The AMBACHTSHEER Letter

Sustainable Pension Design • Effective Pension Management

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MEASURING SHORT-TERMISM:

IS THE *FCLT GLOBAL*'S NEW STUDY USING THE RIGHT METRICS?

"Due to data limitations and various necessary assumptions, [our] vision is slightly blurred. Despite the mist, however, we see a prominent intention-allocation gap that persists across the investment value chain. In other words, our concrete data suggests the status quo is failing savers while also squandering the raw fuel that could power economic growth."

FCLT Compass Report, 2020
Focusing Capital on the Long Term (FCLT) - Global

A Blurred and Misty Vision?

FCLT Global is a non-profit organization that "develops research and tools that encourage long-term investing……emphasizing initiatives that market participants can take to make a sustainable financial future a reality for all". Given its international membership of some 50 high profile asset owners, asset managers, and corporations, the organization's research findings and initiatives deserve careful attention. This is the context in which this *Letter* assesses the just-released **FCLT Compass Report**, the source of the quote above .

A starting observation relates to the 53-page Report's key conclusion that the status quo is failing savers while also impeding sustainable economic growth. Or more specifically, the Report's findings indicate short -termism continues to be a problem requiring a solution. This is strong stuff, given the Report's admission of a blurred and misty vision due to necessary assumptions and data limitations. Ironically, while this *Letter* agrees with the Report's key conclusion, it shows that the conclusion does not logically follow from the Report's findings. This is problematic, because if the intent is to use the metrics developed in the Report to assess if the short-termism problem is improving, it is not clear that they can serve that purpose.

The goal of this *Letter* is to identify the reasons why short-termism on the part of both savers and corporations continues to exist, and what must be done to reduce, and eventually eliminate its negative impacts on global well-being. This leads directly to actions and metrics needed to address the problem. The *Letter* starts by briefly reviewing the FCLT Compass Report and pointing to the reasons why it does not get to the heart of the matter.

The FCLT Compass Report: Investor Time-Horizons

To identify a presumed 'intention vs. actual allocation' time-horizon gap across the investment value chain, the Report defines five classes of savers: 1. Households, 2. Pensions, 3. Insurance, 4. Sovereign Wealth Funds (SWFs), and 5. Endowments and Foundations (E&Fs). Each of these classes of savers is assigned a liability-based 'intended' time-horizon: Households 13.1yrs., Pensions: 15.0yrs., Insurance: 12.4yrs., SWFs: 20.0yrs., E&Fs 20.0yrs.[i] Next, based on the average asset mixes/average holding periods for individual investments in each asset class, the actual investment horizon for each savers group is calculated: Households: 5.0yrs., Pensions: 5.8yrs., Insurance: 4.6yrs., SWFs: 4.3yrs., E&Fs: 4.3yrs.

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Comparing the five 'intention vs. actual allocation' time-horizon gaps, the conclusion is clear: actual individual investment holding periods are far shorter than intended ones.

However, both the 'intention' and 'actual' time horizon calculations are problematic. On the 'intention' side, time horizons are much longer than the Compass calculations. For Household savers, average asset class holdings are irrelevant because the top 1% of Households around the globe own almost half of total Household wealth[ii], and their intended time-horizon is multi-generational (i.e., much longer than the calculated 13.1yrs.). The intended time-horizons for the other four savers classes are also multi-generational….individual participants will change…..but pension, insurance, SWF, E&F institutions are intended to go on and serve participants decade after decade. On measuring actual investment time-horizons, the Report calculates the average turnover rate for individual investments in the major asset classes. For example, the calculated average holding period for active equities is 2.5yrs. While this is indeed very short for savers with intended multi-generational time-horizons, it is not a new discovery. We have been aware of this 'intention' vs. 'actual' investment horizon gap for decades.

The FCLT Compass Report: Corporate Time-Horizons

The Report performs a similar 'intention vs. actual' time-horizon gap analysis for corporations. The 'intention' calculation is based on allocating capital to support strategic growth initiatives. Key categories are CapEx: 5-15yrs., R&D: 3-11yrs., Acquisitions: 5yrs., Intangibles: 18yrs., Retained Earnings: 4.7yrs., Interest, Taxes, Gross BBs, Divs: 0yrs. This leads to weighted average corporate intended capital investment time-horizon of 5.6yrs. Funding sources of capital are Debt Issuance: 7.1yrs., and Equity Issuance: 3.5yrs., and a weighted average funding horizon of 4.3yrs. So in the corporate sphere, the Report concludes that the average time span of funding sources is marginally shorter than the capital formation investment horizon the funding is supporting.

Once again, the Report's framing of the corporate time-horizon question begs the larger question of whether to take a 'going concern' or a 'wind-up' perspective. Surely capital formation and its funding should be an ongoing dynamic process for corporations that have the intention and expectation of living multi-decade lives. That should certainly be the expectation of the savers (whether individual or institutional) who invest in corporate equities. Stated differently, from a long-term sustainability perspective, logic suggests both corporate managers and investors should think and act in multi-decade rather than multi-year timeframes.

Two Unanswered Questions

The Report's framing leaves us with two unanswered questions: 1. Why do many savers with generally multi-decade investment time horizons have high turnover rates in their equity portfolios? And 2. Why does research on corporate behavior suggest that many executives appear to worry more about smoothing quarterly earnings in the short term, than about allocating capital to enhance sustainable earnings in the long term?[iii] Logic and research provide plausible answers to both questions:

1. Explaining Investor Short-Termism: this author encountered investor short-termism directly upon entering the institutional investment world in 1969. Sell-side brokers pitched investment ideas to buy-side analysts and portfolio managers, often leading to trades to get these ideas into portfolios. These transactions took place in a competitive environment where investor goals were to beat the market and the competition year after year. This competitive short-term trading culture was not new in 1969. In 1936, the great economist John Maynard Keynes wrote in the famous "The State of Long-Term Expectations" chapter of his book "The General Theory of Employment, Interest, and Money": "*It might have been supposed that expert investment professionals would correct the vagaries in financial markets pricing…..It happens, however, that their energies and skills are mainly occupied otherwise……Most of these persons are not concerned with making superior return forecasts of investments over their whole lives, but with foreseeing changes in the conventional basis of valuation a short time ahead of the general public…..This is the inevitable result of investment markets organized around the fetish*

of liquidity.....The actual objective of most skilled investors today is to outwit the crowd, and to pass the bad half-crown to the other fellow.....Long-term investors, who most promote the public interest, will in practice come in for the most criticism wherever investment funds are overseen by committees, boards, or banks. They will be judged eccentric, unconventional, and rash in the eyes of average opinion....Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally." While much has changed since Keynes' world of 1936, or even since Ambachtsheer's world of 1969, this underlying tendency towards conventional short-termism by retail and professional investors alike is still with us today.

2. Explaining Corporate Short-termism: the literature on corporate short-termism also starts in the 1930s, with the 1932 publication of "The Modern Corporation and Private Property" by Adolf Berle and Gardiner Means. Their argument was straight-forward: in a world of widely-dispersed ownership, corporations were effectively manager-controlled, creating the prospect of material agency problems. In their own words: "*Property owners who invest in a modern corporation surrender their wealth to those who control the corporation, becoming merely recipients of the wages of capital......They have surrendered the right that the corporation should operate in their sole interest......If you are to assume that the desire for personal profit is the prime force motivating controlling interests, we must conclude that these interests are different from, and often radically opposed to those of ownership, and hence that those interests will most emphatically not be served by a control group seeking personal profits*." Evidence of the prescience of these almost century-old insights continues to mount. For example, a lot of the 'corporate purpose' debate over the course of the last 25 years has focused on moving it towards shareholder value maximization. More recently, corporate purpose discussions have moved beyond just including shareholder considerations, to also those of employees and customers. Beyond that, the meaning and implications of corporate 'sustainability' have also become part of the conversation.[iv] But again, just as 'savers short-termism' is still with us, so are the original corporate agency issues identified by Berle and Means.

All this leads to another question: is there a link between 'savers short-termism' and 'corporate short-termism'? Do they re-enforce each other? The answer is a plausible 'yes'. Take the quarterly earnings guidance 'game', for example. On the investor side, the challenge is to guess where the surprises are going to be, and to buy or sell before the announcement. On the corporate side, the challenge is to manufacture an ongoing stream of quarterly 'no surprise' announcements. Stating the obvious, this short -termism 'game' detracts from focusing on the far more important long-term value-creating prospects of the corporation for all its stakeholders.[v]

Really Focusing Capital on the Long-Term

None of this should detract from the important steps being taken to transition both investors and corporations towards thinking and acting in longer-term timeframes, including by *FCLT Global*. See for example **2020-Year-in-Review_FCLT Global**. A growing body of empirical evidence supports the proposition that this transition is truly value-enhancing.[vi] However, last month's *Letter* titled "The Accelerating Move to Sustainable Investing: Real or Imagined?" pointed to a still-significant gap between long-termism 'saying and doing'. It reported that a recent ShareAction benchmarking study measured how well 75 leading institutional investors around the world are performing in such long-term investment dimensions as governance oversight, climate change, human rights, and biodiversity. It found that over half received failing grades of D or E, including *FCLT Global* members Baillie Gifford, BlackRock, Goldman Sachs, Fidelity, MFS Investment Management, and State Street.[vii]

Not surprisingly, this 'saying/doing' gap creates skepticism. In a recent op-ed piece in the Globe&Mail titled "**Real action from passive money managers is needed to save capitalism**", Canadian corporate governance expert Ed Waitzer wrote: "*What has transpired in the corporate world over the past 18 months looks, to many, like a revolution. ESG investment practices have become the rage. Companies*

have been shamed for their embarrassing levels of diversity in the boardroom and at senior management levels……If history is any guide however, many of the 'breakthroughs' will end up being little more than smart public-relations moves…..To make a meaningful dent, we must empower the financial system's new behemoths: a small group of giant institutional investors that manage a growing amount of our savings and wide swaths of our economy……For things to truly change, these investors must be held accountable as active catalysts for more sustainable performance."

Making a Meaningful Dent

So what must be done to truly lengthen the timeframes for investor and corporate decision-making? Waitzer's 'to do' list includes these three:

- Governments must create Stewardship Codes that define the responsible management of capital to ensure sustainable benefits for the economy, the environment, and society. The new U.K. Stewardship Code offers a good example. A key feature of the Code is the requirement to report regularly on how investors are aligning the interests of their clients with how the corporations they invest in conduct their value-creating affairs now and in the future. These reports are to be vetted by the Financial Reporting Council.
- Financial regulators must ensure both investor and corporate reporting meets explicit materiality standards. Such standards would impose liability for misleading statements and omissions.
- Institutional investors must be required to be active shareowners, asking tough questions of the companies they invest in, and be held accountable for fostering value-creating cultures in their own organizations. For example, index fund managers could and should be more proactive in how index composition changes over time.

And what about *FCLT Global* itself? What might it do to foster those "initiatives that market participants can take to make a sustainable financial future a reality for all"? Here are two that meet this test:

- Support the creation of benchmarking processes that objectively assess the degree to which investment organizations and corporations actually practice 'long-termism'. What gets measured gets managed.
- Support the wide adoption of the *Integrated Reporting Framework* to tell the investment and business organizations' journeys to long-termism. A caveat is that the resulting <IR> Reports should be subjected to independent assurance protocols.[viii]

For *FCLT Global*'s consideration.

Keith Ambachtsheer

Endnotes:

i. *The Report takes an eclectic approach to calculating investment horizons. The Households horizon estimate of 13.1yrs., for example, is based on an asset-weighted average of the deemed holding periods of cash (0yrs.), retirement savings accounts (30yrs.), equity assets (3.5yrs.), and real estate assets (7.0yrs.).*
ii. *See **Credit Suisse Global Wealth Report 2020**.*
iii. *See "**Rising to the Challenge of Short-Termism**" (2016) McKinsey & Co. for details.*
iv. *See "**Rethinking Corporate Purpose and Performance Measurement: Why 'Shareholder Value Maximization' Is Misguided and What Should Replace It**", Ambachtsheer Letter, July 2018 for details.*
v. *See Endnote ii for details.*
vi. *See "**ESG Schizophrenia….How To Cure It**", Ambachtsheer Letter, November 2019 for details.*
vii. *See "**The Accelerating Move to Sustainable Investing: Real or Imagined?**" Ambachtsheer Letter, December 2020 for details.*
viii. *See "**Asset Owners and Organizational Reporting Frameworks: Time to Consolidate, Simplify, and Innovate**", Ambachtsheer Letter, July 2020 for details.*

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