of global markets behavior and must be understood.

We often say that being "long-term" is a state of mind rather than a certain set of practices. As Keith and his readers know, asset owners have long-term liabilities or goals but have to operate with the pressures of the present. While measurement is important, over our almost 5 years of work, *FCLTGlobal*'s focus has been on the actions investors and businesses can take to self-correct these short-term tendencies or lean against present pressures.

In that spirit, FCLTCompass is practical rather than theoretical or judgmental. The project measures capital flows and investment gaps because we know that what gets measured gets managed. FCLTCompass is a measurement tool that offers a direction for where capital markets are aiming today. But like all compasses, it cannot tell you *why* you are heading in that direction, *whether* that heading will take you to your intended destination, or *how* you might change your course. By knowing which direction things are heading, capital markets participants can evaluate whether that is truly the course they want to pursue, and if not, can begin to chart a new course, chipping away at the pervasive short-termism that has dominated capital markets for decades.

We made practical decisions throughout the course of this work. We know, for example, that sovereign wealth funds and endowments have decades-long or even perpetual goals. We considered a 100-year time frame for these asset owners but instead assigned a 20-year holding period, to both recognize their multigenerational responsibilities and the practical realities of lives and careers. The full methodology of our work is available **here** , and we welcome feedback.

While our methodology will evolve over time as more data is available, our findings are very clear. The intention-allocation timeframes are startlingly disparate across capital markets, and significant changes are underway within the global investment community.

- The shift to indexed equity has reshaped global investment horizons by contributing to an overall increase in average equity holding periods. Asset gathering by indexed products, both mutual funds and exchange-traded funds, started in the United States, but is now a global phenomenon, contributing to the rise in equity investment horizons since the global financial crisis.

- The proportion of assets managed with a sustainability lens has increased by 34 percent, from \$22.8 trillion in 2016 to \$30.7 trillion in 2018.[i] Similarly, the proportion of savers like pensions and sovereign wealth funds that consider material sustainability factors in allocating assets has also increased, by approximately 10 percent during the same period.[ii]

- Investment horizons for fixed income shortened and the low-rate environment inspired yield chasing, with riskier asset classes seeing accelerated asset gathering. From 2009-2018 (and in the years since), interest rates remained stubbornly low worldwide. The growth in fixed-income assets slowed in favor of riskier asset classes like public equities and real estate, as well as private equity, hedge funds and commodities. Pensions, in particular, rotated away from fixed income. This change contributed to a decline in average pension investment horizons over the period.

There is no panacea to solving the investment intention-allocation gap problem, which we believe has a strong influence on short-term decision-making and a real impact on savers, communities, and the planet. For that reason, *FCLTGlobal* takes a multi-faceted "cross value chain" approach to our research by bringing together global asset owners, asset managers, and companies to discuss, debate, and address the sources of financial short-termism. We focus our efforts on what we believe to be the key levers that can effect long-term change in capital markets:

- Strong governance that provides the foundation for long-term value creation.
- Strategies around talent, innovation, climate, capital allocation, and risk that drive long-term performance.

- Incentives that are aligned both over time and across the investment value chain.
- Engagement between companies and their shareholders on their long-term strategies that provides confidence to pursue shared goals.
- Policy and regulation that shapes global discourse and prompts market behaviors to shift toward the long-term.

This brings us back to our focus on what's practical. Our research is meant to inspire action that ultimately moves more money toward the long term. For the investment community in particular, we have found evidence for a number of practices that will enhance potential returns for clients and plan beneficiaries well into the future. Some ideas long-term investors are already putting into practice include:

1. Rewriting investment mandates to incentivize long-term returns by including longevity discounts and long-term incentive fees and reversing the communication of performance reporting to present since-inception or 10-year performance first (and shortest period performance last).
2. Actively engaging with portfolio companies on topics of strategic importance and encouraging companies to publicly share their long-term roadmaps and KPIs for long-term success, while actively discouraging the use of quarterly guidance.
3. Reconsidering investment risk protocols relative to long-term opportunities by using alternative measurement tools better suited to specifically evaluating long-horizon investment risk.
4. Speaking up to curtail short-term financially driven activist hedge fund involvement in portfolio companies, including giving companies advance notice of voting intentions where appropriate.
5. Or, where applicable, rewriting global stewardship codes to explicitly combine the concepts of fiduciary duty and long-term value creation.

This research helps to remedy some of the problems identified in FCLTCompass, although more work is needed. It also aims to help fix capital markets *from the inside*. There are without a doubt external forces that can change capital markets for the better – policy and regulation or public perception to name a few. But more impactful progress is made when it comes willingly, when those companies and investors operating within the markets themselves recognize the issues, workshop the solutions, and put them into practice at their own organizations.

Our other major focus in the measurement area has been collaborating with organizations such as the International Integrated Reporting Council (IIRC), Sustainability Accounting Standards Board (SASB) and the World Economic Forum (WEF) on both nontraditional company-disclosed metrics that can be incorporated into investment decision-making and turning the tables to consider disclosures from investors to portfolio companies and other constituents. As Keith pointed out in the earlier July 2020 *LETTER*, more comprehensive disclosure from investors, rather than simply asking for disclosures from companies, builds stakeholder trust and enables the investors to lead by example.

FCLTCompass is meant to show which way the global investment community is heading – are we still being dragged down by a myopic focus on the short term or are we on a course for the long term, supporting a more secure financial future for savers worldwide? While those horizons between savers, investors, and companies are starting to converge, they remain further apart than we'd like. We've all been aware of these gaps for some time, as Keith noted in the January *LETTER*. But measuring them is the first step toward taking action to close them.

We would like to extend our thanks to Keith Ambachtsheer for the opportunity to guest author this *LETTER*, and we welcome further dialogue. Please contact us at research@fcltglobal.org.

Resolving our Differences: Keith Responds……

First, thanks to Ariel and Sarah for being the first-ever guest writers in this publication since its inception in 1985 (!). Second, it is important to note that our differences relate to means, and not to the end of fostering sustainable wealth-creation in the decades ahead. Third, we agree on fostering 'change from within' rather than having it imposed from outside. For example, we agree that the wide adoption of the *Integrated Reporting Framework* by capital users and suppliers alike could be an important means to lengthening time horizons. So where do we differ?

It is in the metrics that indicate most clearly and directly whether the decision horizons of capital users and suppliers are in fact lengthening, and at what rate. Above, Ariel and Sarah themselves identify three areas where I agree we should be looking for those metrics: 1. incentives, 2. engagement, and 3. behavior. These areas are also mentioned by Harvard Law School Professor Lucian Bebchuck in his recent HBR article "**Don't Let the Short-Termism Bogeyman Scare You**":

1. Incentives: Bebchuck writes "corporate compensation arrangements have long included considerable bonuses that reward short-term improvements even if they are short-lived….alignment between executive pay and long-term results should be tightened." The same argument holds for asset owners and asset managers: incentive compensation should be based on long-term investment results. This leads to a clear metric for both capital users and suppliers: the time horizon on which incentive compensation is based.
2. Engagement: Bebchuck writes "concentrated ownership has introduced the possibility of meaningful investor oversight." This leads to a clear metric for capital suppliers: the frequency of engagements with investee corporations.
3. Behavior: previous *Letters* have referenced academic studies documenting a strong negative relationship between portfolio turnover and long-term portfolio performance.[iii] This leads to another clear metric for capital suppliers: the turnover rates in their actively managed portfolios.

Imagine a world in which 1. the time horizons of incentive compensation in capital user and capital supplier organizations, 2. the frequency of investee corporate engagements by capital suppliers, and 3. the turnover rates of capital supplier portfolios were all regularly measured, benchmarked, and publicly disseminated. In such a world, it would be abundantly clear whether capital user and capital supplier time-horizons were indeed lengthening….or not.

Keith Ambachtsheer

Endnotes:

i. *Global Sustainable Investment Review. 2018. Global Sustainable Investment Alliance; FCLTGlobal analysis, data (2016–2018).*
ii. *FCLTGlobal analysis, data gathered from multiple annual reports (2016–2018). For details on data sources, please see Methodology and Assumptions section.*
iii. *For references to two such studies, see the May 2017 LETTER "**Fostering 'Long-Termism' in Investing**".*

Published by KPA Advisory Services Ltd., 1 Bedford Road, Suite 2802, Toronto ON Canada M5R 2B5
416.925.7525. www.kpa-advisory.com