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TUC

Investment Chains

Addressing corporate and investor short-termism

Contents

Section one

Introduction

"The pressure on the sell side has in my view made analysts very focused on the near term and in some instances their understanding of our business fundamentals is less than it used to be. Some even expect us to fill in their models for them. Research tends to be more sensational and on roadshows there is increasing pressure to put us in front of hedge funds rather than traditional long funds. It may be old-fashioned, but I view a shareholder as a shareholder – someone whose interests in the success and prospects of the company lasts more than three weeks – or less. It may be the market, and we all know we can't buck the market, but I have real concerns about promoting the use of my company's stock as hedge fund plays – just as I would in if they were chips in a casino."[1]

John Sunderland, 21st April 2005

As Chair of Cadbury Schweppes and President of the CBI, Sunderland is well placed to highlight a problem that has often been discussed, but never solved: the UK's relative short-termism in its attitude towards industry.

Put simply, shareholders often respond negatively to short-term difficulties, or lower than expected profits. This attitude makes it difficult for companies to make long-term investment decisions, regarding skills, innovation and research and development, because of the fear, real or imagined, that high, upfront, short-term costs will scare away investors.

Trade unions have often criticised institutional shareholders for looking to maximise short-term profits from business, regardless of the impact on companies and their employees. As John Sunderland's comments illustrate, increasingly it seems that business is also willing to make criticisms of investor pressure. Some business leaders argue that their members are harried into short-termist approaches because their shareholders are looking for short-term relative performance.

There is also an emerging critique that too much investment analysis, as carried out by and for fund managers, focuses on a limited and short-term view of what makes successful companies. Whilst analysts are wedded to a narrow financial interpretation of companies, often based around a structured series of company announcements, this limits the ability of management to break free of short-termist shackles.

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[1] Speech to Investor Relations Conference, 21 April 2005

More recently some in the fund management industry have sought to delegate responsibility for short-term pressure on companies further back down the investment chain to their clients. Fund managers only pressure companies for short-term performance, it is argued, because they themselves are being judged by pension funds and their advisers on their quarterly relative performance.

This question of the investment time horizons of pension funds was picked up as an element of the Myners review in 2001, and subsequently explored by the pensions industry itself. As such there is an ongoing debate about how, if at all, pension funds could alter their behaviour.

Significantly if there are structural failings in the linkages between pension funds, the fund managers they employ and the companies in which they ultimately invest workers' capital, then much of the power to make change already lies in the hands of trade union members. With equal representation on pension fund trustee boards becoming a reality, trade union members who are trustees can play a vital role in implementing any necessary reforms.

Working people can be subject to the negative effects of short-termism both as employees and as investors. As pensions are delivered increasingly through defined contribution structures the importance of the efficient functioning of the investor-company relationship has grown. It is important that unions respond effectively.

There is also a significant shared agenda with business here. Short-termism is typically no more in the interests of companies than it is in the interests of employees. Unions have much to gain from working with employers, and employer trustees, to develop a longer-term perspective in both the corporate and investment spheres.

This paper aims to assess the critiques of short-termism and identify where such pressures may originate. Going further it also seeks to evaluate potential strategies to mitigate such pressures with the aim of encouraging a more long-termist investment and business culture.

Section two

Corporate Short-Termism: The Evidence

In his work, *The State We're In*[2], Will Hutton looked in detail at the role and relationship between corporate Britain, the Banks, and the City. One of his key conclusions was that an excessive focus on liquidity mitigated against both firms taking a long term view and on the development of long term relationships between investing institutions and firms: "*There is a permanent bias in the British system to lack of commitment – and from this all else flows.*" We can identify at least four key concerns with short-termism and the consequences this has for firm behaviour:

- Companies place a premium on stable cash flows, high security and high returns to pay high dividends to shareholders in order to secure the firm against predatory take-over. Technical innovation and building long term market share become secondary objectives;
- The focus by banks on short term profits and puts further pressure on companies to rely on retained income, which in turn re-emphasise the need to make high returns;
- Mergers and acquisitions are preferred over long term organic growth, but while mergers undeniably boost boardroom incomes and the short term income of some shareholders, they seldom improve shareholder value over the longer run or improve underlying firm performance;
- There is little encouragement to develop the long term relationships between lending institutions and firms that characterise some European and Asian economies or to establish institutions such as long term development banks.

Hutton went on to say: "British companies not only suffer one of the highest costs of capital in the world, but the febrile stock market compels them to earn a very big mark-up over even that cost of capital to fend off the threat of takeover and keep their shareholder base stable. This in turn means UK business invests less than its competitors, especially in long-term projects such as R&D."

In 2001 the CBI and the TUC were invited by he Chancellor to submit a report to the government's productivity initiative. The report recognised that the issue

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[2] *The State We're In*, Will Hutton, 1995

of short-termism and investment was still a major concern. The report made a number of recommendations on investment. These included:

" Government, business and unions must work together to ensure that decision-makers realise fully that the more stable economic environment offers the chance to move away from the UK's culture of short-termism."

"There is scope for improvement in communication and understanding between finance (the City) and industry. Firms need to get the right messages across to investors and the group supported suggestions of a move away from too much concern with short-term fund management performance and accepted the need identified in the Myners review to ensure well-informed trustee bodies"[3]

As part of the evidence gathering, the CBI repeated the "hurdle rate" survey for the manufacturing sector first conducted in 1994 and quoted by Hutton as an example of the high returns and short-pay back periods that characterised industry at the time. In the past, the reluctance of business to invest was partly blamed on macro-economic instability, especially high and uncertain inflation, low profitability, and poor industrial relations measured by days lost in strikes. As these negative factors had all largely disappeared, it was anticipated the survey would show significant and positive changes.

The survey did indeed show that some firms had dropped their rates of return and increased their payback periods, so relatively few firms were still using the very high rates mentioned by Hutton of 20 per cent or more. Similarly, significantly fewer firms setting very short pay-back periods of a year or less. The majority of firms showed at best modest and at worst no change in behaviour. Indeed, a minority of firms using nominal rates of return appeared to have increased their rate of returns since the 1990s.

- For those using simple payback to assess projects, the average payback period had increased from 2.7 years to 3.6 years. However, this movement was caused by just 10 per cent of firms revising their payback periods. The majority of firms - nearly 60 per cent of all respondents - still had a pay-back period of 3 years or less;
- For firms using a real required rate of return, thee was a significant cut in the average real rate being demanded – down from an average real rate of 16.4 per cent to 11.1 per cent. Again, however, most firms (just over 60 per cent) indicated no change in the return demanded.
- For firms using a nominal rate of return, again the average had fallen, with the average falling from 16.8 per cent to 11.8 per cent. However, the share reporting a cut (29 per cent) was almost balanced by the share reporting an increase (24 per cent).

[3] *The UK Productivity Challenge: CBI/TUC Submission to the Productivity Review,* November 2001

The results have to be treated with a bit of caution for two reasons. Firstly, firms may not always apply these measures rigidly, using hurdle rates as a guideline rather than a rigid rule. Secondly, the survey covered only manufacturing, and 80 per cent of all business investment is carried out by service sector firms. However, other evidence suggests that short-termism remains an underlying factor in the UK's investment performance.

The Porter Review

The 2003 Porter Review concluded that while the UK had caught up the rates of investment in business investment of other OECD economies, this was not enough to close the gap in terms of capital intensity[4]. Porter concluded: "there is clear evidence that UK companies on average operate with a smaller capital stock and invest less in R&D than their peers in Europe and the United States."

The review concluded that whatever relative competitive gains the UK had secured in the past by deregulating and cutting tax rates, these were now exhausted not least because most OECD economies have also moved to liberalise product markets and reduce corporate tax rates.

As Porter put it, "the UK faces a transition to a new phase of economic development. The old approach to economic development is reaching the limits of its effectiveness and government, companies and other institutions need to re-think their policy priorities." Porter argued for a new investment-led competitiveness agenda, one based on moving from the UK as a low cost business location to a location competing on unique value and innovation. The report concluded: "This transition requires investments in different elements of the business environment, upgrading of company strategies and the creation or strengthening of new types of institutions."

Porter looked at the role of the financial markets. He recognised that the City was one of the world's most competitive and sophisticated financial sectors, and that by European standards UK venture capital was well developed. However, Porter repeated some of the concerns highlighted by previous critics: "While equity financing is competitive, it tends to be more expensive than debt financing. There are signs that debt financing is not as competitive. Investments of UK companies react more strongly to cash-flow changes, indicating constrained access to external financing".

Economic performance, investment and productivity

The recent OECD assessment of the UK economy confirmed that the UK economy has done well over the past decade, with GDP per head overtaking other major economies such as Germany, France and Italy.

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[4] *UK Competitiveness: moving to the next stage*, DTI Economics Paper NO. 3, Professor Michael E Porter and Christian H M Ketels, May 2003

"Over the last decade macro-economic performance has been impressive: GDP growth has been robust and cyclical fluctuations in output have proved smaller than for almost any other OECD economy; whilst inflation has remained close to target. This performance is a testament to the strength of the institutional arrangements for setting monetary and fiscal policy as well as to the flexibility of labour and product markets."[5]

However, the OECD warned against complacency, noting that the relative improvement partly reflected lacklustre performance in the European economies. Moreover, much of the relative improvement in overall prosperity (GDP per head) came from a strong labour market performance and UK productivity remained a weakness. The most recent comparison on productivity measured on output per hour shows the UK has made modest progress since 2000 in closing the gap against France and Germany and none at all against the US. However, since 2002 there has been no relative improvement against other major economies.

Productivity Compared 2000-2005

Output per hour	UK	US	France	Germany	G7 (exc UK)
2000	100	117	134	121	111
2001	100	116	135	119	111
2002	100	112	131	116	106
2003	100	114	131	116	107
2004	100	116	129	116	108

Source: Office for National Statistics

More recent figures on business investment suggest there is still an underlying problem. Over the past five years levels of business investment have grown in real terms by less than 5 per cent. Yet domestic demand has been strong, inflation has remained low and stable and profitability however measured has remained at historic highs and compares well with other economies.

Business Investment and Corporate Profitability 2000-2005

	Business investment (£ billion)	Profitability (net rate of return)
2000	108	12.4%
2001	110	11.8%
2002	110	11.7%
2003	108	12.2%
2004	111	12.7%
2005	113	12.8%*

Note: first three quarters average, non-oil corporations. Business investment real terms chained volume, 2002 prices

Source: Office for National Statistics

[5] *OECD Economic Surveys, UK, November 2005*

Research and Development

Recent research has confirmed that there appeared to be a link between the financial system and investment in innovation, specifically that UK firms encounter financial constraints on investment in R&D which are not faced by German companies. The researchers concluded that their evidence was "consistent with the hypothesis that British firms face significant financial constraints and suggests the British financial system may discourage some firms from engaging in R&D."[6]

Latest figures suggest UK business investment in R&D still lags key competitors. Business Enterprise R&D (BERD) accounted for just over 1.2 per cent of GDP in 2003 in the UK compared with 1.8 per cent of GDP in Germany and the United States and 1.4 per cent in France. There is little sign of catch-up in these figures in recent years. Latest figures for the UK for 2004 suggest business expenditure fell, both in real terms and as a share of GDP.

Business Expenditure on R&D (BERD) 1997-2003

% of GDP	UK	Germany	United States	France
1997	1.2	1.5	1.8	1.4
2000	1.2	1.7	2.0	1.4
2001	1.2	1.7	2.0	1.4
2002	1.2	1.7	1.9	1.4
2003	1.2	1.8	1.8	1.4
2004	1.1	-	-	-

Note: OECD definitions. BERD includes R&D funded by government and R&D funded from overseas carried out within UK enterprises; and excludes business funded R&D in the public sector and R&D carried out overseas.

Source: Economic Trends August 2005.

Investment in R&D will not capture all innovative activity carried out by firms, especially in services. However, we are sceptical that even taking this into account would change the UK's relative ranking significantly, as the same must also be true for other advanced economies.

This does not of itself prove that the system of finance is part of the problem. But it is no longer possible to blame the traditional scapegoats for under-investment of macro-economic instability and high and volatile inflation, lack of corporate profits, or even the state of industrial relations. Nor is it plausible to blame high corporate tax rates or excessive regulation – the UK remains one of the least tightly related economies in the OECD.

Some businesses have been under pressure from pension fund deficit and it has been said that this is inhibiting investment. The historical record, however, suggests there is no systematic relationship. A recent study by Bank of England

[6] *Investment in R&D and Financial Constraints in Britain and Germany*, Bond, Harhoff and Van Reenen, IFS December 2003

economists concluded that between 1983 and 2002: "we find only weak evidence that firms reduce investment in a statistically significant way when pension contributions are increased, implying the adjustment to balance sheets is most likely to come through financial rather than real channels. Our results imply that companies that seek to tackle under-funding of DB schemes by raising their contributions could pay lower dividends than they otherwise would have. There is no conclusive evidence of an impact on investment across all firms, although there may be an impact for some individual companies, particularly if they are unable to adjust their dividend payout[7]."

The aggregate evidence suggests that despite some improvements since 1997 the weaknesses identified by Hutton, the CBI-TUC productivity study and the Porter Report still persist – low productivity and under-investment compared with many of our major competitors.

Growing businesses through merger and acquisition activity

The predisposition British business to expand through deals rather than organic growth also continues to attract critical attention. Merger and acquisition activity reduced dramatically at the time of the collapse in equity markets, but since then has recovered.

Such deals are usually justified by company management in terms of enhancing the position of the business in its particular market(s). By absorbing other organisations the company can achieve synergies and this, in broader terms, improves efficiency. The contrary views sees deals as a short-cut, an exciting alternative (for executives) to the more mundane path of understanding operating businesses and investing to grow in the long term.

Unions have often been critical of mergers because of the impact on employment. Putting two organisations together frequently results in duplication of certain functions, which, in turn, is often the road to redundancies.

"We believe it is essential that directors should be required to take action to protect the interests of stakeholders, particularly those of employees and suppliers, in takeover and merger cases. Mergers and takeovers provide one of the starkest examples of the 'winner takes all' side of the current company law regime. The decision in mergers and takeovers rests entirely with shareholders; yet employees in both the bidding and the target company are nearly always greatly affected by the merger, all too often paying for it with their jobs."

"It is argued that mergers and takeovers provide an important discipline on company management in the UK system. How effective the threat of hostile takeover is as a discipline on management is debatable. What is very clear,

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[7] *Corporate expenditure and pension contributions: evidence from UK company accounts*, by Bunn and Trivedi, Bank of England WP 276 October 2005.

however, is that even if this were the case the price of this form of discipline is too high."

"Repeated studies on the economic effects of takeovers have shown that they have little or no beneficial impact on performance. Some people may gain, principally shareholders in the target firm. But this is at the expense of other stakeholders, especially employees, rather than as a result of greater efficiency - the cake is being divided differently rather than enlarged."[8]

As a result we have called for the Monopolies and Mergers Commission to take account of the impact of employment and industrial competitiveness when considering bids that are referred to it. We have also called for the burden of proof to be shifted to the firm making the bid to demonstrate it would contribute in terms of factors such as employment and competitiveness[9].

More recently there has been analysis of the difficulties and time involved in merging different organisations with distinct cultures and histories, and the implications this has for performance.

Intriguingly merger and acquisition activity is also often not in the interests of shareholders in whose name it is typically carried out. Company management frequently justify deals in terms of generating shareholder value. Yet much analysis of deals done suggests that frequently mergers destroy value for shareholders.

KPMG carried out two studies – in 1999 and 2002 – that attempted to measure whether shareholder value was delivered in deals. The results from the first study were surprising in terms of the perceptions of directors and how far these views were from reality.

"The survey found that 82% of respondents believed the major deal they had been involved in had been a success... When we measured each one against our independent benchmark, based on comparative share performance one year after deal completion, the result was almost a mirror opposite. We found that only 17% of deals had added value to the combined company, 30% produced no discernible difference, and as many as 53% actually destroyed value. In other words, 83% of mergers were unsuccessful in producing any business benefit as regards shareholder value."[10]

When the survey was repeated in 2002 the picture was better, but still only 34% of deals were said to enhance value for the acquirer's shareholders. Even if the definition of delivering value was restricted to post-merger performance

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[8] *Economy - The Strategic Framework: A Consultation Document from The Company Law Review Steering Group - A TUC Response*, page 19, TUC, May 1999
[9] *Your stake at work: TUC proposals for a stakeholding economy*, page 11, TUC, 1996
[10] *Unlocking Shareholder Value: The Keys To Success*, KPMG, 1999

only there was only success in 52% of cases[11]. In other words half of the deals analysed either failed to deliver or actively destroyed shareholder value.

The management consultant McKinsey's found similar evidence. Having reviewed 160 mergers between 1992 and 1999, it discovered that only 12 of the merged groups succeeded in lifting organic growth above the trends before the merger; the other 148 failed.[12]

So not only are mergers often bad for union members as employees, they frequently have a negative impact on them as investors too.

Is short-term pressure part of the problem?

Is there evidence of a link between our obsession with short-termism and our reluctance to invest? Alfred Rappaport believes there is:

"A recent survey of 400 financial executives shows that the vast majority view earnings as the most important performance measure they report to outsiders (Graham, Harvey and Rajgopal 2004) … Companies delay or forego value-creating investments to meet consensus earnings expectations. Although such actions improve the current period's reported earnings, they reduce the company's earnings potential and value. Graham et al reported a startling 80 per cent of survey respondents would decrease discretionary spending on research and development, advertising, maintenance, and hiring to meet earnings benchmarks and more than half would delay a new project even if it entailed giving up value."[13]

This study is reviewed in more detail in the next section.

John Kay argues that investors and companies have become closer in the past two decades, but in a dysfunctional way. Rather than focusing on business strategy, analysts focus on anticipating what the company will announce. This may lead companies to manipulate the process to present their affairs in the most flattering possible light[14].

Whilst some would argue that having an immediate focus on shareholder value may be a useful discipline for company management, it may also provide an incentive to manage the indicator at the expense of long-term success. The potential for this has been well described by John Plender.

"The bizarre irony here is that the shareholder value movement has ended up replicating the errors of socialist planners in the old Soviet Union who imposed targets on industrial managers that were frequently met by fiddling the figures

[11] *Beating the Bears*, KPMG, 2002
[12] *What Europe can teach Uncle Sam*, The Guardian, April 2002
[13] *The Economics of Short-Term Performance Obsession*, Alfred Rappaport, page 69, Financial Analysts Journal, 1 May 2005
[14] *Why a Long Term Approach is Best for Companies*, John Kay, Financial Times, 14 July 2004

or doing damage to some other aspect of the business. By fixing on a single managerial incentive – the share price – the Anglo-American system has encouraged management to maximize short-term profits at the expense of longer term growth. When managers found that they could not generate enough short-term profit to satisfy investors and stock market analysts in the bubble period, they resorted to takeovers as a means of keeping one step ahead of the baying hounds of the financial community. And when takeovers became more difficult to pull off in the depressed stock market conditions that followed the bubble, they took to window-dressing the figures either within the rules or fraudulently as at WorldCom." [15]

At an individual firm level an interesting 'insider' critique of the relationship between companies and capital markets is provided by Don Young and Pat Scott, two former directors of Redland Plc, in their book *Having Their Cake*[16]. In it they describe how the company's management gradually became more fixated on pleasing the capital markets than on what was actually good for the business in the long term. Greater importance was placed on knowledge of corporate finance than operating knowledge of the various businesses in the group. The result was a series of acquisitions that pleased analysts at the time but ultimately failed to deliver.

Michael Skapinker quotes no less a figure than Hans Eichel, former German Finance Minister, as saying: "There are reasons to think about regulations that do not favour people making quick money and moving on."

Skapinker notes the opinion of the late Sumantra Ghoshal of the London Business School, who argued that employees were far more important to corporate success than shareholders and were the true risk takers. After all, most shareholders can sell their stocks much more easily than most employees can find another job[17].

Sheila Nicoll puts the opposite argument, however: "Boldness is the word. Too many directors hide behind the anticipated 'short-term' reaction of the City of London as an excuse for diluting action … The share price volatility that directors complain of simply reflects the diversity of equity investors: the punters and traders as well as the longer-term owners. If they are confident in their business's prospects, and not too worried about their share options, they will know that the positive news will be reflected in the share price over the longer term."[18]

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[15] *Going off the rails: Global Capital and the Crisis of Legitimacy*, John Plender, page 244
[16] *Having Their Cake: How the City and Big Bosses are Consuming UK Business*, Don Young and Pat Scott, 2004
[17] *The Excessive Power of the Uncommitted Shareholder*, Michael Skapinker, Financial Times, 27 April 2005
[18] *Business Leaders Cannot Duck Sykes*, Sheila Nicoll, Financial Times, 21 June 2004

The relationship with investors

The analysis above suggests that companies may feel short-term pressures from investors, and that this might lead to certain behaviours. These include low internal investment and R&D spending, deferring the initiation of projects, or seeking to grow through merger and acquisition activity. As we have seen, a range of commentators attribute such behaviour to the nature of the relationship between companies and their shareholders.

It is certainly true that the company-shareholder dynamic is an important one in the UK economy. It is also more complex than might first appear. There must be reasons why, for example, shareholders seek short-term performance. Some of them at least must be aware of implications this may have for long-term success, and shareholder value. In short it is important to understand what drives investors. In the next section we consider the nature of the various relationships within the investment system.

Section three

Institutional Investment and Short-Termism

The structure of ownership

It is useful to begin with a very brief overview of the structure of share-ownership of UK companies[19]. Not all shareholders are the same, or are looking for the same thing from the companies in which they invest, so it is helpful to understand the current breakdown of ownership.

Beneficial ownership of UK shares at end of 2004

Investor category	% holding
Rest of the world (overseas investors)	32.6
Insurance companies	17.2
Pension funds	15.7
Individuals	14.1
Unit trusts	1.9
Investment trusts	3.3
Other financial institutions	10.7
Charities, churches etc	1.1
Private non-financial companies	0.6
Public sector	0.1
Banks	2.7

Source: *Share Ownership: a report on ownership of shares as at 31st December 2004*, ONS

As can be seen from the table above, a third of the shares of UK companies are now held by overseas investors. These are typically institutional investors including large public sector pension funds in North America and Europe, and mutual funds. The two big classes of institutional investors, the insurance companies and pension funds, own a third of shares, and overall domestic institutions account for around a half. A relatively small proportion is held by individuals. This contrasts with the earliest available comparable figures from 1963 when individuals held over half of UK shares.

The important insight to draw from this is that the significant majority of shares are held by large collective investment vehicles representing the capital of millions of working people. The public are in large part the owners of

[19] A longer analysis of changes in share-ownership, and its implications, is available in a previous paper, *Trading places: Changes in the share-ownership of UK companies*, TUC, September 2005

British business. The very victims of corporate short-termism are the providers of the capital invested in those companies.

Where short-termism may occur

Having established very broadly who the shareholders of British businesses are, attention should next turn to where short-term pressures may arise within the investment market.

In fact, criticism of short-termism has been voiced in relation to a range of the basic components of the investment system. Pension funds and their trustees may be too concerned with relative performance over a short time period. Fund managers may be trading in and out of companies too much in response to short-term news or views. The growing use of hedge funds as part of pension funds' investment strategies may be reducing investor time horizons even further. Analysts may be taking a short-term view of a company's prospects, or losing touch with the long-term drivers of success.

We begin by looking at the relationship between fund managers and their clients.

It is important to make clear that much of the debate around short-termism in the relationship between fund managers and their clients relates to the perceptions the different actors have. It is valuable to consider the views that fund managers and their pension fund clients express on the issue. There is some existing analysis of short-termism, and some difference of opinion.

In 2004 the National Association of Pension Funds (NAPF) and the Investment Management Association (IMA) surveyed their members to ascertain pension fund practice in relation to mandates, and the views of pension funds and fund managers on short-termism[20]. The NAPF's commentary on the results was that they proved that there was no evidence that managers were sacked on the basis of short-term performance.

However, some of the findings do suggest that pension funds, at the least, give the impression to fund managers that they take short-term performance very seriously. For example, the research found that 70% of NAPF members review fund manager performance either quarterly or monthly (although the overwhelming majority of this 70% have reviews on a quarterly basis). Trustees also put performance at the top of the list of issues they monitor fund managers on.

Some of the research carried out in support of the implementation of the Myners Review reinforces the message that there are performance pressures on fund managers coming from their pension funds clients. A DWP study found that almost of third of schemes gave investment managers 12 months or less to achieve performance targets.

[20] *NAPF/IMA Short-termism Study Report*, September 2004

Shortest timescale set for Investment Managers to achieve performance targets when current contract(s) were issued

Shortest timescale	All	Small schemes	Large schemes
12 months or less	29	32	20
13-24 months	8	9	6
3 years	37	29	58
4 years or more	3	4	0
Don't know	23	25	15

Source: The Myners Principles and occupational pension schemes, volume 2 of 2, DWP Research Report 213, page 114, 2004

Notably perceptions of the potential for short-termism resulting from such arrangements were significantly different between pension funds and their appointed fund managers. In the NAPF/IMA study most NAPF members disagreed with the assertion that the way mandates were structured promoted an unduly short-termist approach. In stark contrast most IMA members agreed with the statement.

This suggests that whilst fund managers' clients may not believe that they are exerting short-term pressure, the signals they send through regular reviews of performance and the primary importance of performance in such reviews are significant. If one adds to this the reality that the most common reason for the termination of a mandate is poor performance then it is easy to appreciate the views expressed by fund managers. Trustees may be sending far stronger short-term signals than they realise.

The views of fund managers

If we look more closely at what fund managers say themselves, it is clear they feel there are short-term performance pressures from clients that influence decision-making, even if the clients do not, apparently, believe they are exerting such pressure.

"External pension fund managers, unit trust and unit-linked managers are under constant and intense pressure to maximize current performance. The current quarter is what matters, perhaps the next quarter, certainly not next year's equivalent quarter. Confronted with the prospect of an uplift in the value of his portfolio from a bid, or a decline in performance as a company reports a short-term blip in an upward trend, the gut reaction of a professional fund manager will be to go for whatever enhances or protects his current performance figures."[21]

Such comments bear out the analysis of the Myners review.

[21] *The City: Inside the Great Expectation Machine*, Tony Golding

"If clients are – as at present – extremely vague about the time horizons over which managers' performance will be judged, managers will, perfectly rationally, assume that they *could* be dismissed after *any* quarter's performance."[22]

We do not need to rely solely on anecdotal evidence from fund managers themselves. Recent history in the pension fund market reveals how such pressure can work. Prior to the collapse in the UK equity market Tony Dye of PDFM took a bearish view on its level. However, the correction did not come as early as he had expected. Whilst PDFM waited for the crash its rivals continued to benefit from the last surge of the bull run. As a result PDFM performed poorly relative to its peer group.

Many in the pensions industry admired Dye for taking such a strong position on the level of the market, which earned him the nickname Dr Doom. However PDFM's poor relative performance became a matter of concern for its pension fund clients (although it should be noted that the manager was still generating a positive return). Ultimately dozens of pension funds reviewed their mandates with PDFM and chose to fire the manager.

The views of fund managers are again useful here.

"If an investment manager has model certainty (a hard thing to achieve) and the courage to be independent... does he/she have the time to be proven correct? Moreover, is it good for business? What is the pay-off? Will both clients and the asset manager's shareholders remain supportive?… There is tremendous pressure and incentive, because the potential rewards are significant, to find ways of generating good performance in the short term."[23]

It seems reasonable to conclude that PDFM's experience sent, or re-emphasised, a powerful message to other fund managers that poor relative performance was unacceptable even if a) there was a strong intellectual case for the fund manager's position and b) the fund manager was still generating a positive return. It was safer to be wrong with the majority than to be right alone.

Ultimately of course the correction did come and, as a result of its bearish position, PDFM rose to the top of the performance rankings. It is debatable whether Dye was still 'wrong' rather than 'right' because he called the correction too early.

Equally the position of pension fund trustees who chose to remove PDFM from mandates is understandable in the current context. They were seeking to fund their pension scheme liabilities and better performance would clearly assist this process. The manager was no doubt failing to meet its benchmark in

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[22] *Institutional Investment in the UK: A Review*, page 88, HM Treasury, March 2001
[23] *The role of institutional investors in the boom and bust*, an essay featured in *Boom and Bust: the equity market crisis – Lessons for asset managers and their clients*, European Asset Management Association

many cases. However the example does point up some of the problems that result from the industry's focus on short-term relative performance.

Hedge funds

As the earlier comments of the CBI's John Sunderland indicate, there is concern that investor pressure for short-term results is actually increasing. Frequently criticism is directed at the practices of hedge funds.

It is a little misleading to speak of hedge funds as a specific asset class since each hedge fund is different and they can employ very different strategies, many not involving equities. However it is probably fair to categorise many of them as seeking to exploit short-term market trends to their advantage in order to generate returns. As even some fund managers have argued, this short-termism does not sit easily with the sense of shareholders as owners that the Government has been trying to develop.

Hedge funds are undoubtedly growing in importance. For a typical FTSE100 company meetings with hedge funds now account for about 20% of all investors meetings according to some estimates[24].

In addition one aspect of hedge fund behaviour that has attracted particular concern is the practice of short-selling. This strategy is employed when the hedge fund believes that the shares in a particular company are over-valued and/or likely to fall in value. The hedge fund borrows stock in the company from another investor with the aim of selling it and buying it back at a lower price. Short-selling has been widely criticised during the rise to prominence of hedge funds. In particular concerns have been expressed about the volatility this can cause for companies.

"The stock market is where people with an interest in backing companies meet people who need capital to develop their businesses. That is its reason for existence. Hedge funds and the prime brokerage activities of investment banks are turning the place into a casino where genuine long-term investors and companies are overwhelmed by their superior financial resources… Meanwhile they simply devastate the morale of managements who see share price movements that bear no connection to the work they are actually putting into a business."[25]

There are implications too for corporate governance, an inherently long-term consideration. The ability of hedge funds to short the stock of a particular company is dependent on the availability of the stock. As a result of the demand for stock over limited periods there has been a substantial rise in

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[24] *Hedge fund engagement with UK plcs*, page 4, Lintstock, May 2005
[25] Evening Standard, May 2004

stock-lending on the part of many large institutions. Many institutions report that they lend more than 10% of their portfolio annually[26].

TUC research suggests that the majority of institutions do not always recall stock for the purposes of voting. For example, in a significant number of cases fund managers only recall stock when there is a contentious issue to be voted on, or when they feel it would be in a client's best interest[27]. This is confirmed by other studies[28].

The TUC is aware of cases where pension funds have been unable to vote on contentious issues at AGMs because of stock-lending. In addition there have been cases of a surge in stock-lending in the run-up to particularly contentious votes, for example at last year's BSkyB AGM[29].

There are examples from the US of even more controversial practices. In one case a hedge fund bought a reasonably large block of a company's shares in order to obtain voting rights and help encourage its management to agree to a takeover of another company in which the fund was a shareholder. At the same time it prepared to short the bidding company's stock to avoid the expected fall in the bidder's shares if the deal was successful[30].

However it should be noted that there is evidence that the relationship between hedge funds and companies may be less disharmonious than is sometimes portrayed.

For example a study by corporate governance consultancy Lintstock issued early in 2005 found that many investee companies had a positive view of the business acumen of hedge funds, of their contribution to market liquidity of their 'corrective' influence on complacent management and were relatively unworried by their potential ability to wield significant power[31]. In contrast there was some criticism of some traditional so-called 'long-only'[32] fund managers.

Trustees

An important question at this point is where pension fund trustees fit into these relationships. After all, it is they who employ fund managers, and increasingly hedge funds, to generate returns for them. Investment consultants may provide them with performance figures, but it is ultimately the trustees who take the decision whether or not to act on them.

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[26] *ICGN study of share lending vis-à-vis voting*, page 3, Lintstock, May 2004
[27] *TUC Fund Manager Voting Survey 2005*, page 36, TUC, June 2005
[28] *ICGN study of share lending vis-à-vis voting*, Lintstock, May 2004
[29] *BskyB vote prompts calls for more scrutiny,* The Guardian, 5 December 2005
[30] *Know thy borrower*, BreakingViews.com, 12 January 2006
[31] *Hedge fund engagement with UK plcs*, Lintstock, May 2005
[32] Since traditional fund managers do not 'short' stock and over-weight in or 'go long' on stocks they favour they are sometimes given the pejorative label 'long-only'.

The TUC's own research into trustees' views on short-termism has generated some interesting results[33].

TUC email survey of pension fund trustees

Question	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
Fund managers put too much pressure on companies to deliver short-term results.	2	16	27	7	2
Trustees should be able to terminate fund managers' mandates early if there is persistent under-performance against the agreed benchmark.	27	22	3	2	0
Our fund manager's performance relative to other managers is not important provided they are meeting their benchmark.	3	30	6	14	1
Fund managers' clients, such as pension funds, put too much pressure on fund managers to deliver short-term results.	8	15	10	20	1

As the above table illustrates, just over a third of respondents to an email survey carried out by the TUC said they felt fund managers put too much pressure on companies for short-term results, with half of respondents neutral and well under a fifth disagreeing.

In contrast trustees were much more evenly split on the question of whether fund manager's clients, such as pension funds, were putting the managers under too much pressure for short-term results. Yet trustees also overwhelmingly supported the proposition that they should be able to terminate fund managers' mandates early, even though this may not sit easily with the Myners principle on investment explicit mandates[34].

Clearly of primary importance to the pension fund is whether the fund manager is meeting the trustees' expectations and helping with the job of funding the pension scheme. Accordingly a large majority of the survey respondents agreed that providing that the fund manager was meeting its agreed benchmark its performance relative to other managers was not important, but notably over a quarter disagreed with this proposition.

It is also worth reiterating that it is notoriously difficult to get the timing of manager replacements right. Several studies over recent years have shown that

[33] The TUC carried out an email survey of member trustees in January 2006. In total 54 trustees replied to the survey. Full results from the survey are included as an appendix.
[34] *"[There] should [be] a clear timescale(s) of measurement and evaluation, with the understanding that the fund mandate will not be terminated before the expiry of the evaluation timescale for underperformance alone."*

trustees tend to sack poorly-performing fund managers at the point at which performance improves, and appoint fund managers that are doing well at the point that their performance begins to decline. The most recent study was produced by Watson Wyatt.

"Watson Wyatt's report suggested that fund management performance is cyclical and that investors risk destroying value by chopping and changing. Watson Wyatt believes, that for fiduciary reasons, trustees are over-reliant on past performance when hiring new managers.

"The report found that the average annual outperformance of investment managers in the three years prior to the hiring quarter was 4.4 per cent. Once hired the managers' outperformance after one, two and three years was 'statistically indistinguishable from zero'."[35]

In short, even if trustees act on performance concerns by replacing their managers, this may well not result in improved returns to the fund.

The cost to pension funds

It should be clear from the preceding commentary that there are some existing concerns about short-termism in the field of pension fund investment. In many respects the potential problems result from the unintended consequences of an understandable desire to generate return to pay pensions. As such it might be argued that, whilst some of the outcomes are counter-productive, there are not sufficient grounds for serious concern.

However, it should be stressed that the increased pressure for short-term returns can also have a very real financial cost. For example, the trading of shares is not expense-free, and increased trading results in increased fees paid from fund managers to brokers, which in turn are passed up the chain from fund managers to pension fund clients. Trading costs eat into returns.

There has undoubtedly been an increase in trading activity, but it does not follow that this has been to the advantage of pension funds. Indeed Watson Wyatt has made the contrary point.

"[The growth in trading] has enriched the broking community and impoverished the *average* pension fund."[36]

This point can be particularly true of hedge funds, where fees and trading levels are often significantly higher.

"Investors generally pay a 2% management fee and 20% of returns. On top of this, hedge fund advisors typically charge around 1%. Trading costs, which are often large, are also carried by investors. Burdened with excessive charges,

[35] *Managers 'hired and fired at worst time'*, Financial Times, 16 January 2006
[36] *Remapping our investment world*, page 2, Watson Wyatt, October 2003

hedge fund managers need to excel just to provide mediocre returns for their investors."[37]

When performance is measured in relative terms this can mean that pension funds are charged performance-related fees by funds managers who have lost them money. Such examples have attracted criticism.

"[Trustees] could… mandate funds to deliver proper absolute returns, or real capital gains and income over the long term, as opposed to the fatuous stipulation that funds should lose less money than the market as a whole."[38]

These are not the only costs that pension funds bear. The business of hiring and firing managers also incurs costs. There will be fees for the investment consulting firm advising on manager selection, and there may also be transition management costs. Finally, as made clear earlier, trustees often hire and fire managers at the worst time, resulting in disappointing performance following a switch.

It is interesting to note that mainstream players within the pensions industry have raised the prospect that short-termism is creating problems for pension funds.

An investment report from Watson Wyatt issued in 2003 reached the conclusion that there were indeed issues to be dealt with: "Mainly for behavioural reasons, we conclude that [short-termism] is a real problem. These reasons include the pain of incurring losses, the desire for comfort, and overconfidence. The consequences are (1) that costs are too high due to too much trading, (2) that a comfort premium is paid to contrarian investors, and (3) that corporate governance, by necessity a long-term activity, is neglected thereby reducing returns to shareholders."[39]

So short-termism is not simply a functional problem for pension funds. It can have financial implications too.

Analysts and companies

Next we turn to the role of analysts in the investment system. There are two basic groups of analysts: the buy-side, who work in fund management houses, and the sell-side, who work for brokerage firms. Although both groups are ostensibly analysing the future prospects of companies, they have different positions in the system which may colour their judgment.

As the label implies, the sell-side analysts work for organisations that have a financial interest in promoting the prospects of companies they report on. Therefore concerns have been expressed that this relationship has an impact on what sell-side analysts report and how they report it.

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[37] *Alpha fees for beta performance*, BreakingViews.com, 6 January 2006
[38] *They have the power*, Robert Peston, Daily Telegraph, 3 July 2005
[39] *Remapping our investment world*, page 2, Watson Wyatt, October 2003

As Will Hutton has argued: "The incentives are for advice to generate activity, rather than for more long-term independent knowledge about the company to form investment decisions."[40]

Don Young and Pat Scott make a similar point: "Rather than simply being rewarded for the quality of their analysis, they began to be awarded bonuses on the deal flow for broking and banking."[41]

A more fundamental critique of investment analysis has been developed by Alfred Rappaport. He warns that even though investment professionals believe that discounted cash-flows (DCF) are in theory the right model for valuations, because such analysis is time-consuming and speculative, a focus on short-term earnings has come to dominate[42].

He argues that because investors can see that share prices react to surprises in relation to earnings, it becomes more rational to base analysis, and decisions, on earnings. The result, he claims, is a self-fulfilling prophecy that earnings are a better guide to prices.

This has implications in terms of the efficiency of capital markets. Rappaport argues that markets might exhibit 'informational' efficiency, with all known information factored into share prices, in turn meaning investors are unable to outperform the market over a prolonged period. However the market may demonstrate 'allocative' inefficiency because decisions regarding capital allocation are not being made on the basis of sound valuations.

"Because forecasting cash flows is considered speculative and costly… much of what is known today as fundamental analysis entails the use of shortcut metrics—price/earnings, price/ sales, and price/book multiples—that sidestep direct forecasts."

"Analysts typically use the metrics comparatively. They attempt to identify investment opportunities by comparing, for example, P/E multiples of companies within the same industry and taking into account differences that warrant higher or lower multiples. Such relative valuation exercises make no effort to independently estimate the absolute value of stocks and thereby *make no direct contribution to allocatively efficient prices*."[43]

He is therefore sceptical about the efficiency of allocation through the price mechanism in capital markets.

"The pervasive use on non-DCF investment models makes it difficult to conclude that prices are allocatively efficient. Nevertheless, we would not be

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40 *The State To Come*, page 70

41 *Having Their Cake: How the City and Big Bosses are Consuming UK Business*, page 71, Don Young and Pat Scott, 2004

42 *The Economics of Short-Term Performance Obsession*, Alfred Rappaport, Financial Analysts Journal, 1 May 2005

43 *The Economics of Short-Term Performance Obsession*, Alfred Rappaport, page 67, Financial Analysts Journal, 1 May 2005

prudent to entirely dismiss the possibility that the *aggregation* of many investors with diverse decision rules and information sets can somehow discover allocatively efficient prices in an Adam Smith invisible-hand fashion."[44]

There are also concerns that some analysts are beginning take an even more short-term view than in the recent past, and once more hedge funds are seen as part of the reason.

"I have, if anything, seen analysts becoming more oriented to the short-term in the past three and a half years. This appears to be driven by the hedge funds with their nearer term horizon and by the fact that they control a bigger share of the commission pot. Occasionally, I even hear complaints from the buyside that the quantity of longer term research from the sellside has diminished."[45]

At the risk of stating the obvious, if investors such as hedge funds are trading in and out of companies over shorter timescales this must have an impact on the kind of information about companies that they are demanding from analysts. An investor willing to buy and hold will be more interested in long-term drivers of success than one seeking to take advantage of immediate market trends. The short-term perspective often comes to dominate.

"The shorter the holding period, the more the beliefs of others rather than long-term fundamentals become central to investment decisions. High turnover thus sets the stage for short-term earnings-based decision making or momentum-motivated trading, which is not at all concerned with earnings."[46]

This leads on to a wider criticism of investment analysis, as produced by either the buyside or sellside, namely that it fails to pick up on some of the long-term drivers of successful businesses. Some critics argue that because of the narrowly financial interpretation analysts make of companies they miss out on the importance of so-called extra-financial issues such as employment relations and work organisation, environmental management, health and safety and so on.

Criticism of the failure of analysts to analyse such factors properly, as opposed to in a 'tick box' fashion, has been voiced by the business community.

"I would be much more convinced by an investor who showed that he had worked out the relationship between the effectiveness of say, our HR policies for our performance, rather than by the kind of analyst who asks whether we are complying with a long list of international SRI standards. I am not

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[44] *The Economics of Short-Term Performance Obsession*, Alfred Rappaport, page 68, Financial Analysts Journal, 1 May 2005

[45] Fergus MacLoed, BP's Head of Investor Relations, quoted in *Extra-Financial Issues in Investment Research*, AQ Research, 2005

[46] *The Economics of Short-Term Performance Obsession*, Alfred Rappaport, page 66, Financial Analysts Journal, 1 May 2005

convinced investors have integrated human factors and their relationship risks into their model of the successful business."[47]

There are two reasons to be concerned about such gaps in investment analysis. First, from a purely self-interested perspective, it may leave investors open to risks. By failing to appreciate how certain extra-financial factors contribute to either the success or failure of certain businesses this may provide shocks later on. Second, it means the market is failing to send signals to businesses about the impacts of their behaviour. If investors do not analyse such issues it can mean that, in the short term, poor corporate behaviour may be financially beneficial, even though it is destructive in the longer term.

"Short-termism is a problem… because the benefits of exploiting harmful market failures are often immediate – they arise from current market transaction. However, the costs of acting irresponsibly accrue only over the long-term. It takes time for regulatory and social sanctions to impose costs on companies."

"If boards put too much weight on the short-term benefits of strategies and too little on their long-term consequences, they may end up backing strategies that are both irresponsible and value-destroying. The challenge for boards is to give due weight to long-term outcomes in approving strategy. This can be difficult to do if the company's shareholders are themselves over-emphasising short-term performance."[48]

Investment analysis plays an important role both in helping investors understand the prospects for companies, and in sending market signals to companies about the issues which are seen as important. A trend towards greater short-termism in analysis may subvert both these functions.

Forward-looking reporting

One point in defence of analysts is that they are, to a greater or lesser extent, dependent on the information provided to them by companies. Much of this is derived from company reports, including the annual report and accounts.

Unfortunately much of this information is backward-looking (it refers to activity already undertaken) and is narrow in focus. Even where companies report on corporate social responsibility issues, as they increasingly do, these are typically treated as an add-on to the main business of reporting.

The TUC, along with many others, was therefore very supportive of the Government's attempt to improve the quality of reporting. Under the auspices of the Company Law Review significant progress was made in bringing

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[47] CBI President John Sunderland's speech to Investor Relations Conference, 21 April 2005
[48] *Rewarding Virtue: Effective Board Action on Corporate Responsibility*, pages 21-22, a report of a joint inquiry by Insight Investment, Business in the Community and the FTSE Group

together business, stakeholders and investors to try and develop more strategic, holistic and forward-looking reporting by companies. The result was the proposed mandatory Operating and Financial Review (OFR). Whilst the TUC would have preferred the OFR to go further, as it stood it represented a major step in the right direction.

Therefore we were extremely disappointed by the Government's decision to scrap mandatory OFRs, particularly without any prior consultation. We believe this can only hinder the development of proper long-term engagement between companies and shareholders, and the Government should consider revisiting company reporting as an area for reform.

The linkage to companies

The most important question is, of course, whether the short-termism (real or perceived) in the investment system is having a negative impact on the companies in which shareholders invest.

It does seem that directors expect to have to have to manage at least certain elements of the business performance to meet investor expectations. Such pressures have been picked up by recent academic analysis of how directors view company performance measurement and reporting. One major US study surveyed several hundred executives on factors that drive their decision-making, particularly relating to financial reporting[49].

The study found a very clear picture of directors wanting to meet the benchmarks expected by investors. An overwhelming majority of executives believed that meeting earnings targets built credibility with the capital markets with a slightly lower but similarly large number saying they thought it helped maintain or increase share price. Another incentive to hit earnings targets is career reputation. The research found that most chief financial officers felt that failure to hit targets would be seen by the executive labour market as 'managerial failure'. Repeatedly failing to hit targets could therefore damage a director's career.

"Several CFOs argue that, 'you have to start with the premise that every company manages earnings.' To be clear, these executives are not talking about violating GAAP or committing fraud. They are talking about "running the business" in a manner to produce smooth, attainable earnings every year (unless, of course, they are in a negative tailspin, in which case efforts to survive financial distress dominate reporting concerns). This entails manoeuvres with discretionary spending, changing the timing and perhaps the scale of investment projects, and changing accounting assumptions."[50]

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[49] *The Economic Implications of Corporate Financial Reporting*, Graham, Harvey and Rajgopal, January 2005

[50] *The Economic Implications of Corporate Financial Reporting*, Graham, Harvey and Rajgopal, page 14, January 2005

The finding of perhaps most concern was that many directors would not initiate projects, even if they would generate value for the company, if this meant that they would fail to meet an earnings target. In a specific scenario only 59% would initiate a project if it mean they undershot the analysts consensus estimate.

"Corporate executives point to the behaviour of market participants to justify their short-term focus and their belief that investing for the long-term is not rewarded by higher stock prices. This bias is reinforced by incentive compensation plans that reward short-term financial performance."[51]

As a senior figure in the fund management industry has commented, the one thing you are sure to find on a chief executive's desk is a screen tracking the company's share price[52]. Although arguably this may be a useful discipline for senior executives, equally it may focus them on the wrong measure and the wrong timescale.

It is also noticeable that executives seem to draw a much stronger causal link between their actions and movements in share price than many investors do. It is clear that share prices are driven by a wide range of factors, even psychological ones, and many fund managers seem wary of attributing movements to one specific factor. Senior executives sometimes seem to have a much narrower interpretation of shareholder value creation, and one which sees just a few levers that can be pulled to affect share price. In contrast they appear to feel that corporate governance, a key issue for an increasing number of investors, has limited shareholder value[53].

There is an interesting link back to pensions if one considers the relative importance directors attach to funding their own schemes as opposed to paying dividends. According to a survey by actuarial firm Lane Clark & Peacock (LCP), companies in the FTSE100 paid out four times as much in dividends in 2004 as they contributed to their own pension funds[54].

The study found that the 100 biggest UK companies paid out £39bn in dividends to shareholders in 2004 - almost four times more than the £10.5bn they paid into their final salary pension schemes, and £2bn more than the £37bn pension funding shortfall they collectively face based on LCP's estimates. Of course many shareholders are themselves pension funds, meaning that those firms prioritizing dividends are in part helping to fund the pension scheme of other companies.

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[51] *The Economics of Short-Term Performance Obsession*, Alfred Rappaport, page 69, Financial Analysts Journal, 1 May 2005

[52] Conversation with the TUC, 2004

[53] *Benefits of code compliance doubted*, Financial Times, 23 January 2006

[54] *FTSE 100 Pension deficits remain frustratingly high says Lane Clark & Peacock*, press release, 10 August 2005

Misallocation of capital

Looking more broadly, it is important to consider the aggregate impact investor short-termism can have in the failure to effectively allocate capital via the stockmarket. Again the views of fund managers are informative.

"When Vodafone acquired Mannesman, many investment managers took the view that it made sense to increase their holding even though they believed the shares to be expensive and likely, eventually, to fall in value. The same managers became ever more likely to invest in TMT stocks the more expensive they became. Why? Because to be underweight in these investments without the certainty of being proved right, created significant business risks if the impact on short-term *relative* performance was serious and if the Principal took a dim view of the way his funds were being managed. Failing conventionally when managing a portfolio can sometimes lead to an acceptable outcome for an investment manager's business."[55]

In other words, in situations such as the TMT bubble, fund managers have not felt they had the freedom to allocate capital in line with their beliefs about the merits of investee companies because of the need to maintain relative performance.

As another essay on the development of the bubble suggests, fund managers' decision-making became distorted when faced with the need to react to rocketing TMT stocks. It argues that fund managers effectively reduced their focus on actual investee companies, and instead shifted it onto second-guessing their rivals, compounding the deterioration in decision-making[56]. This is of course the 'beauty contest' scenario described by Keynes[57].

Wisdom is easy with the benefit of hindsight, but it is hard not to view the TMT bubble, and the subsequent correction, as a serious failure in the functioning of the capital markets. It resulted in the misallocation and loss of

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55 *The role of institutional investors in the boom and bust*, an essay featured in *Boom and Bust: the equity market crisis – Lessons for asset managers and their clients*, European Asset Management Association

56 *Excessive volatility or uncertain real economy?,* an essay featured in *Boom and Bust: the equity market crisis – Lessons for asset managers and their clients*, European Asset Management Association

57 *"Professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one's judgement, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest."* J M Keynes, *The General Theory of Employment, Interest and Money*, 1936

billions of pounds of workers' capital, with knock-on effects on the jobs and retirement savings of tens of thousands of working people.

It is notable that in the US there has already been debate around the implications of the recent bubble.

"The valuation of the stockmarket is an important national – and international – issue. All of our plans for the future, as individuals and as a society, hinge on our perceived wealth, and plans can be thrown into disarray if much of that wealth evaporates tomorrow. The tendency for speculative bubbles to grow and then contract can make for very uneven distribution of wealth. It may even cause many of us, at times, to question the very viability of our capitalist and free market institutions. It is for such reasons that we must be clear on the prospect for such contractions and on what should be our individual and national policy regarding this prospect."[58]

US unions have also contributed to the critique. For example, a report by the Centre for Economic and Policy Research commissioned by the United Steelworkers of America highlighted a string of failures in the investment system that it estimated resulted in the misallocation of between $70bn and $90bn to the TMT sector[59].

"[W]hile the market as whole was over-valued, some stocks were more over-valued than others. The most over-valued companies were the tech stocks and dot.coms, many of which never even made a profit, even though they had market valuations in the billions of dollars. These companies were effectively able to raise capital through the market at almost no cost. As a result, investment was diverted from more productive sectors of the economy to the bubble sectors. Much of this investment can now be recognized as having been wasted, leading to capacity that may never be used."[60]

No similar critique has emerged from British trade unions but there is no reason why this should not happen. Indeed, given the scale of misallocation of capital that occurred, this might be actively considered.

Looking ahead – changes in pension provision

A final issue to briefly consider is the impact changes in pension provision may have on pressures within the investment system.

The pressure on fund managers for short-term performance may increase with the widespread shift to defined contribution (DC) pension provision amongst companies. In a defined benefit (DB) scheme the trustees can, in theory at least,

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[58] *Irrational Exuberance*, page 204, Robert Shiller, 2000
[59] *Mismanaging Money: the Investment Practices of the Pension Fund Industry*, page 3, Centre for Economic and Policy Research/United Steelworkers of America, April 2003
[60] *Mismanaging Money: the Investment Practices of the Pension Fund Industry*, page 16, Centre for Economic and Policy Research/United Steelworkers of America, April 2003

seek to look at performance over the longer term. Because most such schemes will be in existence for decades to come, until the last beneficiary has died, investment strategy can be set with a longer-term perspective. Most importantly, for the individual, performance is generally not an issue as the sponsor in theory shoulders the risk.

In contrast in a DC scheme the member bears all the investment risk. Poor returns inevitably result in smaller pensions. In addition the ultimate time horizon is the individual's working life. They may not feel they have time to wait for poor performance to turn around and hence may be more inclined than a trustee to replace a poorly-performing fund manager. In addition it seems certain that demand for certain alternative asset classes will be affected[61].

The obsession with performance is already even more marked in the retail fund management sector than its institutional counterpart. Much DC marketing makes a big point of the ability of members to change their investments regularly, and retail fund management advertising relies heavily on performance. This surely points to an even greater focus on short-term figures in future and, in turn, more churning amongst fund managers.

Reform

As should be clear from the preceding analysis, there are several areas within the investment system where concerns about short-termist pressures have been expressed. The potential outcomes from such pressures vary widely from inefficient decision-making by trustees, to increased trading costs, to inefficient allocation, and misallocation, of capital. There is also substantial commentary, and growing academic research, bearing out such concerns.

The efficient and productive functioning of the relationship between companies and investors is important both in creating and maintaining good businesses, and in funding retirement incomes for working people. If there are genuine short-term pressures within the investment system, which subvert the relationship and lead to negative outcomes, then it is not enough to assert that capital markets are naturally volatile and that intervention maybe misplaced.

This is an area where the potential for reform should be evaluated.

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[61] "*Another factor which could have a significant impact on the flow of pension fund money into private equity is the gradual move from defined benefit pensions to defined contribution pensions… [DC scheme] members are unlikely to be fully aware of venture capital or how to measure its associated risks. This lack of knowledge, together with the difficulties involved in investing very small amounts of money, will not be conducive to investment in venture capital.*"
Finance for Small Firms – Seventh Report, page 55, Bank of England, January 2000.

Section four

Addressing Short-Termism

Having identified some of the problems, it is time to consider some possible solutions. Before doing so, it is necessary to accept the fact that, however we got here, the UK economy has a very different structure to some others. It may be desirable to introduce root and branch change, but that may not be possible.

For example, as Wendy Carlin points out in *West German Growth and Institutions, 1945-1990*, in Germany, only about one-fifth of turnover in the economy is accounted for by public joint stock corporations[62]. This contrasts with the UK, where at least 53% of turnover is accounted for by public companies. Even in public companies, share holdings are much more concentrated in Germany than in the US or UK. In the 200 largest listed German companies, almost 90% of firms had at least one shareholding of at least 25%. In the UK, by contrast, in more than four-fifths of the largest 200 listed companies, the largest shareholding was below 25%.

Hutton says: "Industries perform best as dense clusters of competing firms, creating highly skilled labour forces and transmitting information about new techniques between them. They collaborate as well as compete. Investment in new techniques may mean deferred profits and slow growing dividends; but serious industrialists know that the end result will be upgraded production and a capacity to move into higher-value-added markets. These are industrial rather than financial values."[63]

Wendy Carlin also notes that in the German system, large companies have a supervisory board which is obliged to monitor the management board. This supervisory board will typically include stakeholders such as other companies, banks and employees, who may be represented by their trade unions. This type of governance is more likely to promote investment in human, intangible and physical capital that is specific to enterprises and their long-term relationships with related companies.

Will Hutton says: "British institutional shareholders are not bound into the company's strategy through a skein of social and legal commitments such as the German supervisory boards or Japanese *keiretsu*."

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[62] *West German Growth and Institutions, 1945-90*, Wendy Carlin, Cambridge University Press, 1996.
[63] *The State We're In*, Will Hutton, 1995

That may be true, but works councils, introduced by the information and consultation regulations, could help to promote such long-term thinking. Trade unionists serving on works councils could make this activity part of their role. However, this may be less than effective whilst the investor-company relationship continues to drive much management thinking.

In order to make headway against short-termism on a corporate level, unions must consider, and seek to mitigate, short-term drivers in the field of investment. Such fundamental change, in structures or values, may be difficult, if not impossible, to achieve. However, given the importance of the issues at stake there are potential measures that should be considered.

The TUC is certainly not unique is seeking to explore possible reforms to the relationship between companies and their investors to address perceived short-termism. Therefore below we consider some recent studies in this area and their recommendations. We begin with the Myners review.

The Myners review

The Treasury review of institutional investment undertaken by Paul Myners took a much wider look at pension fund investment than is attempted in this paper. Its recommendations broadly sought to address dysfunction within the investment system in a variety of areas. Within the report, however, there was a section dealing specifically with the issue of short-termism. In this section Myners concluded that it was not possible state objectively that pension funds had too much focus on short-term performance, but the review highlighted three key facts:

- a large number of fund managers believe that their pension fund clients are very concerned by short-term performance;
- a number of pension funds and their advisers insist that they are not; and
- pension funds will inevitably look at quarterly performance figures.

The review warned that the mismatch in perceptions between fund managers and their clients, which was explored earlier in this paper, could encourage short-term decision-making on the part of fund managers, with resultant allocative inefficiency in the capital markets.

“Some investment judgements which rely on the market correcting a mispriced valuation may well take longer than one or two quarters to show results. Yet fund managers, if given no clarity over how their performance is to be judged, may well be artificially discouraged from taking the risk of waiting for that long."[64]

The review also warned that a short-term fixation could damage investors' engagement with companies.

"A further unfortunate consequence of lack of clarity on timescales is the weakening of incentives for managers actively to tackle underperformance of companies, which tends to require some length of perspective."[65]

The review's solution to the perceived problem was to clarify the understanding between fund managers and their clients about time horizons and the length over which performance would be measured. Ultimately clients should not terminate mandates before the end of the assessment period on performance grounds alone.

It is not clear, however, that this recommendation has either been effectively implemented, or that it has resulted in changed behaviour. As the TUC's own research has demonstrated, most trustees still believe that they should be able to terminate mandates on the ground of underperformance[66].

In addition, research carried out by the DWP in regards of the implementation of the Myners principles found that many schemes had not made clear to their fund manager(s) that they would not be sacked early for underperformance. In total 43% of schemes said that they had made this clear to their manager(s) against 44% of which that said they had not[67].

It is also worth noting that the NAPF/IMA research which found a difference in perceptions between fund managers and their clients was carried out three years after the initial Myners report had been published.

In short other methods to combat short-termism need to be considered.

Long-term mandates

A fairly common response to perceived short-term pressure is to propose that pension funds award long-term mandates. Indeed there is a surprising degree of consensus amongst a range of commentators that this is a relatively straightforward step which could be taken to mitigate some of the short-term pressure on fund managers.

"It should only be possible to switch between designated investment managers, every five years for funds over a certain size, say £100m; and once any change is made it should be phased in over a period of, say, three years. Ownership is

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[64] *Institutional Investment in the UK: A Review*, page 89, HM Treasury, March 2001
[65] ibid
[66] See table on page 20 of this report. The full results of the survey are included as an appendix to the report.
[67] *The Myners Principles and occupational pension schemes, volume 2 of 2*, DWP Research Report 213, page 115, 2004

a serious business, and those charged with discharging the ownership responsibilities of the bulk of British business need themselves to be given the architecture in which they can take a far-sighted view."[68]

"[B]usinesses which employ fund managers must also be prepared to commit to a longer term investment horizon in order to provide sufficient security of tenure and motivation of their key players to fit in with the longer scale for the delivery of rewards… Mandates should be established on the assumption that they are for the long term, ideally seven to ten years, with a regular review cycle."[69]

"[W]e suggest that absolute return and 'Ten-year Mandates' offer one possible solution to the problem."[70]

Despite the current fixation on short-term relative performance amongst fund managers' clients, there is evidence that some at least would be willing to explore the idea of long-term mandates. The TUC asked trustees if they would be willing to appoint managers on longer mandates. Well over half agreed that they would be prepared to appoint managers for more than 3 years (the typical mandate length) compared to under a quarter who disagreed[71].

The logic is that by extending the time period over which the mandates runs the fund manager should feel less constrained to generate returns over the short term and as such this should affect their investment decision-making and behaviour. They should be more willing to take long-term positions. It is also stressed that alongside the extended mandates there would need to be changes to performance measurement and fund manager remuneration.

"[E]arnings obsession will persist as long as investment managers have inadequate incentives to shift their analytical orientation toward valuing a company's long-term prospects. For this shift to occur, investment managers will need to be convinced, of course, that it will improve their performance and compensation."[72]

"Although there are moves towards extending timeframes, in general, incentives both in fund management and in the companies in which fund managers invest have become too short-term… pay structures should reflect sustained incremental growth in wealth creation with any incentive structure having built into it some form of escalation of reward based on cumulative added-value over the longer term."[73]

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68 *The State To Come*, p69, Will Hutton, 1997
69 *Restoring Trust: Investment in the 21st century*, Tomorrow's Company, June 2004
70 *Remapping our investment world*, page 2, Watson Wyatt, October 2003
71 The TUC carried out an email survey of member trustees in January 2006. In total 54 trustees replied to the survey. The full results are included as an appendix.
72 *The Economics of Short-Term Performance Obsession*, Alfred Rappaport, Financial Analysts Journal, 1 May 2005
73 *Restoring Trust: Investment in the 21st century*, Tomorrow's Company, June 2004

In fact, if real change is to be brought about through the restructuring of mandates, then all of the options suggested may need to be implemented. Simply extending the life of a mandate may have no impact on the behaviour of the fund manager running it. If trustees are still tracking performance on a quarterly basis the manager will no doubt still feel compelled to maintain their short-term performance, or stay close to any index used in the benchmark.

In addition, obviously not all mandates begin and end at the same point. Although one client may give the manager five or even ten years to achieve their target other mandates will be coming up to expiry before that point. A particular quarter's performance may represent an initial set of figures for one client, but the home straight for another. Such overlaps may, quite reasonably, lead the manager to conclude that it is safer to run even long-term mandates on the basis of them being made up of a series of short runs. Therefore, if mandate structure is going to encourage real change, more radical options, such as limits on trading, may need to be considered.

In all cases it will be necessary to provide comfort to the client that new approaches to mandate structure do not mean that they will be locked into poor performance, as it is clear this is an over-riding concern.

"It would not make sense to not be able to sack an investment manager for underperformance: if an investment management company is doing badly, they may need to be replaced for that reason alone."[74]

So it is clear that to be successful such changes will require a significant cultural change in attitudes to performance, both in terms of what kind of performance really matters and the timescale over which it should be measured. This process will need to involve fund managers, but also investment consultants and pension fund trustees.

Pension funds have already changed the way that they approach some aspects of performance measurement, as they have shifted away from peer group benchmarks. It is much less clear that longer-term mandates, and the required associated changes, will be anything more than an interesting concept unless a collective decision is taken to support such approaches.

Marathon Club

In the context of pension funds looking to develop a longer-term perspective to investment it is important to mention the Marathon Club. This initiative can be traced back to the leading position the Universities Superannuation Scheme has taken in trying to encourage the development of long-term responsible investment strategies. Specifically USS, with the support of investment consultant Hewitt Bacon & Woodrow, held a competition entitled '*Managing*

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[74] Investment consultant quoted in *The Myners Principles and occupational pension schemes, volume 2 of 2*, DWP Research Report 213, page 115, 2004

pension funds as if the long term really did matter'. This invited entries suggesting ways to structure long-term responsible mandates.

The competition was successful in stimulating debate about how long-term investment approaches could be created. Subsequently in 2004 a group of large pension funds came together to explore the possibilities for practical action. This group calls itself the Marathon Club.

The Marathon Club is a closed network in which the TUC and its affiliates do not participate and little information on its activities is publicly available. However it is understood that some of the Club's broad aims include helping trustees and consultants to understand how they can foster a more long term and responsible approach, attempting to develop models for long term responsible investment mandates and, ultimately, translating such models into real new mandates.

The TUC believes that this initiative should be welcomed and that trade union members who are trustees may wish to explore how their funds can participate.

Long-term investment research

In the previous section the problems of short-term investment analysis were explored. Amongst the potential problems highlighted were a fixation on earnings, an increasing emphasis from sell-side analysts on short-term factors, and the failure to consider extra-financial issues in the analysis of companies. The results of this could vary from a failure to spot important trends to the misallocation of capital.

The need for better information is well articulated by David Blood and Al Gore of Generation Investment Management.

"[P]ortfolio managers and analysts need to take account of factors that are not routinely monetised on balance sheets – including sustainability issues – as opposed to solely focusing on short-term returns. This means analysing the implications for shareholder value of long-term economic, environmental and social challenges. They include future political or regulatory risks, the alignment of management and board with long-term company value, quality of human resources management, risks associated with governance structure, the environment, restructurings/mergers and acquisitions, branding, corporate ethics and stakeholder relations."[75]

But, as explored earlier, at present little investment analysis takes such a long-term view or considers many of the issues outlined. In particular, as hedge funds have risen to prominence, commanding any ever-growing amount of commission that is handed over to brokers, if anything sell-side research may have become more short-term in nature.

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[75] Financial Times FTFM, 2005

However, if analysts can be incentivised by certain clients to produce short-term research, then they can also be incentivised by other clients to produce longer-term analysis. This positive use of client power is the thinking behind an industry project to improve the quality of investment research called the Enhanced Analytics Initiative (EAI)[76].

The Enhanced Analytics Initiative

In simple terms the EAI seeks to encourage financial analysts to begin taking a broader, and longer-term, view of the companies they analyse. Specifically it encourages research into extra-financial issues such as the corporate governance, environmental impact and human capital management. It does this by assigning a fixed amount of broker commission to research into such areas.

Many large institutional investors, such as internally managed pension funds and fund managers, pay commission to brokers, which employ sell-side analysts, to produce company research. EAI members have agreed to allocate a minimum of 5% of their broker commission to extra-financial research. By assigning this commission solely to reward research into extra-financial issues the EAI hopes to improve investment research.

In practical terms the EAI's members employ a consulting firm to evaluate the research into extra-financial issues produced by analysts over six-monthly periods. At the end of the assessment period the research providers identified as having produced the best analysis are awarded commission from the EAI members. At the end of the most recent assessment period eight research providers were identified, and the overall 'pot' EAI members will allocate totalled approximately 9 million Euros.

In a short space of time the EAI has put together an impressive list of members including the large Dutch public sector funds PGGM and ABP, Hermes Pension Management and the Universities Superannuation Scheme from the UK, and BNP Parisbas Asset Management from France. The total assets under management of EAI members now exceed 681 billion Euros.

It does appear that the EAI is already having an impact in encouraging the greater provision of research into extra-financial issues. In its latest assessment the EAI noted a significant increase in the amount of research being produced since the project was first initiated, and a four-fold increase in the number of research providers involved[77]. As one analyst working for a brokerage firm has commented, although the commissions awarded by EAI members are not substantial as yet, their existence strengthens the position of analysts working on extra-financial issues[78].

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[76] http://www.enhanced-analytics.com

[77] *Taking Stock, Summary of the December 2005 Evaluation of Extra-Financial Research*, page 3, EAI, January 2006

[78] Conversation with the TUC, December 2005

It should be noted that EAI members acknowledge that they still at an early stage in the project. The latest evaluation noted an emerging tendency for 'me too' research where firms would put out research on a topical issue that is already widely covered, rather than seeking to open up new lines of analysis.

"Given the investment relevance of current M&A activity, for example, it surprising not to see more extra-financial research related to mergers and acquisitions… [T]he coverage of corporate governance issues, including remuneration, has improved, but it is still surprisingly low compared to the relevance of these issues. On another note, while the cover of relevant environmental issues has improved, issues related to social impacts, such as human capital, human rights and community concerns, are clearly insufficiently covered."[79]

Clearly it will be of interest to trade unions that investment research into employment-related issues improves. In addition one question that does not seem to have been explored is whether the EAI is having an impact in terms of the interaction between analysts and companies. Are companies noticing that some sell-side analysts are starting to ask about long-term issues, and does this have any impact on the company's behaviour?

That said, the thrust behind the EAI is very much in tune with trade unions' aspirations to develop longer-term thinking. As such unions should seek to support the initiative where possible.

Company reporting

Analysts need information to work with. As was made clear in the previous section, the Government's decision to scrap mandatory OFRs may cause issues for those seeking to develop more comprehensive and forward-looking company reporting, with the objective of improving engagement between companies and investors and stakeholders.

It should be noted that the main investor bodies were supportive of the proposed OFR.

"The NAPF strongly supports the statement of the purpose of the OFR "to provide a discussion and analysis of the performance of the business and the main trends and factors underlying the results and financial position and likely to affect performance in the future, so as to enable users to assess the strategies adopted by the business and the potential for successfully achieving them". An understanding of the implications of these extra financial issues, include forward looking strategies, risks and uncertainties facing the business and the

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[79] *Taking Stock, Summary of the December 2005 Evaluation of Extra-Financial Research*, page 7, EAI, January 2006

implications of environmental, social, and employee related issues where material, is very much to the advantage of shareholders."[80]

Similarly the decision to scrap mandatory OFRs attracted criticism from a wide spread of organisations ranging from NGOs, to employer groups to investors[81].

Along with others, the TUC believes the rationale behind the OFR was correct, and that there is still a place for forward-looking company reporting, and we were signatories to a letter written to the Department of Trade and Industry calling for clarification of what is expected of companies[82]. It is hoped therefore that the Government takes the opportunity provided by the incoming Business Review to revisit the scope for more comprehensive reporting.

Hermes

Hermes is rather unique as a fund management business as it is owned by the BT Pension Scheme, the UK's largest pension fund. Hermes maintains that this ownership structure has an influence on its decision-making, in particular it has a strong focus on 'long-term shareholder value'.

It manages most of its assets on a passive basis but has also pioneered the use of so-called focus funds. These funds target a small number of under-performing companies and aim to work with the companies' management to turn them around. Hermes argues that such an approach distinguishes it from other managers whose response to underperforming companies would be to sell out, or at least go underweight in them relative to the index.

Hermes is also active in encouraging debate about the investor-company relationship. In order to articulate clearly to investee companies its expectations as an owner, in 2002 it produced the Hermes Principles. This set of 10 guiding principles is aimed at creating a common understanding between businesses and their owners of the goals of a public company. Several of the principles would fit very well with a long-term approach to investment.

For example, in relation to growth versus acquisitions Hermes states the following.

"Principle 4 'Companies should allocate capital for investment by seeking fully and creatively to exploit opportunities for growth within their core businesses

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[80] *Draft Regulations on the Operating and Financial Review and Directors' Report; A DTI Consultation Document; A response by the National Association of Pension Funds*, NAPF, July 2004

[81] Criticism of the decision was voiced by, among others, the CORE coalition, the Association of British Insurers and the Institute of Directors.

[82] *Action urged to cut risk caused by abolition of reporting rule*, Financial Times, 23 January 2006

rather than seeking unrelated diversification. This is particularly growth when considering acquisitive growth."[83]

Principles 9 and 10 cover companies' social, ethical and environmental responsibilities. In Principle 10 in particular Hermes makes the point that failing to manage such responsibilities may be counter-productive both for investing institutions and the beneficiaries they represent.

"[M]ost investors are widely diversified; it makes little sense for them to support activity by one company which is damaging to overall economic activity. The ultimate beneficiaries of most investment activity include the greater part of the adult population who depend on private pensions and life insurance. It makes little sense for pension funds to support activity which creates an equal or greater cost to society by robbing Peter to pay Paul."[84]

More recently Hermes has actively responded to some of the comments from the business community about short-termism on the part of investors. In a speech last year, Hermes chief executive Tony Watson highlighted the control businesses and unions had over the issue.

"[C]orporate Britain isn't just the recipient of the attentions of investing institutions. Via its pension fund trustees it helps these institutions in the first place. Boards themselves influence great swathes of the investment industry through their corporate pension funds… Boards, particularly where they are supporting Defined Benefits Schemes, have a right to know that the assets are being managed in everyone's long-term interest... Make those who are holding the investment mandates given out by the pension fund exercise their ownership obligations as well as they can."

"So, I call upon John Sunderland and his Boardroom colleagues to demand that the investing institutions demonstrate that they manage the assets on a long term basis or pay the penalty. I call upon the Government, which is the custodian of very large Public Sector pension funds to make the same demand. And I call upon the Trades Unions, whose members sit on the Boards of Pension Fund Trustees to press those Boards and the investing institutions to start getting it right."[85]

Hermes' role in the debate about long-term investing is interesting. It demonstrates that some fund managers are willing to think seriously about the issues that are involved. In addition Hermes' recognition that trade union members who are trustees have a role to play in possible reform should act as an encouragement as unions seek to position themselves in this debate.

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[83] *The Hermes Principles: What shareholders expect of public companies – and what companies should expect of their investors*, page 6, Hermes Pensions Management, October 2002

[84] *The Hermes Principles: What shareholders expect of public companies – and what companies should expect of their investors*, page 18, Hermes Pensions Management, October 2002

[85] Tony Watson speech to the ICAEW Annual Conference, 28 June 2005

Tomorrow's Company

In 2004 the business think tank the Centre for Tomorrow's Company published a report of its long-running review of the investment system in the UK chaired by Sir Richard Sykes[86]. In common with the Myners Review this was a much wider assessment of the system than the TUC is attempting. However there was much in the final report with which unions would have sympathy and the report is worth reading in its entirety.

The review supported a number of initiatives already covered in this section, including the implementation of longer-term mandates and the improvement of the quality of investment research. Turning to companies themselves, the review recommended reforms both to executive remuneration and procedures in elation to mergers and acquisitions.

On remuneration the review called for packages to be structured in a way that did not deliver excessive results *relative to* either performance or pay levels across the organisation. In this respect the emphasis appears to further than the relevant section of the Combined Code which only guides companies to take account of pay within the organisation in setting salaries[87]. The review also recommended a greater level of remuneration in shares, as opposed to options, to achieve a better alignment with performance.

On merger and acquisition activity the review recommended that non-executive directors should seek independent advice on proposals. It also recommended that companies should carry out an independent review of acquisitions that they have made to assess whether the transactions had served to create shareholder value.

The attempt to try and encourage companies to assess merger and acquisition activity more thoroughly, and to raise awareness that such activity is not synonymous with the creation of value for investors, should be welcomed. Trade unions will no doubt wish to see a rather more thorough-going approach to this important issue developed. However it is helpful to see that even those coming from a business perspective recognise that reform is needed in this area.

Executive remuneration

As has been discussed earlier, there has been some debate around the incentives for company directors to manage for the long term. Specifically there is criticism that options schemes can be counter-productive as they may fixate

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[86] *Restoring Trust: Investment in the 21st century*, Tomorrow's Company, June 2004
[87] *'[The remuneration committee should] be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases.'* Supporting Principle, Principle B.1, *The Combined Code on Corporate Governance*

executives on the management of the share price over the short-term. There is some argument therefore over ways to reform remuneration.

John Plender has argued that a move away from share option schemes is needed in order to incentivise the right kind of behaviour from directors.

“[T]he emphasis of compensation at quoted companies [should shift] from stock options to plain equity so that directors share the pain when the stock goes down. Directors also need to be locked into equity incentives for much longer periods, with no opportunity to cash in early in the event of loss of office or the company being taken over… Better still would be to go back to a much greater emphasis on basic pay, with awards of equity being used only at the margin for exceptional performance.”[88]

Conversely Alfred Rappaport warns against moving away from share-based remuneration as this may make directors risk averse. He suggests instead reforming options in order that they are better at rewarding genuine performance, as opposed to market movements, over the longer-term[89]. In contrast some have suggested, in common with John Plender, that remuneration could be radically simplified and stripped back to salaries and bonuses[90].

Others have looked at trying to incentivise directors to take proper account of extra-financial issues. A report by Henderson Global Investors and the Universities Superannuation Scheme explored this as an area[91]. They found that rewards for directors’ performance in relation to extra-financial issues were almost exclusively linked to short-term incentive schemes, such as annual bonuses. This does not sit easily with the long-term nature of many such issues.

It is notable that the Combined Code gives no guidance to companies to structure remuneration in a way that incentivises the delivery of long-term shareholder value. Nor does it refer to the inclusion of extra-financial factors in incentive schemes.

Of course the aim of any reform of executive remuneration should be to provide incentives for the right behaviour. It is interesting therefore that company executives themselves claim not to ascribe much importance to remuneration as a drivers of their desire to hit short-term targets.

“CFOs view the compensation motivation as a second-order factor, at best, for exercising accounting discretion. They tell us that companies often have internal earnings targets (for the purpose of determining whether the executive

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[88] *Going off the rails: Global Capital and the Crisis of Legitimacy*, John Plender, page 263
[89] *The Economics of Short-Term Performance Obsession*, Alfred Rappaport, pages 72-74, Financial Analysts Journal, 1 May 2005
[90] Discussion on remuneration at the Local Authority Pension Fund Forum annual conference, December 2005
[91] *Getting what you pay for: Linking executive remuneration to responsible long-term corporate success*, Henderson Global Investors/USS, February 2005

earns a bonus) that exceed the external consensus target. Hence, meeting the external earnings target does not guarantee a bonus payout. Furthermore, several interviewed CFOs indicate that bonuses are a function of an internal "stretch goal," which exceeds the internal "budget EPS," which in turn exceeds the analyst consensus estimates. Finally, many executives indicate that bonus payout is simply not that important relative to salary and stock compensation (for themselves and for lower level employees)."[92]

Further intervention in the area of executive remuneration may be unpalatable for either government or industry. However, given the importance of remuneration as a system of targets and incentives for directors it is surely right to review whether the system is structured in a way that encourages desirable outcomes, for investors or companies.

Such a review might pay attention to the question of quantum. Some will no doubt warn that attempting to tackle the question of relative levels of pay within companies will politicise the executive remuneration debate. It should be noted, however, that already some mainstream investor organisations have expressed concern at leaving the issue unchecked.

"We cannot ignore the societal impact of what seem to be unfair or disproportionate rewards being received… [I]f the electorate as a whole reacts against a system that enables people to be remunerated on a basis that seems unjustifiable to any reasonable mind, then the managerial capitalism that dominates the world at present may be under threat."[93]

Representation for employees as investors

As previous analysis and commentary makes clear, the public is to a large extent the owner of British businesses, and the purpose of much existing investment is to generate retirement incomes for working people. The shift to DC pension provision means they now have an even more direct investor interest in the success of British businesses. Yet, despite this, the formal architecture of UK corporate and investor governance barely acknowledges the interests of working people and their representatives.

Corporate governance, as expressed through the Combined Code, falls under the auspices of the Financial Reporting Council. The FRC is largely made up of representatives of business, the accounting profession and the fund management industry. There is only one place allocated to representatives of investment beneficiaries.

Self-regulation of the investment industry is left to the Institutional Shareholders Committee which includes the trade bodies representing the fund

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[92] *The Economic Implications of Corporate Financial Reporting*, Graham, Harvey and Rajgopal, page 13, January 2005

[93] *Executive Remuneration – The Caucus Race, A Report to the International Corporate Governance Network*, page 3, ICGN, July 2002

management and insurance industries, and that representing the interests of employers running pension funds. There is no representation of employee investors.

Given the role that working people play as employees of investee companies, the providers of capital, members of pension schemes and insurance policyholders, and as trustees of pension schemes, it is surprising that they are so poorly represented in the formal decision-making structures that affect investment policy.

It is worth noting that the Institute for Public Policy Research has made recommendations in this area. In 1997 the IPPR produced a paper entitled *Promoting Prosperity: A Business Agenda For Britain*[94]. One of the proposals in the paper that merits further discussion is that to create a UK equivalent of the Council of Institutional Investors (CII) that exists in the US. This proposal has won backing elsewhere[95]. The CII in the US includes a specific role for employee representatives.

A British equivalent of the CII could be structured in a way that ensured that ensured that the current lack of employee investor representation was corrected. Alternatively the existing representative bodies could be restructured to reflect the changing nature of pension provision and shareownership.

Further Government intervention

It should be noted that the large majority of the proposed reforms to the investor-company relationship outlined so far in this section involve voluntary action on the part of those involved. However, there has also been some discussion of whether the Government should intervene directly to help foster a longer-term perspective amongst shareholders.

There does seem to be developing support amongst trustees for the Government to take action. In 2005 the Just Pensions project carried out a survey of the TUC Member Trustee Network to establish views on responsible investment[96]. The survey included questions on trustees' views on further Government intervention and particular policies that might be introduced. These included improved voting rights or higher dividends for longer-term investments, or conversely lower capital gains tax.

"A clear majority (64%) agreed that Government should use its legislative and regulatory powers to encourage investors to commit for the longer term in equity investment. However a significant number of trustees (36%) either disagree or are neutral on this as an important question…"

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94 *Promoting Prosperity: A Business Agenda For Britain*, IPPR, January 1997
95 See PIRC's response to the Hampel review: www.pirc.co.uk/prhamp.htm
96 *Will UK Pension Funds Become More Responsible? A Survey of Trustees: 2006 Edition*, Just Pensions, February 2006

"However, those who would support such a public policy initiative seemed to favour higher dividends and tax breaks as the most appropriate mechanisms (see table 23). Larger funds were broadly in line with the overall results in relation to voting rights (46%) and higher dividends for long-term shareholders (76%). However, they were slightly more circumspect about lower capital gains (65%) than other trustees."

Once again, the TUC's own research supports such findings. In our own email survey over two-thirds of trustees agreed that there should be incentives for investors to hold shares for the long term rather than trade them. Around one in seven trustees disagreed[97].

Whether calls for such intervention are politically practical is another question. For example, differential voting rights for long-term investors would seem an unlikely option to succeed given the current Europe-wide convergence on the idea of 'one share, one vote'. However we believe the wider potential for Government to create incentives for long-term investment should be considered.

Conclusions

It is hoped that the analysis in this section demonstrates two important facts. The first is that a wide range of organisations with differing backgrounds believe that there are structural issues within the pensions investment that may lead to short-termism and in turn create negative outcomes. The second is that there are already practical proposals for reform being debated and, to a much lesser extent, being put into practice.

In the final section of the report we draw conclusions from this preceding analysis and, more importantly, make recommendations for how unions can make a practical response.

[97] The full survey results are included as an appendix.

Section five

Conclusions and Recommendations

"So who is going to make the first move? If it is a question of perception then the perception is in the whole circle. We think we are being measured on a short-term basis and board directors think that is what investors want of them so in fact their remuneration arrangements are getting shorter and shorter term, with all their LTIPs running off annual bonuses, because that is what they think shareholders want, so they operate on that basis. Who is going to break that chain?"[98]

Anita Skipper, Morley Fund Management

Having reviewed the available evidence, the TUC believes that there are short-term pressures at play in the investor-company relationship that are unhelpful. Some commentators have argued that in some cases the problem is not real short-term pressure, but the perception of short-term pressure.

This argument has some merit. For example, it does appear that, despite focussing much attention on short-term performance figures, trustees do not fire their fund managers after particularly short periods of time (at least as compared to the average length of mandate awarded). Equally some fund managers would argue that they continue to hold the bulk of the shares they own, particularly in large companies, for the long term, and only really trade at the margin.

However, it is also clear that perceptions on the part of both investors and companies of what is expected of them are leading to behaviour that is not necessarily in the best interests of either party. In a sense it does not matter if the pressure is real or perceived if the result is destructive behaviour.

In addition we should not underestimate the importance of the investor-company relationship. The bulk of share-ownership in the UK has the function of funding retirement incomes for working people. This ownership is typically highly diversified, meaning that working people are investing in large swathes of British industry in order to benefit from its success and growth. Therefore

[98] *The Corporate Governance Report: Investor Policies and Corporate Practice*, page29, KPMG/Lintsock, January 2006

the efficient functioning of the investor-company relationship has major implications for both economic and pensions policy.

The public would be, rightly, alarmed to discover that tens of billions of pounds of tax revenue was being used by politicians to fund initiatives in which they had no faith, and which they expected to fail. Yet the misallocation by professional investors of billions of pounds of the public's money to the TMT sector, and its subsequent loss, has largely not been seen as a question worthy of serious political discussion in the UK. It is time we changed the way we think about such issues.

Our recommendations

We do not propose to make finely detailed policy recommendations. We believe that it is more important to identify those areas where change should be sought and make broad suggestions for change that can be explored with other interested parties. The investor-company relationship contains too many elements to address only one area, or to only involve one of the relevant participants.

We do not believe that a voluntarist approach to these issues will be sufficient, therefore a number of our recommendations relate to activity we believe the Government could consider.

- The Government should initiate an inquiry into short-termism, to include representatives of employees, employers, the pensions and investment industry and other interested parties.
- Trade unions should identify and network their trustees on pension funds and begin a programme of education on developing long-term investment strategies. The largest funds should be a priority.
- Trustees should consider the implementation of long-term mandates. The Government should encourage the development of such mandates in the Local Government Pension Scheme.
- Trustees should encourage the incentivisation of long-term investment analysis by supporting the Enhanced Analytics Initiative.
- The section of the Combined Code dealing with executive remuneration should be revised to make an explicit link to long-term shareholder value and the importance of extra-financial issues. Companies' remuneration policies should be reformed accordingly, including a move away from options-based rewards.
- The Government should review the potential to introduce incentives to encourage investors to hold shares for the long term.

- The Government should consider the creation of a British equivalent of the Council of Institutional Investors. Alternatively existing organisations such as the Financial Reporting Council and Institutional Shareholders Committee should be reformed in order to ensure the interests of working people as investors are properly represented.
- Given the poor success record (both financial and organisational) of deals, companies and their investors should operate the 'precautionary principle' in relation to merger and acquisition activity. Bidding companies should be able to demonstrate that a proposed deal would operate in the public interest. The impact on impact on employment and industrial competitiveness should be put to shareholders when bid is being decided upon.

The TUC hopes this report and its recommendations will help feed the debate about short-termism and how it might be addressed. We would welcome the opportunity to discuss and develop these ideas with business, investors and other interested parties.

Section six

Appendix

TUC email survey of pension fund trustees

Question	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
Fund managers put too much pressure on companies to deliver short-term results.	2	16	27	7	2
Trustees should be able to terminate fund managers' mandates early if there is persistent under-performance against the agreed benchmark.	27	22	3	2	0
Our fund manager's performance relative to other managers is not important provided they are meeting their benchmark.	3	30	6	14	1
Fund managers' clients, such as pension funds, put too much pressure on fund managers to deliver short-term results.	8	15	10	20	1
There should be incentives for investors to hold shares for the long term rather than trade them.	15	22	9	7	1
Fund managers' clients, such as pension funds, put too much pressure on fund managers to deliver short-term results.	8	15	10	20	1

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