



FOCUSING CAPITAL on the **LONG TERM**

Jean-Hugues Monier – Senior Partner –
McKinsey & Company
Princeton University - November 2016

CONFIDENTIAL AND PROPRIETARY

Any use of this material without specific permission of McKinsey & Company and CPP Investment Board is strictly prohibited

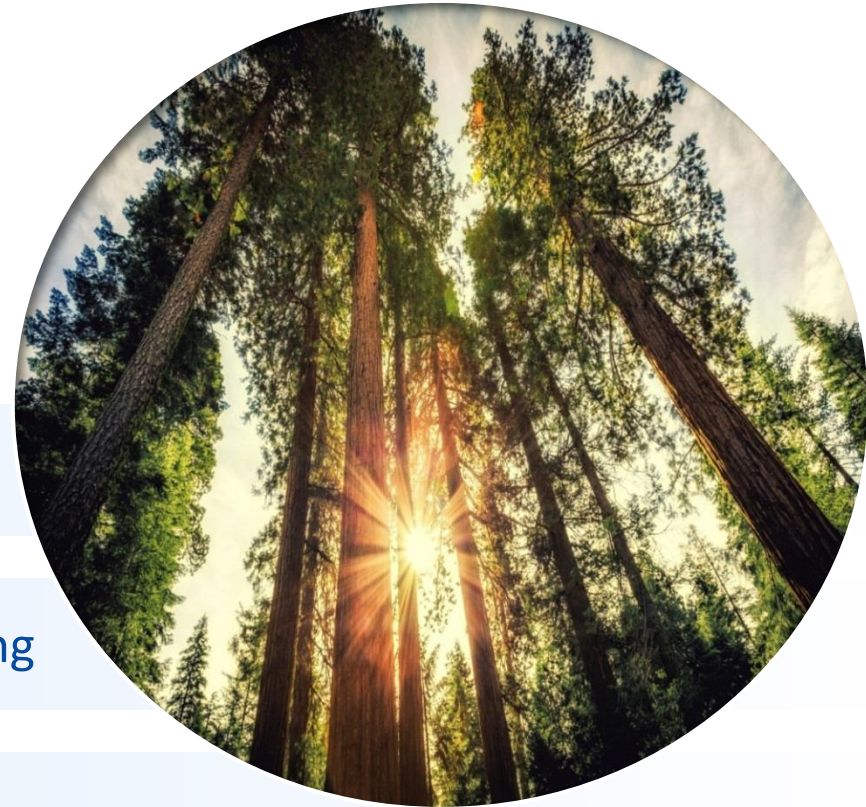
For discussion

1 The rise of short-termism

2 The importance of long-term thinking

3 The FCLT initiative: a call to action

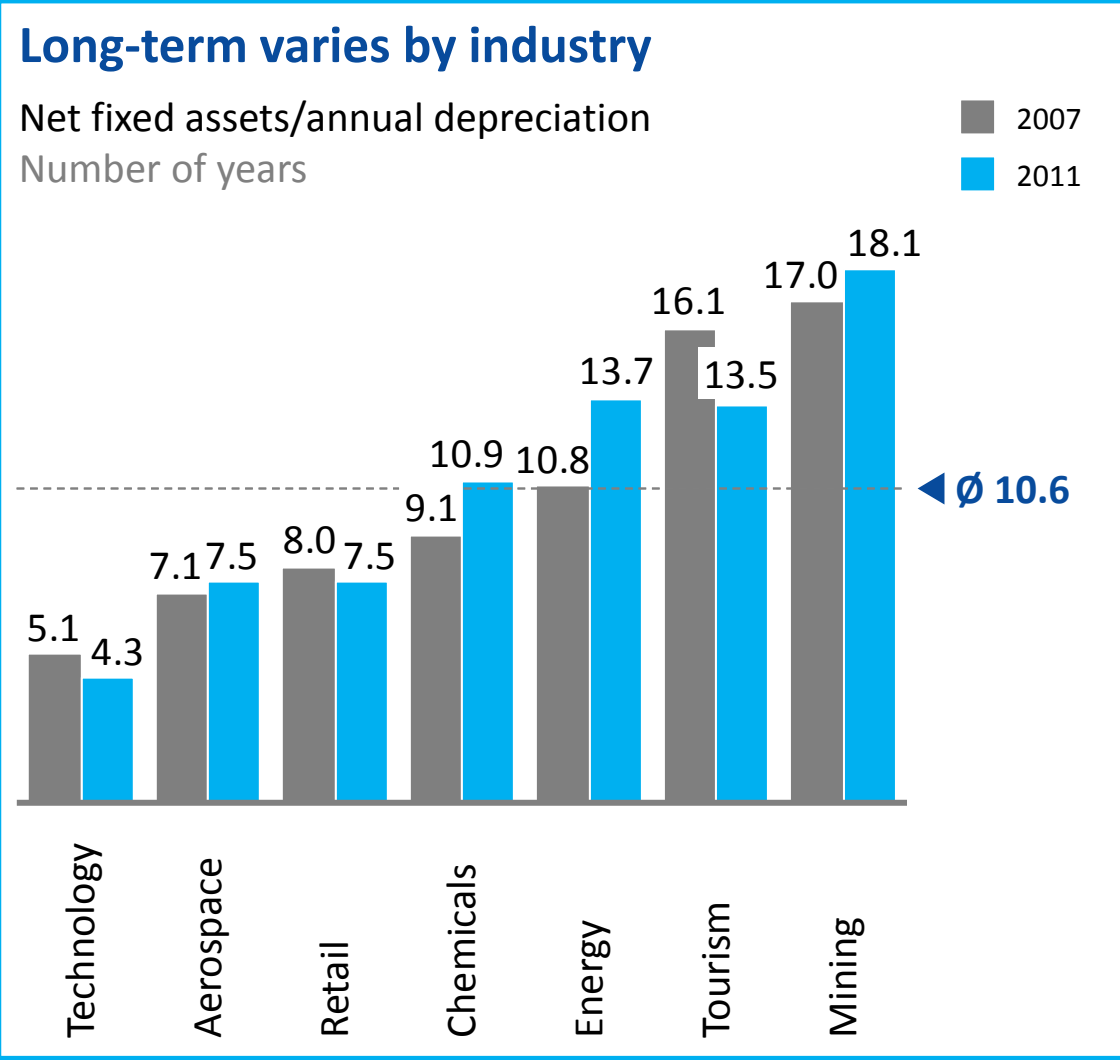
4 A roadmap for focusing capital on the long term



FOCUSING CAPITAL
on the **LONG TERM**

1 The rise of short-termism

What qualifies as 'long term' varies by industry, but thinking long-term is essential



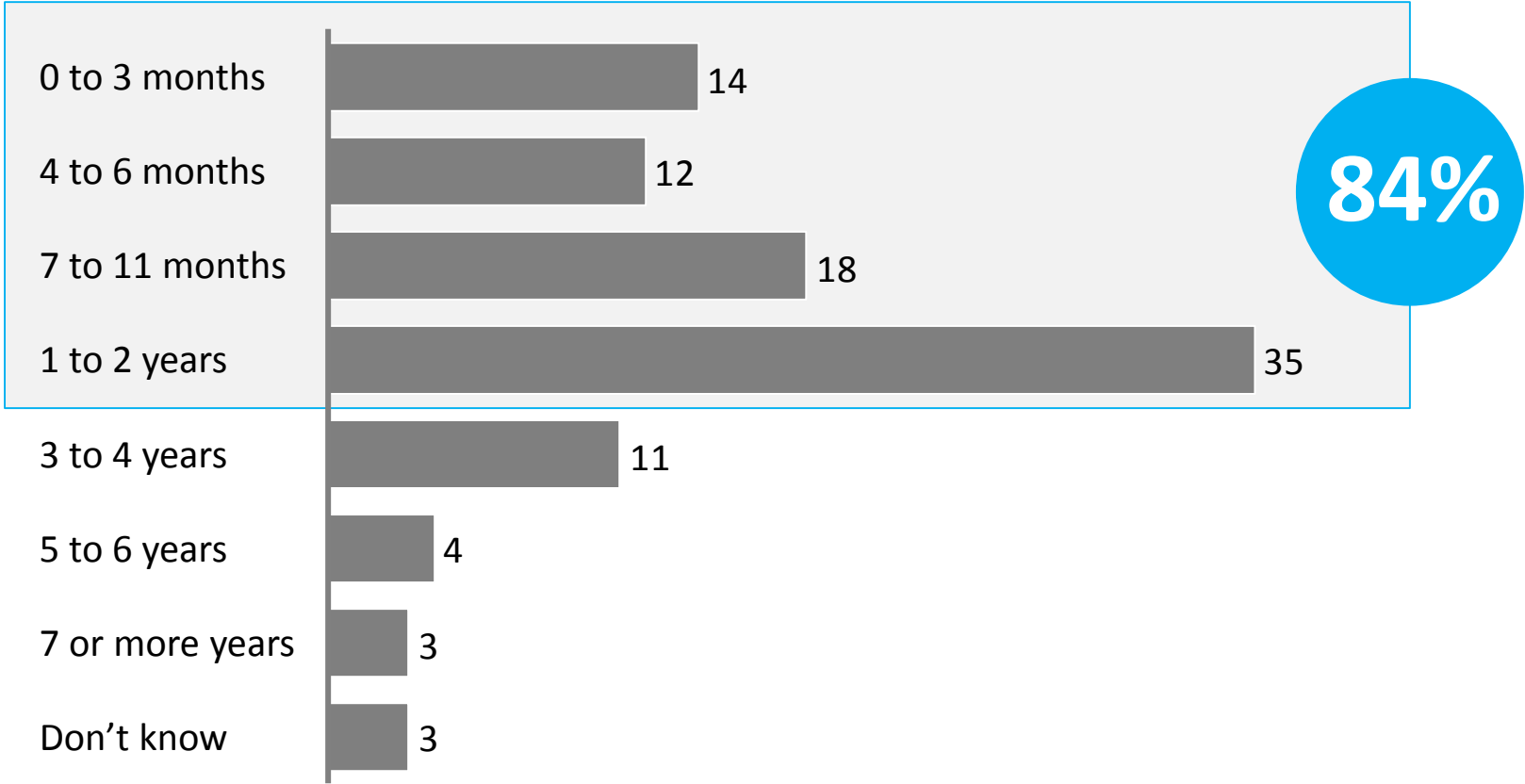
Actual time horizon
companies manage
to **varies between**
industries and asset
classes

Short-term pressures
companies are
subject to **pervade**
all industries

Globally, 84% of senior executives report feeling most pressure to demonstrate financial results within 2 years

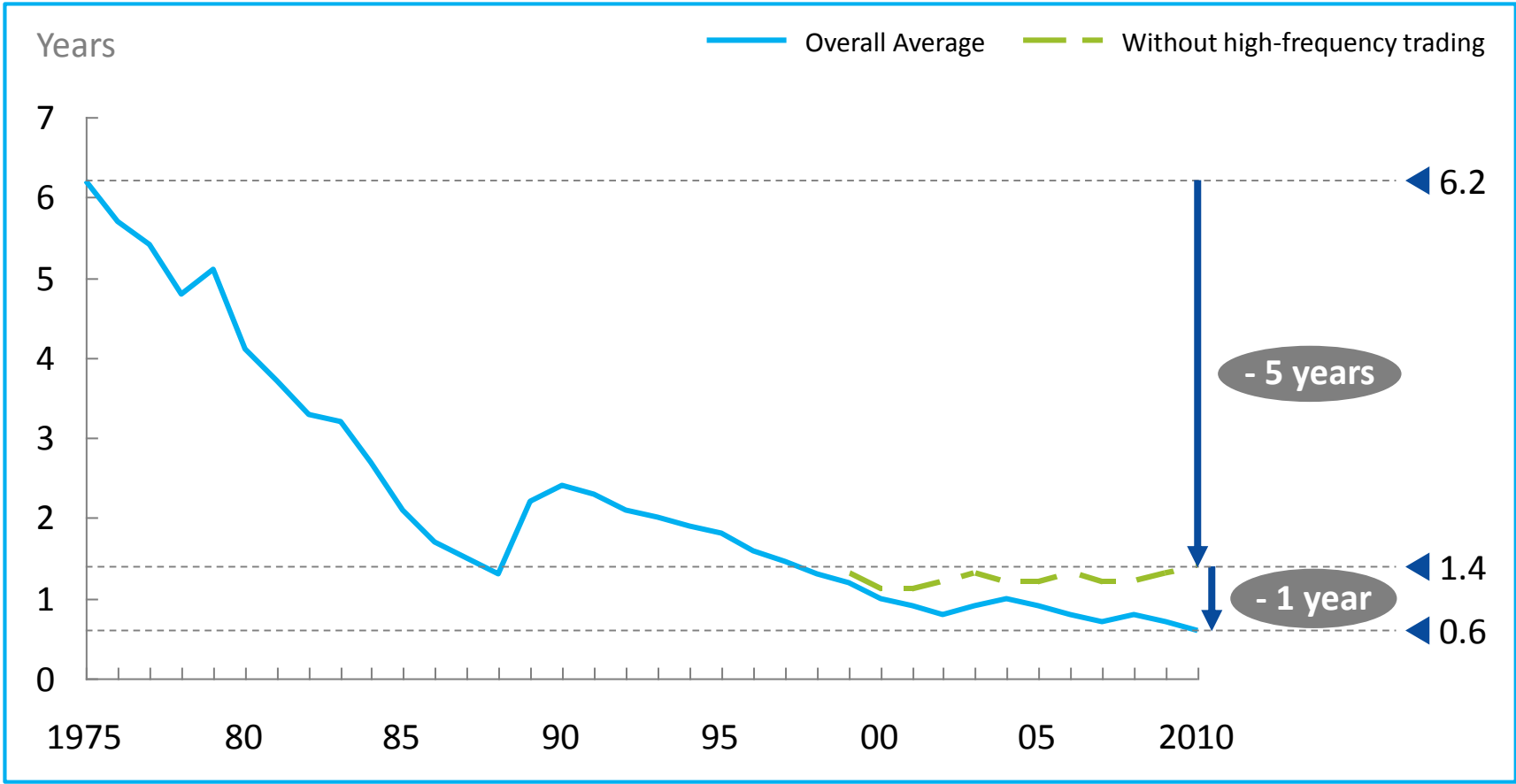
Over what time period do you feel the most pressure to demonstrate financial results?

Percent



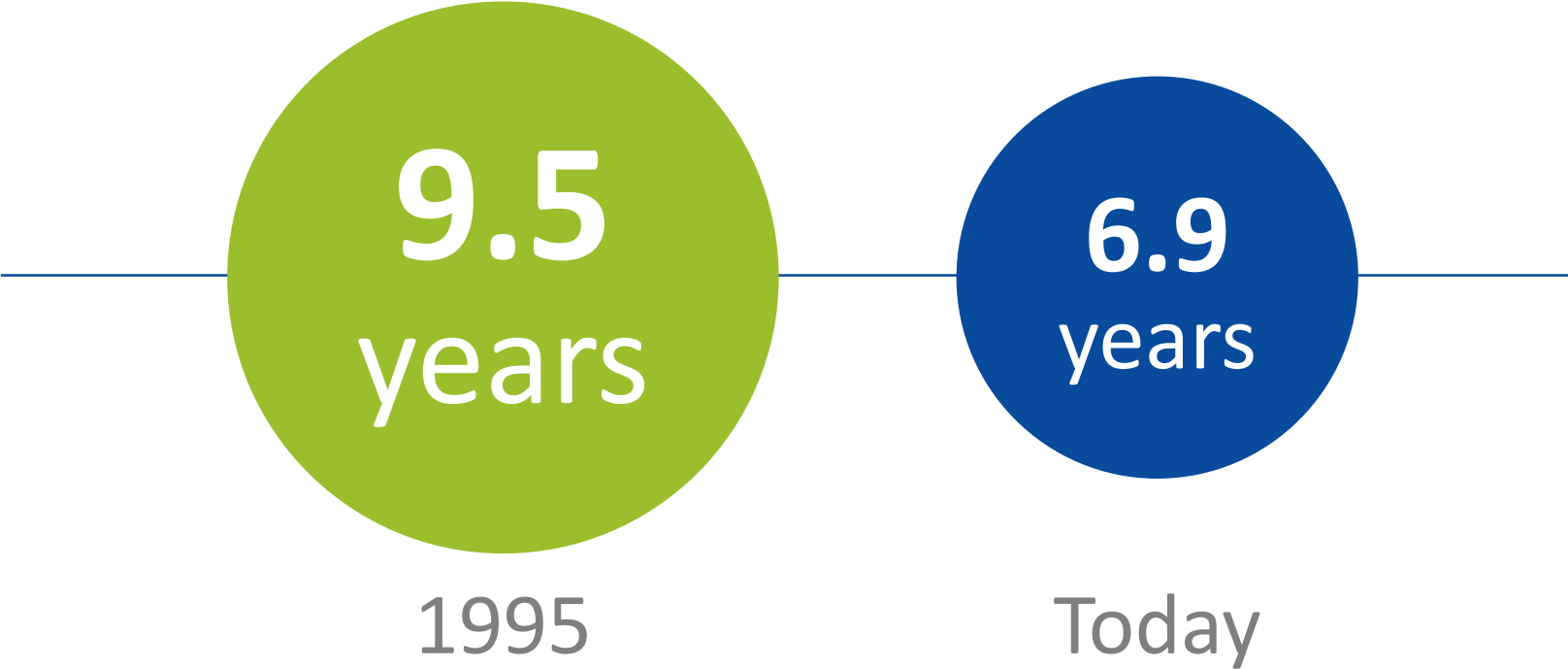
This is partly driven by market pressures to meet returns over very short horizons

Average stock holding period on the NYSE



1 For All Market Cap US Active Equity Mutual Funds net of fees

It is also partly driven by a decline in CEO tenure, which is increasing short-term pressures to perform



Short-term thinking is leading public companies to systematically underinvest

For matched small-medium private and public companies¹; 2002–2011

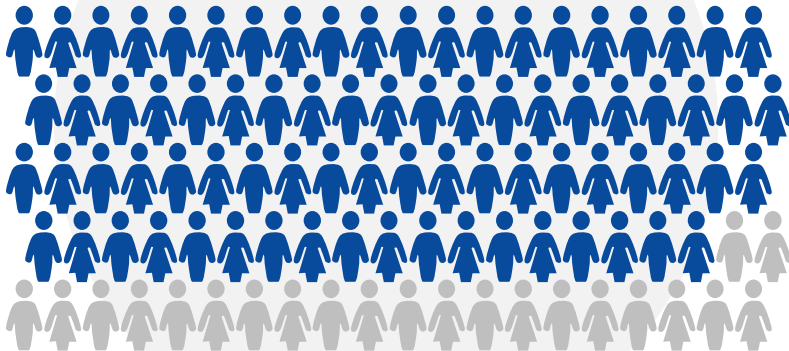
Net Investment² as % total assets



¹ Using NAICS 4 matched on size and industry (North American Industry Classification System)
² Net investment defined as annual increase in net fixed assets scaled by beginning of year total assets

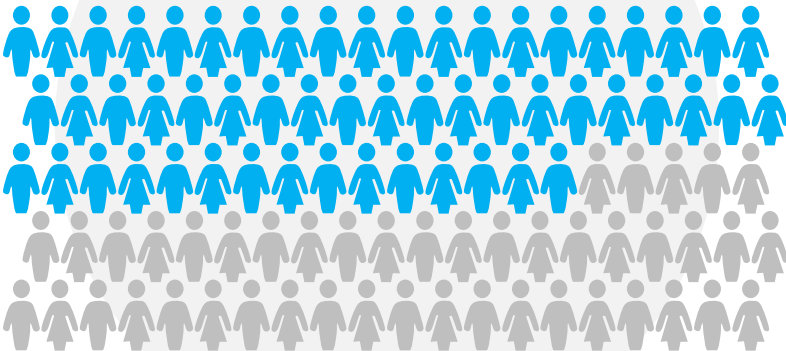
CFOs say they would forgo opportunities to increase long-term value creation and approve NPV-positive investments in order to improve short-term earnings

78%



Would sacrifice value for smooth quarterly earnings

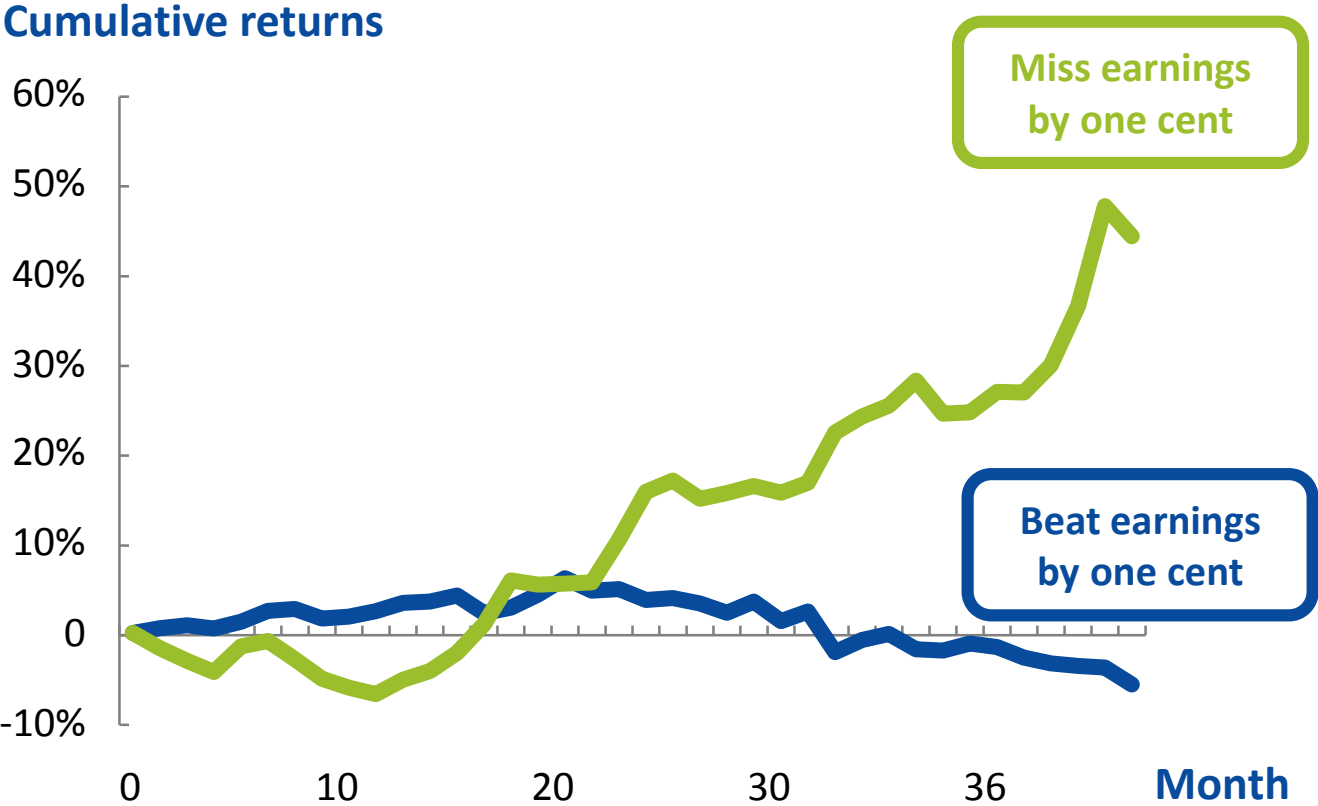
55%



Would forgo NPV+ investment to avoid missing EPS consensus

Note: Based on survey of ~400 CFOs

At the same time, managing to short-term earnings targets can destroy long-term value for companies

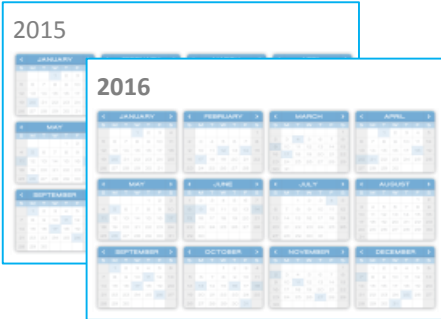


1 The graphs show the cumulative monthly size adjusted returns for firms with high or low earnings quality indicator values that either miss or beat analyst forecasts by a penny

Senior executives feel they should be using a longer time horizon than they are currently and agree that longer time horizons would improve performance

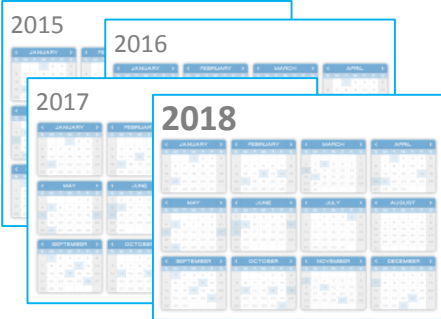
44%

use a time horizon of less than 3 years in setting strategy



73%

say that they should use a time horizon of more than 3 years



86%

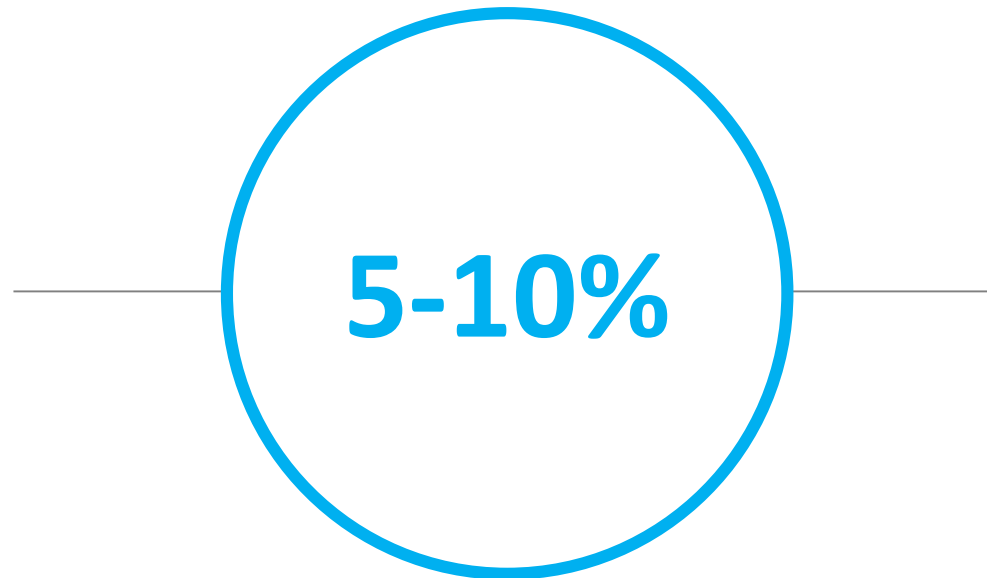
agree longer time horizon for business decisions would improve performance



Markets have increasingly over-discounted future cash flows creating barriers to longer-term investments being fairly reflected in company valuation

Over-discounting of future cash flows

US and UK public equity market prices, actual vs. estimated prices from 1995-2005



Lower estimate than risk and actual returns¹

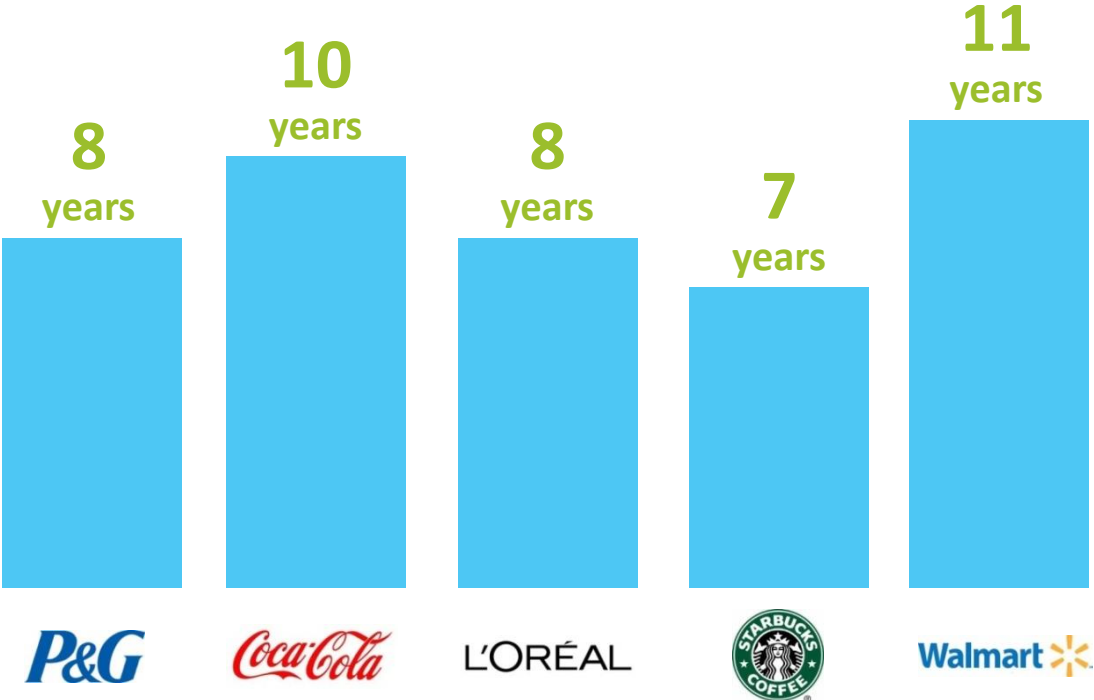
¹ Calculated by looking at stock prices, capital gains and dividend flows from 1985 to 2005

FOCUSING CAPITAL
on the **LONG TERM**

2 The importance of long-term thinking

Long-term thinking is essential for long-term success

Years to break even in China



70-90% of company value is related to cash flow 3+ years out

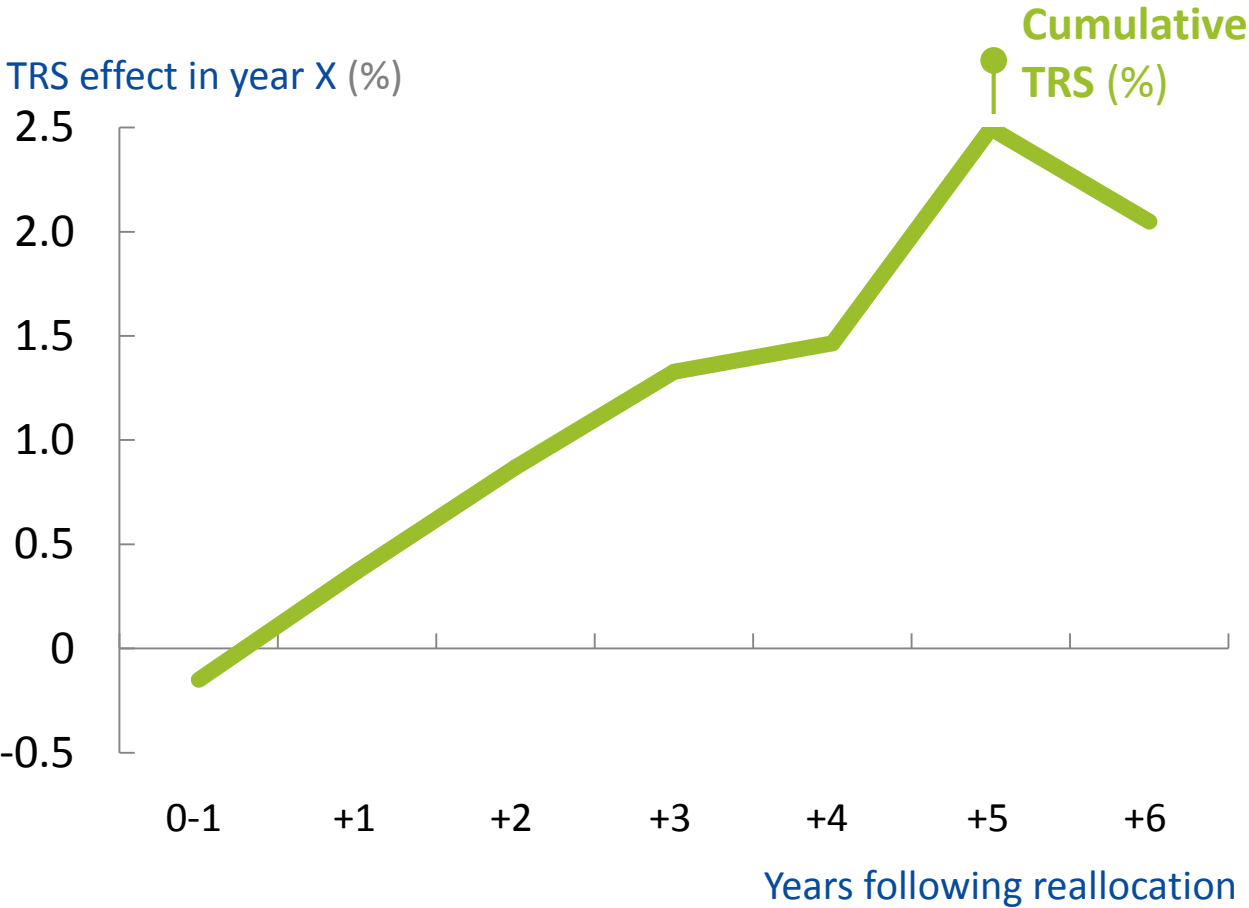
Long-term thinking is essential for long-term success

**Apple's share price fell
25% the year the first
iPod was released**



Companies that allocate investments behind long-term priorities out-perform in the long-run

Effect on TRS of raising reallocation by 10%¹ ...



¹ Analyzes data from 1508 companies, 1990-2010



Savers



Asset owners



Asset
managers



Corporate
boards



Management



Regulators and observers

Yet, barriers to long-term thinking
and behavior exist across the
investment value chain

FOCUSING CAPITAL
on the **LONG TERM**

3 The FCLT initiative: a call to action

'Capitalism for The Long Term' and 'Focusing Capital on the Long Term' called business and investment leaders into action

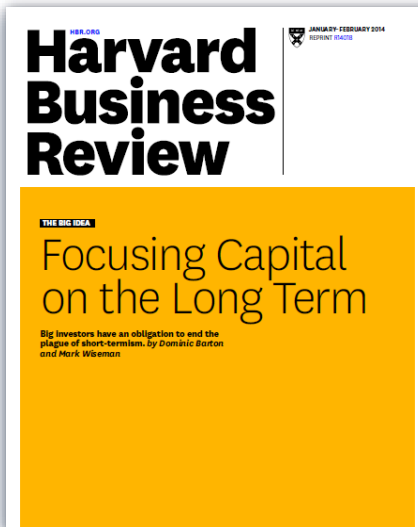


Capitalism for The Long Term

March 2011

“ The *deep-seated, systemic changes* I’m calling for can be achieved *only if boards, business executives, and investors* around the world *take responsibility* for bettering the system they lead

By rebuilding capitalism for the long term, we can make it stronger, more resilient, more equitable, and better able to deliver the sustainable growth the world needs ”



Focusing Capital on the Long Term

January 2014

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

The best place to *start moving* this debate from ideas to action is with the people who provide the essential fuel for capitalism – the *world's major asset owners* ”

Focusing Capital on the Long Term or 'FCLT' was founded to...

FOCUSING CAPITAL
on the **LONG TERM**

Bring together corporate
and investment **leaders**

Focus on practical ideas and
tangible **actions**

Generate broad awareness
and **debate**

A diverse group of leaders committed to taking action



Global Managing Director
McKinsey & Company



President and CEO
CPP Investment Board



Chairman and CEO
AXA



Chairman and CEO
BlackRock



Group Chief Investment Officer
GIC



Chairman
Tata Sons



Dean
Harvard Business School



Chief Executive Officer
Unilever



Chief Executive
E.L. Rothschild



Chairman
Barclays



CEO
PGGM



President and CEO
Edelman



CFRO
APG Groep N.V.



VP, Fixed Income & Alternative Investments
Ontario Teachers' Pension Plan



CEO
Aviva Investors



Group Chief Executive
Standard Chartered PLC



CEO
New Zealand Superannuation Fund



Chairman
The Capital Group Companies



President and CEO
Caisse de dépôt et placement du Québec



Executive Director
Washington State Investment Board



Chief Executive Officer
ATP

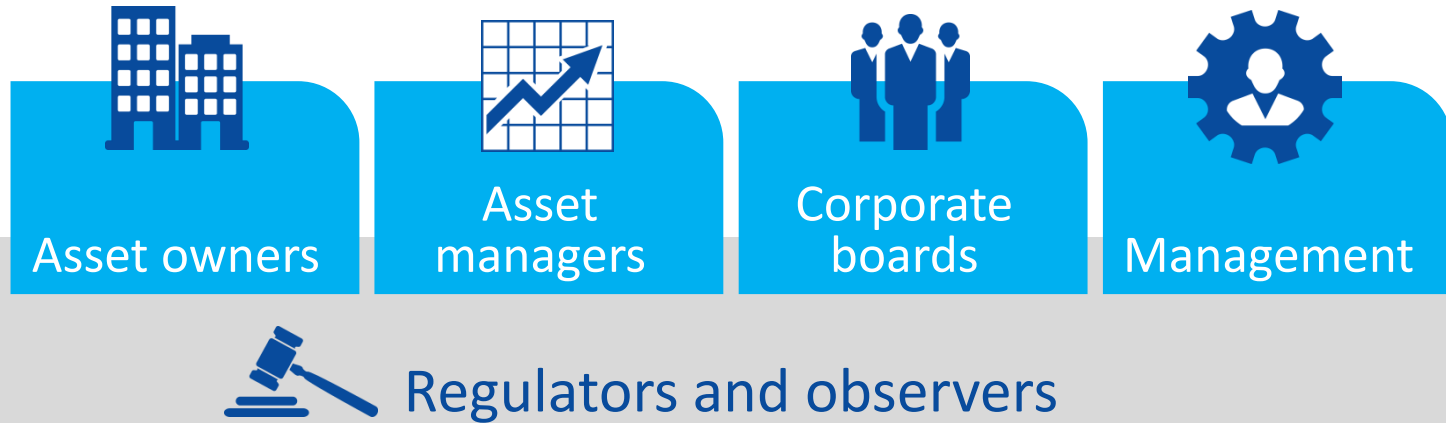


Chief Investment Officer
Wellcome Trust



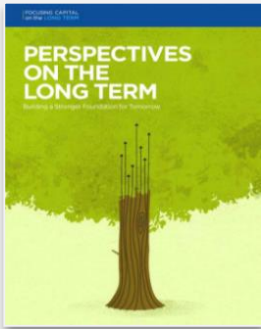
President and CEO
State Street Global Advisors

Plus more than 40 senior delegates from our organizations



Our work has focused on key actors to influence system-wide change

We have delivered new thinking and ideas on long-term value creation...



Perspectives on the Long Term, capturing the thoughts of the world's leading practitioners as they think long-term, from regulation and business to the environment and technology



Investing for the Future, laying out steps investment managers and owners can take to shift markets to the long term



Straight Talk for the Long Term, providing an in-depth look at how the dialogue between investors and corporates should be improved



Where Boards Fall Short, giving an overview of what today's corporate boards are lacking and what they can do to be more long-term oriented



All materials are available at: www.fclt.org

And convened over 120 leaders from across the investment value chain to discuss these ideas, actionable next steps and what many were doing moving forward



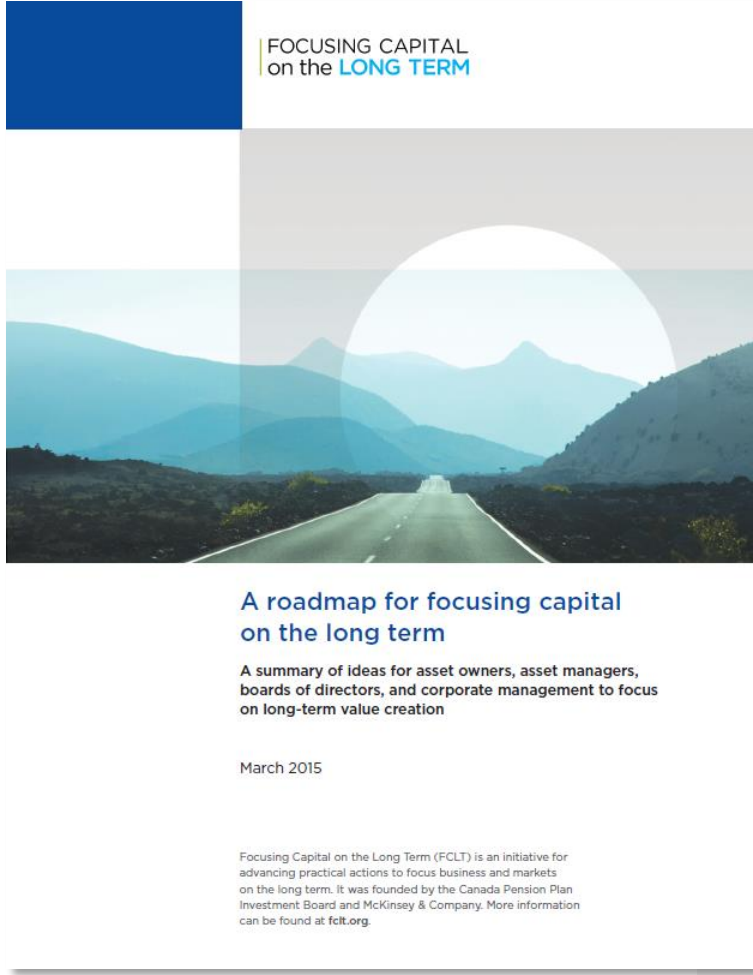
Commitments to action

- “ Create a long-term value index to replace existing benchmarks
- Change the time horizons for firm-wide compensation model
- Institute a long-term value training program for all investment professionals
- Release a suite of long-term performance and health metrics
- End quarterly reporting
- Hold more frank conversations with Boards
- Work in small groups of investors and companies to ‘fix’ the investment value chain ”

FOCUSING CAPITAL
on the **LONG TERM**

4 A roadmap for focusing capital on the long term

Five areas for action



A Reorient the **portfolio strategy** and management of institutional investors

B Unlock value through **engagement** and active ownership

C Improve the **dialogue** between investors and corporations

D Shift the **Board's focus** to support long-term strategy and sustainable growth

E Modify **regulation** to encourage a long-term ecosystem¹

¹ Important underlying issue not directly addressed by an FCLT workstream

A What asset owners and managers can do to reorient portfolio strategy and management

Asset owners and managers should have a mutual understanding of the characteristics of long-term investing and a set of guiding principles. Aligning on the following five areas can ensure a long term-focused culture pervades each organization

1



Clearly articulate **investment beliefs** with a focus on portfolio consequences to provide a foundation for a sustained long-term investment strategy

2



Develop a comprehensive **statement of key risks, risk appetite, and risk measures**, appropriate to the organization and oriented to the long term

3



Select and construct **benchmarks focused on long-term value creation**; distinguish between assessing the strategy itself and evaluating the asset managers' execution of it

4



Evaluate internal and external asset managers with an emphasis **on process, behaviors, and consistency with long-term expectations. Incentivize with a greater weight on long-term performance**

5



Use **investment-strategy mandates as a mutual mechanism to align the asset managers' behaviors** with the objectives of the asset owner, not simply as a legal contract

A What asset owners and managers can do to reorient portfolio strategy and management

2



Develop a comprehensive **statement of key risks, risk appetite, and risk measures**, appropriate to the organization and oriented to the long term

Reasons to focus on risk appetite statements

- Support long-term investment horizon, by acknowledging periods of short-term losses in the pursuit of long-term strategic objectives and by identifying the economic and market environments in which these losses may occur
- Articulate the organization's motivation for accepting, mitigating, or avoiding certain types of risk as it relates to strategic advantages and / or investment strategy
- Identify tolerance for discrepancy from benchmark as it relates to investment beliefs, strategy and requirements (e.g., liquidity constraints, delinked from cycles, asset holding periods) and leverage tools for on-going monitoring and oversight

Investor example



- Uses a clearly articulated risks framework to assess willingness and ability to take risks associated with:
 - Assets (i.e., fiduciary and investment risk)
 - The organization (i.e., strategic, governmental environment, and operational risk)
 - Safeguarding its reputation
- Indicates risk tolerance in each area, why, and what actions this means they will and won't take
- For instance, not letting 'strategy be influenced by short-term market trends' and not investing until having 'the expertise and resources' translates into more illiquid assets in forestry and has led to having no active equity portfolio/risk

A What asset owners and managers can do to reorient portfolio strategy and management

4



Evaluate internal and external asset managers with an emphasis **on process, behaviors, and consistency with long-term expectations. Incentivize with a greater weight on long-term performance**

Reasons to focus on evaluations and incentives

- **Asset manager evaluations can incentivize long term behavior:**
 - Total return relative to objectives over stated period
 - Performance over ≥five-year rolling windows
 - Performance fees or internal incentive compensation earned only at end of each five-year time horizon
 - Defer significant earnings and relate to future performance
 - Rely on qualitative evaluations, specifically tailored to assess the adherence to, or success of, stated investment beliefs or strategy, over time
- **Qualitative evaluations of an asset manager can address:**
 1. Key personnel changes / corporate ownership
 2. Robustness of stated process, and adherence to beliefs and philosophy
 3. Evidence of effective risk management
 4. Ability to coherently express ideas and effectively implement them
 5. Transparent decision-making and performance attribution
 6. Loyalty to research agenda

Investor examples



- Focuses more on qualitative measures rather than quantitative ones when evaluating portfolio managers
- Managers are evaluated based on their adherence to long-term process as observed by peers
- Determinants include the quality of their company research, interaction with colleagues and idea generation
- Discretionary annual bonuses typically are structured as 25 percent cash and 75 percent deferred compensation for three to four years



Caisse de dépôt et placement
du Québec

- Compensates external asset managers using low management fees and rolling four-year incentives phased
- Managers often reluctant but align around long-term returns and the focus on a long-term relationship
- CDPQ's negotiation process helps it identify the best managers willing to commit to its beliefs and strategy

B What asset owners and asset managers can do to unlock value through engagement and active ownership

- 

1 Fulfill shareholder responsibilities to be engaged owners of both active and passive long-term holdings based on equity stake
- 

2 Engage in constructive two-way dialogues with companies such that engagement is proactive and positive rather than reactive and hostile
- 

3 Focus on corporate strategy, key longer-term performance indicators, and activities that will enhance the intrinsic value of the business
- 

4 Be prepared to support companies facing short-term threats if management presents sound plans and processes for long-term value creation

B What asset owners and asset managers can do to unlock value through engagement and active ownership



Vanguard, State Street, BlackRock, CALPERS, JPMorgan, Yum! Brands and others representing >\$10B AUM and some of largest corporations developing framework / platform for shareholder-director engagement



CEO managing >\$4T penned two letters sent to S&P 500 directors and executives calling for longer-term behavior and engagement



Technological applications brings tools enabling all investors to be heard, not just the loudest, providing directors with the collective wisdom of their shareholders



Creating a model for effective collective engagement with UK FTSE 100 and governed by leaders from Capital Group, Aviva Investors, Wellcome Trust, Marks & Spencer among others

C How the dialogue between investors and corporates can be improved

1



Develop and communicate a compelling long-term strategy to investors by including the 10 elements of a compelling long-term strategy – from outlining the mission, value drivers, and market views to covering competitive advantage, goals, implementation roadmap, and risks

2



Measure long-term value creation and performance relative to a set of longer-term metrics specific to the company's long-term strategy, explaining how they underpin value creation business by business and are aligned to management incentives

3



Report to and engage with the right long-term investors regarding value creation by focusing on a longer-term dialogue in one-on-ones, investor days, financial reports, and earnings communication

C How many elements of long-term strategy does your company currently satisfy? How many are communicated to investors?

In FCLTs discussions with institutional investors, experts on corporate strategy and CEOs of companies across various industries, we found broad agreement on 10 key elements that companies should include when building a compelling long-term strategy and communicating it to investors:

- ❑ Express a **clear statement of purpose, mission, and vision**.
- ❑ Explain how the company's business model creates long-term value by identifying **key value drivers** at the reporting unit level (e.g., business, sector, geography).
- ❑ State **management's market view**, major trends impacting it, potential for growth, the business' relative positioning, and implicit assumptions underlying the view (e.g., macroeconomic factors).
- ❑ Highlight sources of **competitive advantage** such as talent, access to resources, or other assets that enable the company to execute its strategy and win in the marketplace, clearly substantiated by fact.
- ❑ Disclose **strategic goals** ultimately tied to drivers of value creation (e.g., returns on invested capital, organic revenue growth) in the context of current and future market trends, and in the company's competitive advantage.
- ❑ Lay out a **detailed execution roadmap** that defines short-, medium-, and long-term actions linked to key milestones and strategic goals targeted at long-term value creation.
- ❑ Provide **medium- and long-term metrics and targets** that indicate the company's ability to deliver on its strategy, including an explanation of how the selected metrics will be measured and tracked consistently (see Section 2).
- ❑ Explain how **capital and noncapital investments**, including the mix of profit allocation, lead to sustained competitive advantage and the creation of long-term value.
- ❑ Provide an overview of **risks** and their mitigation plans, inclusive of sustainability challenges.
- ❑ Articulate how **executive and director compensation** tie to long-term value creation and strategic goals.

C How the dialogue between investors and corporates can be improved

3



Report to and engage with the right long-term investors regarding value creation by focusing on a longer-term dialogue in one-on-ones, investor days, financial reports, and earnings communication

Reasons to focus on engagement activities

- Individuals across the investment value chain are having conversations which reinforce short-termism
- Corporates should ensure they are focusing their communications on the right investors and the long-term
- Focusing reporting on long-term strategy and consistently using long-term terminology on earnings calls is correlated with benefits; for those who fail to cost of capital is 0.42% higher on average and they experience increased share price volatility
- Corporates and investors can immediately address one-on-ones, investor days, financial reports, and earnings communications to be more long term

Corporate examples



One-on-ones

- Built its long-term investor base by focusing on regular meetings between business heads and investors, rather than relying on quarterly earnings reports



Investor days

- Held frequent Investor Days during which management reviewed full strategy and shorter, region-specific sessions to review regional strategy in more detail



Reporting statements

- Reworked its annual report to more clearly reflect how value is created across the company, industry-by-industry



Earnings communications

- Aggressively leverages long-term strategy to tie short-term performance to long-term objectives

D What boards can do to shift focus to support long-term strategy and sustainable growth



1 **Select the right directors** to ensure diversity of opinion and proven experience in building relevant businesses, as well as deep functional expertise. Look for individuals with track record for independent thinking



2 **Spend more quality time** fulfilling duties and allocate larger portion of that time to discussing long-term strategy. Regular and creative group outings can also be valuable



3 **Engage key director with long-term investors** through discussions on long-term strategy and metrics, not just 'say-on-pay'



4 **Pay directors more, especially for long-term performance,** but not in cash. Leverage an incentive structure that would require directors to have a significant equity stake for an extended period of time

E What regulators can do to create an economic system promoting long-term, sustainable value creation

1



Reinforcing the concept of fiduciary duty across the investment value chain (e.g., pension fund and corporate directors to consider the long-term implications for the company, shareholders, and broader set of stakeholders)

2



Remedy policies and regulations unintentionally encouraging short-term behaviors (e.g., Solvency II increasing pressure on insurance companies and defined benefit pension funds to limit exposure to equities)

3



Provide preference to long-term value creation in tax and shareholder rights policies (e.g., capital gains tapering to reduce tax rate longer an investment held, differentiated voting rights for long-term shareholders)

For discussion



1 How do you balance short and long-term performance and health in your organization?

2 What additional steps could regulators and policy makers take to support long-term investment by companies and asset owners?

3 How could the financial press and media provide better coverage of these issues?

4 What is the macro-economic impact of systematic short-termism?

For more information...



www.fclt.org