FOCUSING CAPITAL
on the LONG TERM

A roadmap for focusing capital on the long term

A summary of ideas for asset owners, asset managers, boards of directors, and corporate management to focus on long-term value creation

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Focusing Capital on the Long Term (FCLT) is an initiative for advancing practical actions to focus business and markets on the long term. It was founded by the Canada Pension Plan Investment Board and McKinsey & Company. More information can be found at **fclt.org**.

Short-termism is a problem that affects us all.

Too many investors continue to seek returns on their strategies as quickly as possible. Companies are missing out on profitable investments for fear of missing quarterly earnings guidance. Corporate management significantly undervalues and underinvests in longer-term prospects. Savers are missing out on potential returns because stock markets are penalizing companies that make long-term investments. Society is missing out on long-term growth and innovation because of underinvestment.

A 2014 global survey of more than 600 C-suite executives and directors conducted by McKinsey & Company and the Canada Pension Plan Investment Board indicates that senior executives today are seeing increased short-term pressure on financial performance, notwithstanding their belief that a long-term approach to business decisions is a key driver of company performance. Nearly two-thirds of respondents said that the pressure to deliver strong short-term financial performance stemmed from their board and executive team. One-quarter of respondents also pointed to their institutional shareholders.

Despite strong evidence that short-term strategies and behaviors have become entrenched in today's markets, change is possible, and the best place to begin the process is with corporate boards and institutional investors. Together, they are the key influencers with the ability to create space for executives to run companies for the long term to the benefit of all stakeholders.

Focusing Capital on the Long Term (FCLT) was founded in 2013 to address this problem. It brought together a diverse group of more than 20 leaders who represent major institutional investors and corporations. Our goal was to develop practical structures, approaches, and ideas to foster longer-term behaviors in the investment and business worlds. Our aim is to shift market dynamics and behaviors in the investment value chain from excessive short-termism toward longer-term capital investment, business practices, and value creation for all stakeholders.

The following ideas for action are the outcome of hundreds of working sessions, interviews, and meetings. Each of the organizations involved in this effort may hold these ideas to varying degrees based on their unique mandates and industries. We are presenting these ideas for debate. We urge investment and corporate leaders to evaluate which of these ideas they might adapt and adopt to enhance the long-term value they create for their beneficiaries and stakeholders.

Institutional investors and corporations can unlock system-wide change

Asset owners, asset managers, corporate directors, and managers have the ability to unlock system-wide change, yet today too many of these individuals are the source of short-term pressure.

An ideal market will always include a mix of investors with different investment time horizons and investment strategies. Time horizons will always vary by industry and asset type. Yet, across industries, long-term thinking goes beyond a product cycle, beyond the average tenure of directors or the CEO, and beyond a typical investment cycle. If the major players in the market, starting with the world's big asset owners and managers, start to adopt such longer-term perspectives, it can create a virtuous circle across the investment value chain.

In theory, the benefits of long-term corporate strategies should be reflected accurately in the current share price. However, evidence strongly suggests that numerous and substantial market-pricing failures exist and today's asset prices do not accurately reflect long-term value. The relentless focus on short-term performance and hypersensitivity to the current news cycle have distorted asset prices and market volatility in general. This is self-defeating in that it undermines corporate investment, holds back economic growth, and lowers returns for savers. By investing countercyclically, long-term investors can reap rewards forgone by short-term investors, allocate capital to long-term opportunities, and strengthen the market.

Areas for action

The following presents four areas for action that institutional investors, corporate directors, and management can use to influence other market participants and focus capital on the long term.

1 Reorienting the portfolio strategy and management of institutional investors

Institutional investors own 70 percent of the outstanding stock of the largest 1,000 US public companies, either directly or through external managers. They have not only the size and clout to be champions of long-term thinking but also a vested interest in generating higher economic value for all of their beneficiaries. FCLT gathered more than 20 professionals from nine investment-management organizations, with an aggregate of more than $6 trillion in assets under management, to develop practical ideas on how fund managers can reorient their strategies and practices toward long-term value creation.

The output of these discussions has been organized into these six broad action areas:

- Understand and define the characteristics of long-term investing. Develop a set of principles that can guide, and be used to test, current and future practices.
- Clearly articulate investment beliefs, with a focus on their portfolio consequences, to provide a foundation for a sustained long-term investment strategy.
- Develop a comprehensive statement of key risks, risk appetite, and risk measures, appropriate to the organization and oriented to the long-term.
- Select and construct benchmarks focused on long-term value creation. Distinguish between assessing the strategy itself and evaluating the asset managers' execution of it.
- Evaluate internal and external asset managers, with an emphasis on process, behaviors, and consistency with long-term expectations. Formulate incentive compensation with a greater weight on long-term performance.
- Use investment-strategy mandates not simply as a legal contract but as a mutual mechanism to align the asset managers' behaviors with the objectives of the asset owner.

While institutional investors should build and maintain a culture that rewards and encourages long-term thinking, long-term investors cannot and should not completely ignore short-term opportunities. Institutional investors need to optimally balance their portfolios across a mix of short-, medium-, and long-term strategies to generate returns for their clients and beneficiaries. Nonetheless, there needs to be a shift in the focus of equity investing away from short-term stock-price movements. Those who can invest long term should invest long term. Long-term investors should allocate a meaningful proportion of their assets to long-term strategies and reorient their portfolio strategies and management to enable them to do so.

Read "Investing for the future: How institutional investors can reorient their portfolio strategies and management to focus on the long term," FCLT, March 2015, for further details on these six action areas and steps some investors have already taken.

2 Unlocking value through engagement and active ownership

Engagement by asset owners with their investee companies—either through the acquisition of a meaningful ownership position or through proactive, ongoing dialogue with the board and management—is an important means of unlocking long-term value in their investments.

Recognizing that engagement carries its own costs and that not all asset owners are large enough to engage on their own, a range of strategies should be considered, from monitoring of investees on an ongoing basis and building coalitions with other investors, to taking an active ownership position (usually below 5 percent), to taking a significant ownership position (more than 10 percent) and holding seats on the board of the investee company.

While working behind the scenes to improve an investee's performance is typically the most effective approach, there are times when exerting public pressure, such as voting on shareholder proposals or forming microcoalitions with other large investors, is the most effective route.

In addition, asset owners should become more involved in debates around capital requirements, financial-market reform, and reporting standards.

Read Dominic Barton and Mark Wiseman, "Focusing capital on the long term," Harvard Business Review, *January–February 2014, for more detail.*

3 Improving the dialogue between investors and corporations

Many public companies dedicate significant resources to meeting quarterly earnings guidance and communicating their performance relative to this guidance. Research shows that this emphasis on short-term earnings targets can lead to value-destroying behaviors, such as forgoing net-present-value-positive investments that put at risk meeting the quarter's consensus earnings per share estimates. Yet, despite this focus on short-term actions and communications, McKinsey research shows more than 50 percent of a typical company's value is created by activities that will take place three or more years in the future.

The investor–corporate dialogue can help counteract this short-term bias. We define investor–corporate dialogue as the flow of information and ideas between corporations and their current and future investors. A healthy dialogue can empower management to make strategic and operating decisions that build value for the long term.

Companies that seek to build a more strategically focused long-term culture by striking a better balance between short-term performance and long-term value creation should consider how they can:

- build a compelling long-term strategy and communicate it to investors
- measure long-term value-creation initiatives and performance relative to a set of long-term metrics that are specific to the company and its long-term strategy
- report and engage with investors on the company's progress against long-term strategic goals

Read "Straight talk for the long term: How to improve the dialogue between corporations and their investors," FCLT, March 2015, for a discussion of these three areas and examples of these ideas in action.

4 Shifting the board's focus to support long-term strategy and sustainable growth

Data show that most directors lack understanding of their companies' strategies to create value or the dynamics of their industries. They overemphasize short-term financial results and pay scant attention to long-term opportunities to create value. And, as mentioned, boards put pressure on their management to pursue short-term strategies and investments. This harsh assessment arises from directors and C-suite executives themselves.

The first step to resolving this problem is to select the right directors—independent thinkers with the appropriate industry-specific knowledge and business experience. As well, retirement rules should be applied in a way that balances the value of experience with the need to introduce fresh thinking to the board.

There must be more time spent on developing the organization's long-term strategy. The emphasis here is on quality time, rather than number of days spent. Strategic discussions should be rich and free-flowing, and should involve both financial and nonfinancial objectives and metrics.

Boards also have a significant role to play in engaging in dialogue about long-term strategies with major long-term shareholders, who themselves have a strong influence on financial markets and are currently a source of pressure to produce short-term results. Participating in such conversations is one means for investors to unlock value through engagement and more active ownership.

Finally, board compensation should be restructured to ensure directors are adequately compensated for their efforts, especially in light of the fact that these recommendations involve more time and effort, and higher-quality directors. This recommendation is reflective of a growing consensus that directors should be paid more and sit on fewer boards.

Read Dominic Barton and Mark Wiseman, "Where boards fall short," Harvard Business Review, *January–February 2015, for more on these ideas and a list of additional articles on board reform.*

For more information on the Focusing Capital on the Long Term initiative, visit fclt.org.