Tomorrow's Finance

Finance, business and the public good

Tomorrow's Finance lecture, 11 July 2013

by Colin Melvin

Tomorrow's Company in partnership with Miton Group plc

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As CEO of Hermes Equity Ownership Services (EOS) Ltd, Colin Melvin helps pension funds to become active owners of public and private companies, advising on responsible investment and corporate governance on £90 billion of assets.

Colin is a member of the UK Commission on Ownership and the Supervisory Board of Eumedion. He has co-founded and led various investor groups and initiatives such as the United Nations Principles for Responsible Investment, for which he was the first Chairman. He currently chairs the Integrated Reporting Investor Network and is Non-Executive Director and Remuneration Committee Chair at Aedas, an architectural firm.

He is an associate member of the Chartered Financial Analysts Institute and holds an MA from Aberdeen University and an MPhil from Cambridge University, both in History and Diplomas in Investment Analysis and Company Directorship.

Thank you Tony, and good afternoon everyone.

Thank you to Tomorrow's Company for the kind invitation to speak in the Tomorrow's Finance lecture series and for your excellent marketing of my session!

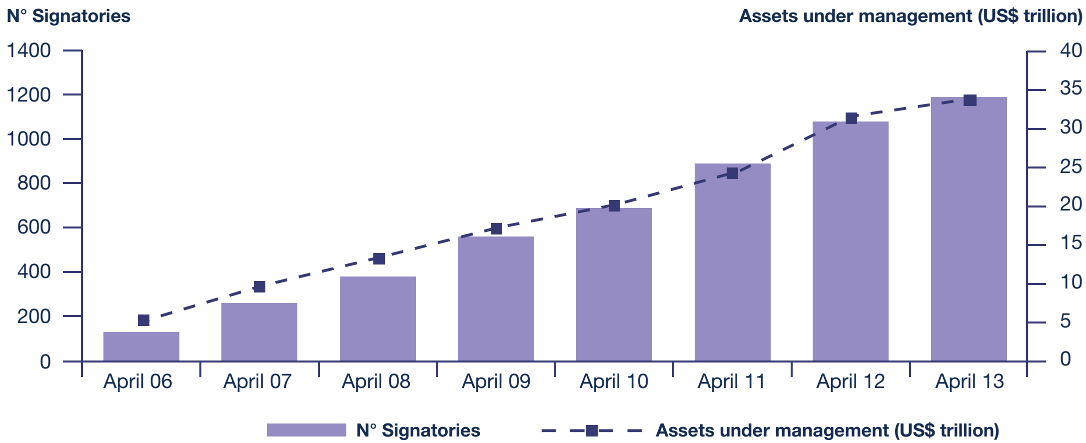
I have nearly 20 years experience in stewardship (six at Standard Life and two at Baillie Gifford in Edinburgh and eleven at Hermes) and in the past 18 months, I have seen probably the most exciting and encouraging development since 1994. This is an increase in corporate pension funds adapting the sustainability practices of their sponsoring companies into responsible investment policies.

Having spent most of my career representing the views of long-term investors to the companies in which they invest, promoting long-term thinking, good governance, alignment of interests through well-designed incentives, good risk management and sustainability, it is particularly rewarding to see companies understanding the business needs and benefits of such behaviours and for these to migrate to their pension funds. The pension funds of Unilever, RBS, Shell, Marks & Spencer, ING, BAE Systems and BT are amongst those already behaving as good owners of the companies in their portfolios and many others are considering this and looking to incorporate longer-term factors into asset allocation and investment decision-making.

Furthermore, from the Middle East to Asia, Europe and North America, we are seeing public pension funds and sovereign wealth funds starting to investigate and adopt responsible investment policies, although as we will discuss, the financial services industry seems very slow in responding to this interest and demand.

When the Global Financial Crisis struck in 2007/8, I feared this would end the then growing interest in responsible and sustainable investment; that there would be a flight to short-term money and behaviours, undoing the excellent work on responsible investment. At that time, the growth in interest was best evidenced by the progress of the UN Principles for Responsible Investment (PRI) initiative in the two years following its launch in 2006, when it more than trebled its signatories to 362 and saw committed assets double to USD 13 trillion by April 2008. Indeed, I was so concerned about a potential decline that I spent much more time than usual with print and broadcast journalists, at home and abroad explaining and exploring the connections between the financial crisis and short-term thinking and behaviour by investors and companies and particularly their agents and advisors; presenting the crisis as one of ownership, accountability and governance.

But, my fears for responsible investment were not realised. Rather than slowing its progress, the financial crisis seems to have accelerated interest. From 100 signatories and USD 6.5 trillion at launch in April 2006, the PRI now has over 1200 signatories and USD 35 trillion in committed assets[1].



Source – UNPRI, July 2013 (http://www.unpri.org/about-pri/about-pri/)

Indeed, considering the very many post-crisis, enquiries, reviews and regulations hard and soft, on governance, stewardship and tackling short-termism, the PRI initiative now seems prescient. Those of us involved in the PRI expert and investor working groups in 2005 and those who drew up the principles and the initial group of asset owner and asset manager signatories, were sufficiently concerned about the dysfunctionality of the investment process and the relationship between investors and the entities in which they invested, that we were prepared to spend countless hours in the underground bunkers at the UN Headquarters in New York; arguing over each word of the later drafts, over whether the Principles should be voluntary and aspirational (which they were) and whether or not we should reference behavioural norms and standards (which we didn't).

[1] Of the 1,205 signatories signed up as of 10 July, 269 are asset owners (defined as an organisation where the sum of the on-balance sheet investment assets exceeds the assets that it manages for external clients through any majority-owned investment manager subsidiaries), 745 are investment managers and 191 are professional service partners.

For those of you unfamiliar with the PRI, I would strongly encourage you to visit www.unpri.org – There are six Principles and the core of the initiative can be found in Principles 1 and 2 – which are:

Principle 1 – "we will incorporate ESG issues into investment analysis and decision-making processes"; and

Principle 2 – "we will be active owners and incorporate ESG issues into our ownership policies and practices."

Of course the PRI initiative was not the first to consider and promote longer term thinking by businesses and their investors in the interests of the broader economy, society and the public good. You can see this in the development of corporate governance codes and guidelines. In the UK alone we have had many reviews and reports, including Cadbury (governance) (1992), Greenbury (remuneration) (1995), Hampel (1998), Turnbull (internal control) (1999), Smith (auditors) (2003), Higgs (Non-executive directors) (2003), many of which were produced in response to crises, or corporate failures, including Poly Peck, Maxwell, Enron, WorldCom and Tyco.

Our hosts today, Tomorrow's Company produced the visionary 'Restoring Trust' inquiry, in 2004, partly in response those corporate scandals of 2003, which proposed good corporate ownership by institutional investors as a solution to short-termism in business and finance. Earlier still, we had the excellent Myners review in 2001, which formed the basis of the Stewardship Code that now applies to (and is part of the regulation of) all investors in UK companies, although you might not think this by observing their behaviour!

This is because we continue to have a problem with short-termism. Despite all of this effort, short-termism in business and financial markets persists, to the detriment of our economies and societies. Indeed it seems hard-wired into our current version of capitalism and the public and political anxiety about this problem is reaching fever pitch. Consider the very many initiatives looking at short-termism and linking this to financial market behaviour and poor corporate ownership.

In the UK, in recent months we have had the Cox Review, Ownership Commission, Kay Review[2], several inquiries into banking, including the current Parliamentary Commission on Banking Standards and Tomorrow Company's own work on capital markets. One of the largest Canadian investors, the Canadian Pension Plan Investment Board (CPPIB) in partnership with McKinsey has just launched a very interesting joint initiative entitled "Focusing Capital on the Long Term." The OECD, European Commission and the Financial Stability Board all have current initiatives on promoting longer-term behaviour.

I believe this represents no less than a hegemonic shift in the way the public, society, business leaders and politicians view and understand the relationship between, business, finance and the public good, with an understanding of need for sustainability and long-term decision-making. But no one seems able to do anything to change the current system.

[2] The Kay Review of UK Equity Markets and Long Term Decision Making, July 2012

Much of this concern sees corporate short-termism as a reaction to financial market short-termism and its effects can be damaging to businesses and their stakeholders. Specifically, these may include disincentives to recruit, invest, undertake research, develop new products and plan for the long term. In a survey of business leaders carried out for the Cox Review, published in February this year, shareholder pressure was given by 80% of respondents as the most significant cause of short-termism in UK business[3].

In a recent speech to launch CPPIB and McKinsey's initiative, Dominic Barton stated that:

"a ten or twenty year horizon is needed to embrace the five forces that are reshaping the global economy"

Which he gave as:

- "The Rise of Africa and Asia
- Aging populations
- Technology which is changing three times as fast as management techniques
- Resource productivity challenges
- Increasing strains on governments"[4]

Yet companies are called to account by their shareholders, the fund managers who buy and sell their shares, on quarterly earnings numbers and the management of short-term risks and opportunities.

Concern over short-termism has also been expressed by politicians of all major parties in the UK and many business leaders in the context of the structure and quantum of executive pay.

My role in corporate engagement on behalf of long-term shareholders leads me to talk to many public company directors, who by December 2011, were starting to express great concern around executive pay, which was echoed in the press and by politicians. They told me that long-term plans had become unclear and complex, which made them inadequate for incentivising directors. CEOs treated a payout of some of these plans like 'winning the jackpot', without knowing what they had done specifically to achieve this outcome. They therefore tended to focus on the shorter term cash bonuses. The remuneration committee chairs felt unable to act alone, owing to apparent competitive and market pressures and some asked for assistance.

[3] Overcoming Short-termism within British Business, The key to sustained economic growth, An independent review led by Sir George Cox commissioned by the Labour Party, 26 February 2013

[4] Barton, D., Wiseman, M., *'Focusing Capital on the Long Term'* (Speech to Institute of Corporate Directors, May 2013)

Such requests and the near political, public and business consensus prompted me to write to the FTSE 100 remuneration committee chairs and invite them to a meeting in February 2012. Forty-four of the FTSE 100 remuneration committees were represented at the meeting, by the chair or another committee member. We matched this with the same number of senior pension fund representatives, as the owners of the companies and we considered various questions around the structure and quantum of pay. We have since a held a series of smaller meetings, retaining the character of the conversation, as that between company and end asset owner (pension fund) rather than portfolio managers and we have developed a set of five high level "remuneration principles for building and reinforcing long-term business success", with examples of how they may be applied in practice [5].

A major problem with executive pay and a reason for its current dysfunctionality is that its policing has been largely undertaken by fund managers, as agents of the underlying owners of the companies, such as pension funds. A combination of fund managers' disinterestedness, their own often poorly designed incentives and their favouring performance measures which made sense in the context of their own performance targets and metrics has resulted in structures which are wholly unsuited for the companies concerned.

Furthermore, I believe the problem of executive pay is illustrative of the basic problem with our capitalist system – that is: *its control or capture by agents, rather than principals*.

"Capitalism", coined in the mid 19th century [6], describes an economic system characterized by private or corporate ownership of capital assets or goods. We would therefore expect the owners of capital to run the system and control the owned assets. Unfortunately, we presently seem to have what a colleague describes as "agentism" rather than "capitalism", whereby agents have captured and control the capitalist system and are able effectively to contract out of their fiduciary duty to act in the best interests of their clients, the principals or owners.

A consequence of such "agentism", where the agents' interests and incentives are misaligned with those of the principals (their clients), is that the agents may undertake actions to meet their own targets, such as excessive trading at the principals' expense, which risk destroying value for the principals and (in the case of listed equities) sending short-term signals to the companies whose securities are being traded.

[5] The current draft principles are as follows:
– Management should make a material long-term investment in shares of the businesses they manage
– Pay should be aligned to long-term success and the desired corporate culture throughout the organisation
– Pay schemes should be clear, understandable for both investors and executives, and ensure that rewards reflect long-term returns to shareholders
– Remuneration committees should use the discretion afforded them by shareholders to ensure that awards properly reflect company performance.
– Investors should commit sufficient resources to enable them to have informed discussions with companies on pay, taking account of their individual circumstances and strategy.

[6] Although "capitalism" appears twice in Das Kapital, Marx preferred "capitalistic system"

At the other end of the investment chain, investment banks may also have misaligned incentives, promoting and completing mergers and acquisitions, which meet their own targets and those of other agents, such as trading intermediaries, but destroy value for the end asset owner.

Investing for the short-term does seem to destroy value. A Bank of England study undertaken by Andrew Haldane and Richard Davies in 2011 found that stock prices of UK and US listed companies over-discounted the value of future cash flows by 5-10%, suggesting that investors have been pressuring CEOs and boards against making long-term investments[7].

Unfortunately, perhaps following the advice of another set of agents, investment consultants and advisers, pension funds and retail investors have come to measure fund manager performance on a short-term, often quarterly basis, thereby perpetuating and exacerbating the problem.

Barton has noted that short-termism amongst the clients of fund managers “is driving some to become ‘closet indexers’ trading in and out of the same stocks frequently to show activity, but overall just following the index to avoid any years of significant underperformance. They can’t afford to invest for the long term. Their clients will abandon them. The average US active equity mutual fund now turns-over more than three-quarters of their investments every year. When combined with the rise of quantitative momentum strategies the result has been a significant decline in stock holding periods. Between 1975 and 2010, the average period for holding stocks on the New York Stock Exchange declined from six years to close to six months. And, this is not just about high frequency trading. Even excluding these trades, the trend to short term holds is staggering.”[8]

My work and that of my team in engaging with thousands of companies on behalf of pension funds leads us to have frequent meetings with CEOs and other board directors. It is clear that corporate executives and boards are under significant pressure from fund managers, investment analysts and the media to develop short-term strategies, deliver short-term gains and explain short-term losses.

Now this may all be depressingly familiar and indeed recent surveys and reports, such as the Kay Review in the UK have analysed the problem of short-termism along these lines. But most such analyses miss a key insight, which is that we are all part of the same system – capital owners, fund managers, investment banks. Financial services are integral to the economy and to society, and should not be considered apart from it. And further, that the end asset owner is not really the pension fund or insurance company, but rather the current and future pensioner or saver, who is often also a corporate employee.

This concept, known within Hermes as the “cycle of corporate ownership,” has guided our thinking for many years and was behind the creation of Hermes EOS, our stewardship service for long-term investors, which I run.

7 Haldane, A., Davies, R., ‘The Short Long’ (Bank of England, May 2011)
8 Barton, D., Wiseman, M., *‘Focusing Capital on the Long Term’* (Speech to Institute of Corporate Directors, May 2013)

Simply put, I believe there is a coincidence between the long-term interests of companies and society or the public good, because they are interconnected and interdependent. Properly directed and controlled, corporations enable us to organise labour and capital to maximize what Alastair Ross Goobey, a former CEO of Hermes used to term the "common weal." Companies that behave well and are well governed tend to be rewarded through more loyal consumers and lighter-touch regulation.

Seeing the promotion of such good behaviour as a responsibility and opportunity for the corporate owner, enables us to link values and value in the City within the broader theme of connecting and aligning the interests of the citizen with the corporation. But, for this to succeed the public does need to feel a stronger connection to business and the City and I applaud Tomorrow's Company's efforts to restore trust and popularise this concept of stewardship.

So, understanding this interconnectedness and the potential influence of large institutional investors, who have a self-interested opportunity to be drivers of long-term thinking and behaviours, will lead us to the solution to the problems of capital market short-termism.

The solution to short-termism in business and finance, therefore lies mainly and simply in the principals' greater control of their agents[9].

This can be achieved through well-designed investment mandates, that better align the interests of agents with principles, as has been proposed by the International Corporate Governance Network, amongst others[10]. In most cases, this should lead to the promotion, adoption and integration of longer-term factors, risks and opportunities[11] into mainstream investment.

We also need better stewardship of owned assets (companies) through pooled ownership and collaborative engagement by asset owners, such as pension funds. Much of the work in this area is currently ad hoc and inefficient, undertaken with limited and inexperienced resources. There is also in some quarters a misunderstanding of stewardship as a fire-fighting exercise.

9 Barton and Wiseman propose the following excellent action plan for investors and corporate boards –
"For Institutional Investors that requires:
1) An asset owner-led collaboration and engagement platform
2) 'Activated' passive holdings
3) And a set of agreed upon engagement principles
And for Corporate Boards that means:
1) Long-term value committees
2) New compensation models that reflect the workload Directors have, and reward them over at least a product or risk cycle
3) Narrative integrated reporting rather than quarterly earnings"
Barton, D., Wiseman, M., 'Focusing Capital on the Long Term' (Speech to Institute of Corporate Directors, May 2013)

10 See the International Corporate Governance Network's Model Mandate Initiative for an example of this – http://www.icgn.org/files/icgn_main/pdfs/drafts/mmi_consultation_31jan2011.pdf

11 Such factors are now generally referred to as ESG (environmental, social and governance), an acronym that was coined during the drafting of the UNPRI. At that time we had intended 'ESG' to mean all factors material to investment decision-making, which were beyond the agents' (or indeed the principals') usual short-term horizon. However it has since become more narrowly defined.

The Kay Review[12] provided an excellent description of the problems of and consequences short-termism within equity markets, but has been criticized with regard to the limitations and impracticality of some of its proposed solutions. For example, although I hope it succeeds, the current proposal for an ad hoc and informal investors' forum seems unlikely to be an effective vehicle for delivering stewardship. Taking the fire-fighting analogy, a successful fire service spends more time on preventing than extinguishing fires. Good stewardship requires significant effort to be devoted to ongoing monitoring and engagement with companies before crises develop.

Also, owing to the ownership structures of particularly large public companies, effective collaborative corporate engagement is necessarily and international task. We need the largest asset owners to work together to promote the good performance of the companies in which they jointly invest. Lastly, it requires engagement on regulation, policy and best practice as these affect entire sectors and markets.

Many of you will work within public companies and with large investors. As citizens, employees and savers, you all have a stake in the capitalist system and means for promoting its success. The solution to the problem of short-termism and the opportunity to connect business, finance and public good therefore lies with you. Consider your position as corporate owner through your pension fund. Write to your trustees and ask them about long-term investment and stewardship. In this way you can drive better behaviour by your agents and support the long-term investment and business decisions that we all need.

Thank you.

[12] The Kay Review of UK Equity Markets and Long Term Decision Making, July 2012

About Miton

Miton is a leading multi-asset and equity fund management specialist. The group manages £1.8bn of assets including nine OEICs, three investment trusts and segregated client accounts. Members of the fund management team invest in their own funds and are significant shareholders in the company. Miton has offices in Reading, Liverpool and London.

www.mitongroup.com

About Tomorrow's Company

Tomorrow's Company is the agenda setting 'think and do' tank which looks at the role of business and how to achieve enduring business success. We focus on strong relationships, clear purpose and values as the foundation of effective leadership and governance. In our programmes we challenge business leaders around the world to work in dialogue with others to tackle the toughest issues. We promote systemic solutions, working across boundaries between business, investors, government and society. We believe that business can and must be a 'force for good'. This in turn requires a strengthening of stewardship by shareholders in partnership with boards of companies. We argue that the Age of Sustainability has begun, and that in the future success and value creation will come from recognising the 'triple context' – the links between the economic, social and environmental sub-systems on which we all depend, and the opportunities this brings.

www.tomorrowscompany.com
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About Slow Finance

Slow Finance by Gervais Williams focusses on the types of businesses that banks and other financial institutions should finance, the criteria they should adopt and above all the nature of the relationships which can best secure long-term returns – such as exploring in depth financing for food production and other areas vital for economic prosperity and future wellbeing.

To order the book and use the app: **www.slowfinance.com**

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