FOCUSING CAPITAL on the LONG TERM

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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
The rise of short-termism
What qualifies as ‘long term’ varies by industry, but thinking long-term is essential.

<table>
<thead>
<tr>
<th>Industry</th>
<th>2007</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technology</td>
<td>5.1</td>
<td>4.3</td>
</tr>
<tr>
<td>Aerospace</td>
<td>7.1</td>
<td>7.5</td>
</tr>
<tr>
<td>Retail</td>
<td>8.0</td>
<td>7.5</td>
</tr>
<tr>
<td>Chemicals</td>
<td>9.1</td>
<td>10.9</td>
</tr>
<tr>
<td>Energy</td>
<td>10.8</td>
<td>13.7</td>
</tr>
<tr>
<td>Tourism</td>
<td>13.5</td>
<td>16.1</td>
</tr>
<tr>
<td>Mining</td>
<td>17.0</td>
<td>17.0</td>
</tr>
</tbody>
</table>

Actual time horizon companies manage to vary between industries and asset classes.

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

 SOURCE: McKinsey
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?

<table>
<thead>
<tr>
<th>Percent</th>
<th>0 to 3 months</th>
<th>4 to 6 months</th>
<th>7 to 11 months</th>
<th>1 to 2 years</th>
<th>3 to 4 years</th>
<th>5 to 6 years</th>
<th>7 or more years</th>
<th>Don’t know</th>
</tr>
</thead>
<tbody>
<tr>
<td>14</td>
<td>12</td>
<td>18</td>
<td>35</td>
<td>11</td>
<td>4</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
</tbody>
</table>

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

SOURCE: Global Strategy Research, Strategic Insights using 1,086 US mutual funds
It is also partly driven by a decline in CEO tenure, which is increasing short-term pressures to perform.

SOURCE: Strategy& (formerly Booz)
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

Private Companies
9.4%

Public Companies
2.2%

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.

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.

SOURCE: Graham, Harvey, Rajgopal, 2011; Bhoraj et al, ‘Making Sense of Cents: An Examination of Firms That Marginally Miss or Beat Analyst Forecasts,’ 2004
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 returns

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

The importance of long-term thinking
Long-term thinking is essential for long-term success

Years to break even in China

- **8 years**
- **10 years**
- **8 years**
- **7 years**
- **11 years**

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 outperform in the long-run

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

1 Analyzes data from 1508 companies, 1990-2010

SOURCE: How to put your money where your strategy is, Stephen Hall, Dan Lovallo, Reinier Musters, McKinsey Quarterly 2012 #2, McKinsey Corporate Strategy Service Line
Yet, barriers to long-term thinking and behavior exist across the investment value chain.
The FCLT initiative: a call to action
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.

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...

- 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 Officer
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
Aviva Investors

Executive Director
Washington State Investment Board

CEO
ATP

Chairman
Caisse de dépôt et placement du Québec

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](http://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
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 ecosystem\(^1\)

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1 Important underlying issue not directly addressed by an FCLT workstream
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.

SOURCE: FCLT Long-Term Portfolio Guide
What asset owners and managers can do to reorient portfolio strategy and management

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

SOURCE: FCLT Long-Term Portfolio Guide
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 adhesion 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
- 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
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.

SOURCE: FCLT Roadmap for focusing capital on the long term
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

SOURCE: FCLT Roadmap for focusing capital on the long term
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.

SOURCE: FCLT Straight Talk for the Long Term report
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.

For examples, reference FCLTs Straight Talk for the Long Term white paper
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.

SOURCE: FCLT Straight Talk for the Long Term report
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.

SOURCE: FCLT Where Boards Fall Short, January-February 2015 HBR
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