The Cox Review into the impact of 'Short-Termism' on British business

Call for Evidence

Submission by Standard Life Investments

Introduction

Standard Life Investments is a major UK institutional investor, with assets under management of £163.4 billion as at 30 September 2012. A significant proportion of our assets under management are invested in UK listed equities. Importantly, we also invest in bonds, including corporate bonds issued by UK listed companies, private equity and property. Our clients are generally long-term asset owners and savers, who seek attractive returns that will enable them to meet their liabilities or other investment objectives.

In fulfilling our responsibilities, we engage regularly with the boards and senior management of companies to discuss a wide range of issues including strategy, corporate governance, corporate social responsibility and risk management. This engagement provides us with insights of the approach taken by boards and management in respect of decision taking over various time horizons. The relationship that we enjoy with many of our investee companies places us in a position where we can exercise constructive long-term influence consistent with the interests of our clients.

1. What are the timescales under consideration by boards and senior management in evaluating corporate risks and opportunities, and by institutional shareholders and managers in making investment and governance decisions, and to what extent do these match the long term needs of the business?

When evaluating corporate risks and opportunities, boards need to consider a number of parameters such as the cost of capital, inflation and expected return. These parameters will be determinants of the time horizon which a board will use. In addition the competitive conditions in an industry will determine the rate at which return will be achieved and therefore will impact the timescale under consideration. For example the Boards of oil companies and pharmaceutical firms will be making decisions today in relation to returns delivered in ten or twenty years. Whereas banks may be making trading decisions that have a very significant impact on corporate risks and opportunities within a relatively short period, perhaps even days or months.

It is important that, in evaluating corporate risks and opportunities, boards and senior management consider the long term competitive position of the company. From a shareholder and societal perspective it is important that company boards and senior management do not take decisions for short term gain that introduce risks that could threaten the long term viability of the business.

The key consideration of Standard Life Investments is the need to deliver returns that are aligned to the liabilities and expectations of our clients. We have commented on the nature of long term investing in a number of fora and a recent speech covering some of the key issues can be found at the following link:

http://www.standardlifeinvestments.com/press_office/press_releases/long_term_investing_keith_skeoch.html

In particular, the speech highlights the research undertaken by Standard Life Investments that suggests that there is no persistency in return to equity investors beyond eight years and that, furthermore, the 'sweet spot' for an investment horizon is between two and five years. Fund management is about bridging the gap between the shorter time periods of predictable returns from companies and the long term liabilities of savers and asset owners. Building investment processes and portfolios that bridge this gap is difficult but very important if savings are to be perpetually connected with the investment opportunities that sustain growth, employment and deliver a decent return and income in retirement.

2. Is 'short-termism' – the pressure to focus on short-term performance to the detriment of the long-term development of the business – really an issue?

Professor Kay's review does not provide any conclusive evidence that long term performance is negatively impacted by short-termism. However, we believe that there are incentives to boards to take decisions that improve short term performance to the detriment of long term development. An example of this would be remuneration policies that provide increased payments based on short term measures may cause decisions to allocate capital to short term gain rather than long term investment. We have provided in question 3 below other examples of incentives to take short term decisions above long term development. Industry commentators such as Andrew Smithers, of Smithers and Co, have also made this point publicly.

There is evidence that in the run up to the financial crisis there was focus on short term performance in the Banking sector. As an industry it operates in markets where strategies can be short term in nature and the results of decisions can be almost instantaneous in their effect.

3. What's the cause of short-termism?

See the answer to 2 above regarding the susceptibility of some industries to short-termism. The causes of the banking crisis may never entirely be identified, but key elements could include:

Short Term Interim Management Statements (IMS)
The increased incidence of listed companies providing quarterly updates on their trading and financial position, and the behavioural consequences thereof, do not encourage boards to focus on the long-term development of their business. This is because the market reaction to such statements, often fuelled by comments by sell side analysts who are incentivised to generate commission from their clients, is reflective of the frequency of these reporting intervals. These comments frequently focus on short term targets being either met or missed, which of itself is unrelated to the execution of long-term strategy by a company's board and management. The 'noise' - positive or negative - arising in response to quarterly IMS is an unwelcome distraction in the context of encouraging boards to focus on the long-term development of their business.

The European Commission's proposed revisions to the Transparency Directive would abolish the requirement to publish IMS 'in order to reduce the administrative burden linked to listing on regulated markets and encourage long-term investment'. These proposed revisions are very welcome, as too is the Government's support for them, which it confirmed in its recent response to the Kay Review.

Transaction led Advice from Investment Bankers and Other Professional Advisers
It is the usual practice for investment bankers who act for companies in respect of specific transactions, which generally includes the provision of advice to boards, to be paid in cash for their services. There is often poor alignment between the fees that are paid for advice and the outcome of that advice.

Shareholders have little or no say in respect of the quantum and other aspects of payments made to advisers. Although there is some degree of transparency in respect of the fees paid, shareholders have to accept them as 'part of the deal' and there is no effective accountability in respect of the advice given. Evidence from a number of academic analyses of corporate transactions indicates that often such transactions result in investment bankers and other advisers being rewarded handsomely and boards failing to focus effectively on the long-term development of their business with significant adverse consequences for the financial returns to shareholders.

We would like to see shareholders having more of an opportunity to give views on payments to advisers, perhaps in a similar way to the input in relation to remuneration. The fees paid to advisers should be structured to ensure that they can be held accountable for the long term impact of their advice.

Management incentives

One of the most important determinants of board behaviours is the process by which their executive members are incentivised. The link between executive remuneration and the measures by which investors evaluate corporate success is sub-optimal. Arguably, there is a disproportionate focus on incentives based on share prices. However, a share price merely represents the consensus of investor expectations about the future performance of a company – its correlation with the achievement of real corporate performance is far from axiomatic.

Nonetheless, if this is the primary element by which wealth is shared with executive board members then it would be logical to suppose that more time and energy will be spent on the management of expectations than on the business as a whole. The problem is compounded by the relatively short time horizons over which such awards crystallise compared with those of the providers of the share capital. It is right that executive incentives should be aligned ultimately with the achievement of shareholder value as executives are the day-to-day stewards of the equity capital provided by those investors; but there is a case for the adoption of more sophisticated and diverse measures of value – intangible as well as tangible - in order to provide the right incentives to sustain the returns from the corporate strategy over a longer time-scale.

Most publicly traded companies have incentive schemes that comprise an annual bonus and a long-term incentive scheme based on 3 year performance. Furthermore, it is not uncommon for the performance measure to be the total shareholder return (TSR) or some other measure based on share price performance. These attributes are evidenced in the remuneration reports of listed companies. Whilst we are strong supporters of pay for performance, we believe that there is a need to break the mould so that the time horizons used to reward executives are much more demonstrably aligned with the time horizons used by long-term investors, such as Standard Life Investments. We commend to you work done by Professor Brian Main, of the University of Edinburgh. His paper entitled 'Executive Pay - a career perspective'[1] contains some very interesting ideas. In particular, with the benefit of supporting evidence, he recommends that executives should be required to hold shares in the company for a period of time after they leave it. This proposal would provide encouragement to executive directors to focus on the long-term development of their business.

It is the role and responsibility of boards and their remuneration committees to determine the remuneration policies and practices that are used in their businesses. However, government should be seen to endorse best practice improvements that will achieve a better alignment of interest between executives, boards and the long-term shareholders in publicly listed companies.

Impact of legislation and regulation

To the extent that laws act as an incentive or disincentive to invest, they can have a decisive impact on equity returns and hence the time horizon of investors. Such laws are themselves often driven by the short term requirements of the electoral cycle and the funding needs of the public sector. For example, much has been written about the detrimental effects on the attractiveness of equity resulting from the changes in the Advanced Corporation Tax (ACT) regime in 1997, which had the effect of removing the tax credit available to a significant proportion of the investing community. Arguably a greater impact was made by the requirements of the 1986 Finance Act which had the effect of limiting the build up of surpluses in corporate sponsored occupational pension schemes to 5% of a scheme's liabilities. The Act proved to be a significant disincentive to what had hitherto been one of the main providers of long-term equity capital to UK

[1] Executive Pay - a career perspective' by Brian G M Main, Hume Occasional Paper No 89, June 2011

companies. The last decade has seen changes to savings and pension regulation on an almost annual basis; indeed the volume of the exhortation to citizens to invest for their retirement often rises in inverse proportion to the availability of incentives to do so. The uncertainty associated with such changes means that the time horizon of investors must also shorten, so contributing to the rise in the cost of capital to companies and an increase of the return required by investors from it.

4. To what extent, if any, does it have an effect on the sector/economy as a whole?

The cumulative impact of decisions made by investors, government, regulators and companies ahead of the financial crisis had an effect on the global economy. What is less clear is whether the decisions made can all be put down to short-termism.

Certainly the ‘charge sheet’ against short-termism is serious. This includes the notion that absentee shareholders failed to hold boards to account, which some believe was instrumental in creating the conditions that both fuelled the boom and exacerbated the bust that generated the global financial crisis. Short-termism is also seen as a fundamental source of inequality as a result of shareholders unwillingness or inability to rein in executive reward. Technology has permitted the evolution of financial techniques and investment strategies that are better able to take advantage of short term investment or trading opportunities. To the extent that these techniques increase the volatility of the price placed upon capital in the marketplace, they thereby raise the cost of capital needed by companies for investment.

There is an element of truth in all of these assertions. However, it is not clear that simply lengthening the time horizon would have prevented such a big set of problems. The danger is that long-term has become a simple substitute for good behaviour and short-term for the bad behaviour that exacerbated and deepened the global financial crisis. We note that Professor Kay’s review does not evidence the benefits of long termism except the expectation that such an approach will foster successful companies.

5. What role, if any, does government have in driving a more long-term approach within UK business?

Governments provide the regulatory framework in which businesses and industries operate and the weight of regulation reflects the societal importance of industries so regulated. Government intervention and regulation should aim to balance providing economic incentives to invest with protection for consumers and citizens as a whole.

This relates to the broader notion of ‘Stewardship’, which we consider should lie at the centre of financial and economic life. Asset gatherers are the Stewards of savers’ funds and need simple transparent and cost effective propositions to deliver returns that allow individuals to cope financially with life’s trials and tribulations. Investors are the Stewards of the assets they manage and have fiduciary responsibilities to their clients about their ability to deliver a return to help meet savers’ needs. Companies and boards of directors are Stewards of the capital they are allocated, the assets they acquire with it and the return delivered to investors and their ultimate clients’ savers. Finally, policymakers are Stewards of the economic and financial system and should take a long run approach to its health rather than looking for shorter run fixes.

6. The financial crisis has had far reaching implications for the business environment and for the economy as a whole. Are there any signs that either firms or investors have been changing their behaviour since the financial crisis?

The evaluation of Governance and Stewardship factors is an integral part of our philosophy. Since the financial crisis there has been a perceptible change to the importance placed on good stewardship and the behaviours of Boards, directors and senior management. Governments, regulators, businesses and investors have recognised the fact that society is demanding change, leading to changes in the behaviours of all of these parties. All are working to improve trust and to ensure that lessons are learnt from the financial crisis and it is important to ensure that the actions taken to address these lessons do not, in themselves, drive a more short term view from savers and asset owners.

Useful Links

SLI's input to the Kay Review
http://www.standardlifeinvestments.com/CG_Kay_Review_Letter/getLatest.pdf
http://www.standardlifeinvestments.com/CG_Kay_Review_Call_For_Evidence/getLatest.pdf

SLI's Paper on Stewardship and the Investment Process
http://www.standardlifeinvestments.com/CG_Stewardship_Investment_Process/getLatest.pdf