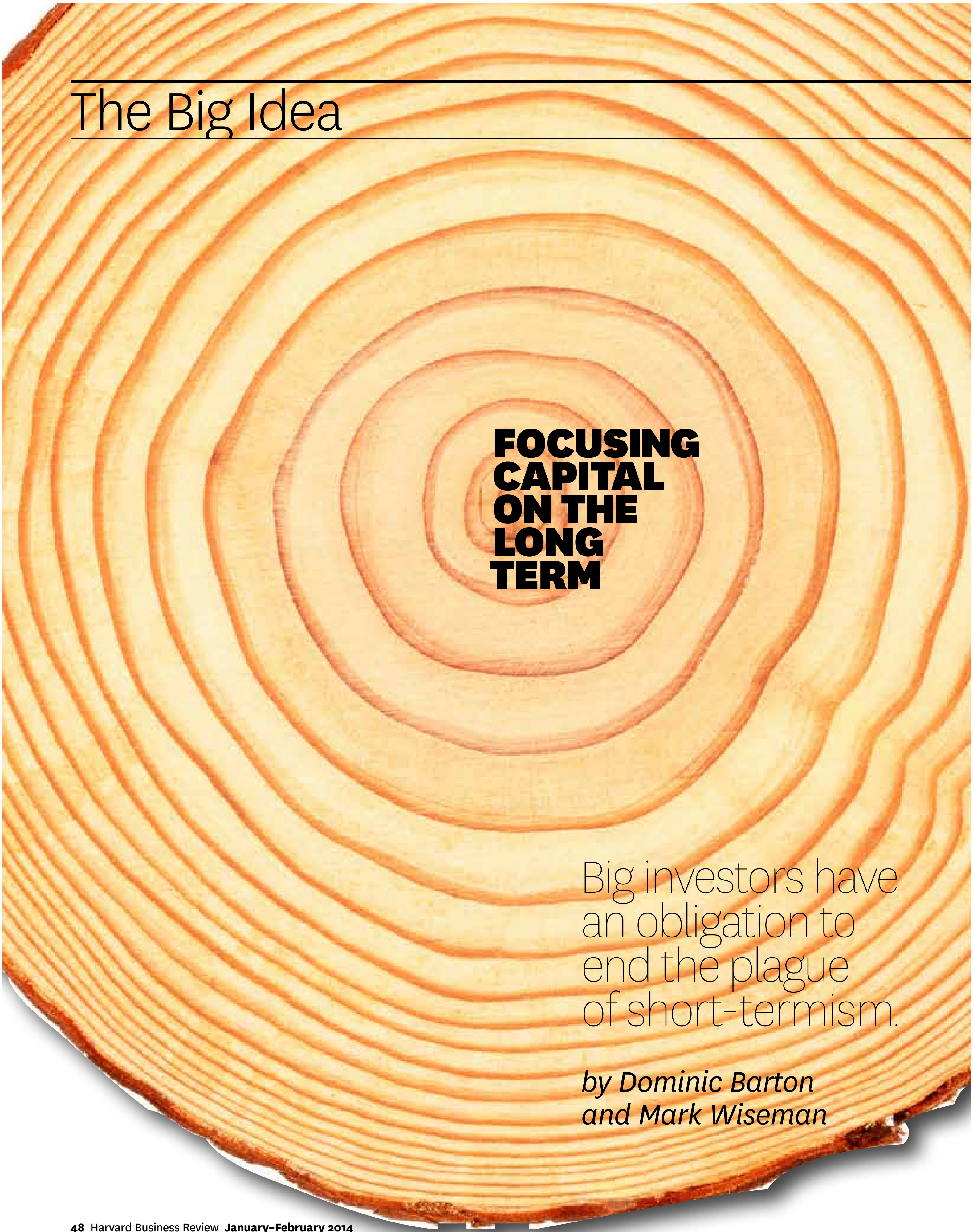
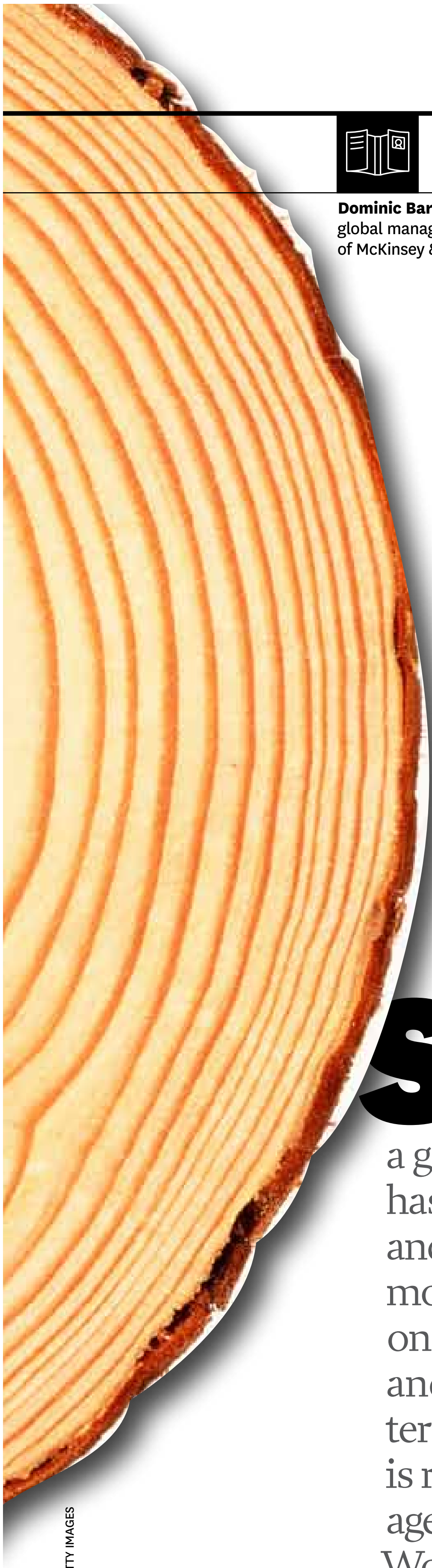


FOCUSING CAPITAL ON THE LONG TERM

Big investors have an obligation to end the plague of short-termism.

by Dominic Barton and Mark Wiseman



PHOTOGRAPHY: GETTY IMAGES

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Since the 2008 financial crisis and the onset of the Great Recession, a growing chorus of voices has urged the United States and other economies to move away from their focus on "quarterly capitalism" and toward a true long-term mind-set. This topic is routinely on the meeting agendas of the OECD, the World Economic Forum, the G30, and other international bodies. A host of solutions have been offered—from "shared value" to "sustainable capitalism"—that spell out in detail the societal benefits of such a shift in the way corporate executives lead and invest. Yet despite this proliferation of thoughtful frameworks, the shadow of short-termism has continued to advance—and the situation may actually be getting worse. As a result, companies are less able to invest and build value for the long term, undermining broad economic growth and lowering returns on investment for savers.

The main source of the problem, we believe, is the continuing pressure on public companies from financial markets to maximize short-term results. And although some executives have managed to ignore this pressure, it's unrealistic to expect corporate leaders to do so over time without stronger support from investors themselves. A crucial breakthrough would occur if the major players in the market, particularly the big asset owners, joined the fight—something we believe is in the best interests of their constituents. In this article we lay out some practical approaches that large institutional investors can take to do this—many of which are already being applied by a handful of major asset owners.

The Intensifying Pressure for Short-Term Results

One of us (Dominic Barton) previously wrote about the need to "fight the tyranny of short-termism" (see "Capitalism for the Long Term," HBR March 2011), and over the past few years both our organizations have been monitoring the debate on short-termism. Early in 2013 McKinsey and the Canada Pension Plan Investment Board (CPPIB) conducted a *McKinsey Quarterly* survey of more than 1,000 board members and C-suite executives around the world to assess their progress in taking a longer-term approach to running their companies. The results are stark:

- 63% of respondents said the pressure to generate strong short-term results had increased over the previous five years.
- 79% felt especially pressured to demonstrate strong financial performance over a period of just two years or less.
- 44% said they use a time horizon of less than three years in setting strategy.
- 73% said they *should* use a time horizon of more than three years.
- 86% declared that using a longer time horizon to make business decisions would positively affect corporate performance in a number of ways, including strengthening financial returns and increasing innovation.

What explains this persistent gap between knowing the right thing to do and actually doing it? In our survey, 46% of respondents said that the pressure to deliver strong short-term financial performance stemmed from their boards—they expected their companies to generate greater earnings in the near term. As for those board members, they made it clear that they were often just channeling increased short-term pressures from investors, including institutional shareholders.

That's why we have concluded that the single most realistic and effective way to move forward is to change the investment strategies and

Idea in Brief

THE PROBLEM
Calls in the past five years for corporate leaders to abandon their focus on maximizing short-term financial performance have been ineffective. The ongoing short-termism in the business world is undermining corporate investment, holding back economic growth, and lowering returns for savers.

WHO SHOULD LEAD CHANGE?
Action must start with large asset owners such as pension funds, mutual funds, insurance firms, and sovereign wealth funds. If they adopt investment strategies aimed at maximizing long-term results, then other key players—asset managers, corporate boards, and company executives—will likely follow suit.

MAKING IT HAPPEN
Big investors can take four proven, practical steps: (1) Define long-term objectives and risk appetite, and invest accordingly. (2) Practice engagement and active ownership. (3) Demand long-term metrics from companies to inform investment decisions. (4) Structure institutional governance to support a long-term outlook.

approaches of the players who form the cornerstone of our capitalist system: the big asset owners.

Practical Changes for Asset Owners

The world's largest asset owners include pension funds, insurance firms, sovereign wealth funds, and mutual funds (which collect individual investors' money directly or through products like 401(k) plans). They invest on behalf of long-term savers, taxpayers, and investors. In many cases their fiduciary responsibilities to their clients stretch over generations. Today they own 73% of the top 1,000 companies in the U.S., versus 47% in 1973. So they should have both the scale and the time horizon to focus capital on the long term.

But too many of these major players are not taking a long-term approach in public markets. They are failing to engage with corporate leaders to shape the company's long-range course. They are using short-term investment strategies designed to track closely with benchmark indexes like the MSCI World Index. And they are letting their investment consultants pick external asset managers who focus mostly on short-term returns. To put it bluntly, they are not acting like owners.

The result has been that asset managers with a short-term focus are increasingly setting prices in public markets. They take a narrow view of a stock's value that is unlikely to lead to efficient pricing and collectively leads to herd behavior, excess volatility, and bubbles. This, in turn, results in corporate boards and management making suboptimal decisions for creating long-term value. Work by Andrew Haldane and Richard Davies at the Bank of England has shown that stock prices in the United Kingdom and the United States have historically overdiscounted future returns by 5% to 10%. Avoiding that pressure is one reason why private equity firms buy publicly traded companies and take them private. Research, including an analysis by CPPIB, which one of us (Mark Wiseman) heads, indicates that over the long term (and after adjustment for leverage and other factors), investing in private equity rather than comparable public securities yields annual aggregate returns that are 1.5% to 2.0% higher, even after substantial fees and carried interest are paid to private equity firms. Hence, the underlying outperformance of the private companies is clearly higher still.

Simply put, short-termism is undermining the ability of companies to invest and grow, and those missed investments, in turn, have far-reaching consequences, including slower GDP growth, higher unemployment, and lower return on investment for savers. To reverse this destructive trend, we suggest four practical approaches for institutional investors serious about focusing more capital on the long term.

1 Invest the portfolio after defining long-term objectives and risk appetite. Many asset owners will tell you they have a long-term perspective. Yet rarely does this philosophy permeate all the way down to individual investment decisions. To change that, the asset owner's board and CEO should start by defining exactly what they mean by long-term investing and what practical consequences they intend. The definition needs to include a multiyear time horizon for value creation. For example, Berkshire Hathaway uses the rolling five-year performance of the S&P 500 as its benchmark to signal its longer-term perspective.

Just as important as the time horizon is the appetite for risk. How much downside potential can the asset owner tolerate over the entire time horizon?

And how much variation from the benchmark is acceptable over shorter periods? Short-term underperformance should be tolerated—indeed, it is expected—if it helps achieve greater long-term value creation. Singapore's sovereign wealth fund, GIC, takes this approach while maintaining a publicly stated 20-year horizon for value creation. The company has deliberately pursued opportunities in the relatively volatile Asian emerging markets because it believes they offer superior long-term growth potential. Since the mid-2000s GIC has placed up to one-third of its investments in a range of public and private companies in those markets. This has meant that during developed-market booms, its equity holdings have underperformed global equity indexes. While the board looks carefully at the reasons for those results, it tolerates such underperformance within an established risk appetite.

Next, management needs to ensure that the portfolio is actually invested in line with its stated time horizon and risk objectives. This will likely require allocating more capital to illiquid or "real" asset classes like infrastructure and real estate. It may also mean giving much more weight to strategies within a given asset class that focus on long-term value creation, such as "intrinsic-value-based" public-equity strategies, rather than momentum-based ones. Since its inception in 1990, the Ontario Teachers' Pension Plan (OTPP) has been a leader in allocating capital to illiquid long-term asset classes as well as making direct investments in companies. Today real assets such as water utilities and retail and office buildings account for 23% of OTPP's portfolio. Another believer in this approach is the Yale University endowment fund, which began a self-proclaimed "revolutionary shift" to nontraditional asset classes in the late 1980s. Today the fund has just over 35% in private equity and 22% in real estate.

Finally, asset owners need to make sure that both their internal investment professionals and their external fund managers are committed to this long-term investment horizon. Common compensation structures like a 2% management fee per year and a 20% performance fee do little to reward fund managers for long-term investing skill. A recent Ernst & Young survey found that although asset owners reported wanting annual cash payments to make up only 38% of fund managers' compensation (with equity shares, deferred cash, stock options, and other forms of compensation accounting for the rest), in practice they make up 74%. While many institutions have focused on reducing fixed management fees over the past decade, they now need to concentrate on encouraging a long-term outlook among the investment professionals who manage their portfolios. CPPIB has been experimenting with a range of novel approaches, including offering to lock up capital with public equity investors for three years or more, paying low base fees but higher performance fees if careful analysis can tie results to truly superior managerial skill (rather than luck), and deferring a significant portion of performance-based cash payments while a longer-term track record builds.

2 Unlock value through engagement and active ownership. The typical response of many asset owners to a failing corporate strategy or poor environmental, social, or governance practices is simply to sell the stock. Thankfully, a small but growing number of leading asset owners and asset managers have begun to act much more like private owners and managers who just happen to be operating in a public market. To create value, they engage with a company's executives—and stay engaged over time. BlackRock CEO Laurence Fink, a leader in this kind of effort, tells companies not to focus simply on

winning over proxy advisory firms (which counsel institutional investors on how to vote in shareholder elections). Instead, says Fink, companies should work directly with BlackRock and other shareholders to build long-term relationships. To be clear, such engagement falls along a spectrum, with varying levels of resources and commitment required (see the sidebar "The Equity Engagement Spectrum"). But based on their in-house capabilities and scale, all asset owners should adopt strategies that they might employ individually or collaboratively.

Some asset owners are large enough to engage on their own by formally allocating dedicated capital to a relationship-investing strategy. This could involve taking a significant (10% to 25%) stake in a small number of public companies, expecting to hold those for a number of years, and working closely with the board of directors and management to optimize the company's direction. For smaller asset owners, independent funds like ValueAct Capital and Cevian provide a way to pool their capital in order to influence the strategies of public companies. The partners in such a coalition can jointly interact with management without the fixed costs of developing an in-house team.

Engaging with companies on their long-term strategy can be highly effective even without acquiring a meaningful stake or adopting a distinct, formal investment strategy. For example, the California Public Employees' Retirement System (CalPERS) screens its investments to identify companies that have underperformed in terms of total stock returns and fallen short in some aspect of corporate governance. It puts these companies on its Focus List—originally a published list but now an internal document—and tries to work with management and the board to institute changes in strategy or governance. One recent study showed that from 1999 to mid-2013, the companies targeted through the Focus List collectively produced a cumulative excess return of 12% above their respective industry benchmarks after five years. Other studies have shown similar results, with companies doing even better in the first three years after going on the Focus List. Interestingly, the companies CalPERS worked with privately outperformed those named publicly, so from 2011 onward, CalPERS has concentrated on private engagement.

Despite the evidence that active ownership is most effective when done behind the scenes, there will inevitably be times when public pressure needs to be applied to companies or public votes have to be taken. In such cases, asset owners with sufficient capacity should go well beyond following guidance from short-term-oriented proxy advisory services. Instead they should develop a network with like-minded peers, agree in advance on the people and principles that will guide their efforts, and thereby position themselves to respond to a potentially contentious issue with a company by quickly forming a microcoalition of willing large investors. Canadian Pacific Railway is a recent example where a microcoalition of asset owners worked alongside long-term-oriented hedge funds to successfully redirect management's strategies.

Transparency makes such collaborative efforts easier. In the United Kingdom, major institutions are required to "comply or explain" their principles of engagement under the UK's Stewardship Code. Elsewhere, big asset owners and managers should also publish their voting policies and, when a battle is joined, disclose their intentions prior to casting their votes. Smaller asset owners or those less interested in developing in-house capabilities to monitor and engage with companies can outsource this role to specialists. Hermes Equity Ownership Services, for example, was set up by the BT Pension Scheme in the UK to provide proxy voting and engagement

The Equity Engagement Spectrum

Asset owners are developing a range of approaches to engaging with companies in which they have equity investments. As the size of their stake rises, they move from monitoring and coalition building to acting like owners, often with board representation.

OWNERSHIP STAKE IN COMPANY

<2%	1–5%	>10%
ONGOING ENGAGEMENT	**ACTIVE OWNERSHIP**	**RELATIONSHIP INVESTING**
• Continuously monitors companies, with a mix of active and reactive engagement • May build microcoalitions with other investors • Often does not pursue any additional investment beyond an index-weighted holding	• Owns a meaningful position in a handful of companies • Usually remains below the 5% threshold for public disclosure of holdings • Tries to build micro-coalitions with other investors • Works publicly or privately to persuade the board and management to change long-term strategy	• Takes a significant minority ownership • Often has board seats • Works collaboratively with management on long-term strategy

SOURCE MCKINSEY & COMPANY AND CANADA PENSION PLAN INVESTMENT BOARD services to 35 global asset owners that together have some $179 billion under management.

Finally, to truly act as engaged and active owners, asset owners need to participate in the regulation and management of the financial markets as a whole. With some exceptions, they have largely avoided taking part publicly in the debates about capital requirements, financial market reform, and reporting standards. Some of the biggest players in the game are effectively silent on its rules. As long-term investors, asset owners should be more vocal in explaining how markets can be run more effectively in the interests of savers.

3 Demand long-term metrics from companies to change the investor-management conversation. Making long-term investment decisions is difficult without metrics that calibrate, even in a rough way, the long-term performance and health of companies. Focusing on metrics like 10-year economic value added, R&D efficiency, patent pipelines, multiyear return on capital investments, and energy intensity of production is likely to give investors more useful information than basic GAAP accounting in assessing a company's performance over the long haul. The specific measures will vary by industry sector, but they exist for every company.

It is critical that companies acknowledge the value of these metrics and share them publicly. Natura, a Brazilian cosmetics company, is pursuing a growth strategy that requires it to scale up its decentralized door-to-door sales force without losing quality. To help investors understand its performance on this key indicator, the company publishes data on sales force turnover, training hours per employee, sales force satisfaction, and salesperson willingness to recommend the role to a friend. Similarly, Puma, a sports lifestyle company, recognizes that its sector faces significant risks in its supply chain, and so it has published a rigorous analysis of its multiple tiers of suppliers to inform investors about its exposure to health and safety issues through subcontractors.

Asset owners need to lead the way in encouraging the companies they own to shift time and energy away from issuing quarterly guidance. Instead they should focus on communicating the metrics that are truly material to the company's long-term value creation and most useful for investors. In pursuing this end, they can work with industry coalitions that seek to foster wise investment, such as the Carbon Disclosure Project, the Sustainability Accounting Standards Board, the investor-driven International Integrated Reporting Council, and most broadly, the United Nations–supported Principles for Responsible Investment.

But simply providing relevant, comparable data over time is not enough. After all, for several years, data sources including Bloomberg, MSCI, and others have been offering at least some long-term metrics—employee turnover and greenhouse gas intensity of earnings, for example—and uptake has been limited. To translate data into action, portfolio managers must insist that their own analysts get a better grasp on long-term metrics and that their asset managers—both internal and external—integrate them into their investment philosophy and their valuation models.

4 Structure institutional governance to support a long-term approach. Proper corporate governance is the critical enabler. If asset owners and asset managers are to do a better job of investing for the long term, they need to run their organizations in a way that supports and reinforces this. The first step is to be clear that their primary fiduciary duty is to use professional investing skill to deliver strong returns for beneficiaries over the long term—rather than to compete in horse races judged on short-term performance.

Executing that duty starts with setting high standards for the asset owner's board itself. The board must be independent and professional, with relevant governance expertise and a demonstrated commit-

ment to a long-term investment philosophy. Board members need to have the competencies and time to be knowledgeable and engaged. Unfortunately, many pension funds—including many U.S. state and local government employee pension plans—are not run this way; they often succumb to short-term political pressure or lack sufficient expertise to make long-term investment decisions in the best interests of beneficiaries.

However, successful models do exist. For example, the New Zealand Superannuation Fund is overseen by a board of "guardians" whose members are selected for their experience, training, and expertise in the management of financial investments. The board operates at arm's length from the government and is limited to investing on what it calls "a prudent, commercial basis." The board is subject to a regular independent review of its performance, and it publishes its progress in responding to the recommendations it receives. Two other exemplary models are the Wellcome Trust, a UK-based global charitable foundation, and Yale University's endowment fund; each delegates strategic investment implementation to a committee of experienced professionals.

Professional oversight needs to be complemented by policies and mechanisms that reduce short-term pressures and promote long-term countercyclical performance. These could include automatic rebalancing systems to enforce the selling of equities during unsustainable booms, liquidity requirements to ensure there is cash available to take advantage of times of market distress, and an end to currency hedging to reduce the volatility of short-term performance. Such policies need to be agreed to in advance of market instability, because even the best-governed institutions may feel the heat during such periods.

A case in point is Norges Bank Investment Management (NBIM), which invests Norway's revenue from surplus petroleum (more than $814 billion) in the country's global government pension fund. In 2007 the Ministry of Finance and NBIM set a long-term goal: to raise the equity content of the fund from 40% to 60%. Yet when the financial crisis hit, NBIM lost over 40% of the value of its global equity portfolio, and it faced significant external pressure not to buy back into the falling market. Its strong governance, however, coupled with ample liquidity, allowed it to continue on its long-term path. In 2008 it allocated all $61 billion of inflows, or 15% of the fund's value, to buying equities, and it made an equity return of 34% in the following year, outperforming the equity market rebound. In similar circumstances a few years later, NBIM kept to its countercyclical strategy and bought into the falling equity market of mid-2011, turning an equity loss of nearly 9% that year into an 18% return in 2012.

A final imperative for the boards and leadership of asset owners is to recognize the major benefits of scale. Larger pools of capital create more opportunities to invest for the long term by opening up illiquid asset classes, making it cost-effective to invest directly, and making it easier to build in-house engagement and active ownership capabilities. According to analysts such as William Morneau, the Ontario Ministry of Finance's pension investment adviser, these opportunities are often cost-effective once an asset owner has at least $50 billion in assets under management. That suggests that savers, regulators, and board members of smaller asset owners should be open to these institutions pooling assets or even merging.

Large asset owners can be a powerful force for instituting balanced, long-term capitalism that ultimately benefits everyone.

Leading the Way Forward

Today a strong desire exists in many business circles to move beyond quarterly capitalism. But short-term mind-sets still prevail throughout the investment value chain and dominate decisions in boardrooms.

We are convinced that the best place to start moving this debate from ideas to action is with the people who provide the essential fuel for capitalism—the world's major asset owners. Until these organizations radically change their approach, the other key players—asset managers, corporate boards, and company executives—will likely remain trapped in value-destroying short-termism. But by accepting the opportunity and responsibility to be leaders who act in the best interests of individual savers, large asset owners can be a powerful force for instituting the kind of balanced, long-term capitalism that ultimately benefits everyone.

HBR Reprint R1401B