FCLTGLOBAL
FOCUSING CAPITAL ON THE LONG TERM

18 September 2019

European Securities and Markets Authority
103 rue de Grenelle
75007 Paris, France

To whom it may concern at European Securities and Markets Authority,

On behalf of FCLTGlobal, we would like to express our appreciation for the opportunity to participate in the European Supervisory Authorities' call for advice to collect evidence of undue short-term pressure from the financial sector on corporations. Please find below a short background on our organization and several pieces of evidence that we hope will assist in developing your reports.

Background on FCLTGlobal and its research

FCLTGlobal is a not-for-profit organization that works to encourage a longer-term focus in business and investment decision-making by developing practical tools and approaches to support long-term behaviors across the investment value chain.

Started as the Focusing Capital on the Long Term initiative in 2013, our organization was founded in July 2016 by the CEOs of the Canada Pension Plan Investment Board and McKinsey & Company, together with BlackRock, The Dow Chemical Company, and Tata Sons. In addition to our Founders, today we involve 51 Members from across the investment value chain, including asset owners, asset managers and corporations. While we do not speak on behalf of our members, our Members are broadly committed to accomplishing long-term tangible actions to lengthen the timeframe of capital allocation decisions.

We work closely with our Member organizations to conduct research, including a thorough investigation of the predictors of long-term value creation. For corporates, this includes appropriate capital allocation, including higher fixed investment, greater board gender diversity, greater presence of long-term investors, and the absence of ESG controversies. We will publish this research shortly.

Also with our Members, we develop practical research and accessible tools to facilitate long-term behaviors, such as approaches to the investor-corporate dialogue, including sharing a long-term roadmap and discontinuing quarterly guidance.

We were encouraged to see our members BlackRock, KPMG, Nasdaq, and Schroders share key insights through their responses to the ESMA survey and to hear our members HSBC, BlackRock, ….. comment at last week's ESMA workshop on short-termism.

We provide additional detail on this research in our comments, and the complete reports are available on our website at www.fcltglobal.org.

<u>Evidence of Undue Short-Term Pressure from the Financial Sector on Corporations</u>

Below, please find assembled evidence from our own analysis, from that of our members, and from our review of the existing literature on long-term and short-term dynamics in the capital markets.

<u>Evidence from large data sets analyzed by FCLTGlobal staff</u>
<u>(Investment strategy and investment horizon,</u>
<u>Disclosures of ESG factors and their contribution to long-term investment, and</u>
<u>Institutional investors' engagement)</u>

Approach. We reviewed 320 pieces of academic or investment research, consulted with over 125 experts, and analyzed 20 million data points to shortlist predictors of long-term value creation. We focused on the large, publicly traded companies in the MSCI ACWI, which represent 85% of the global investable opportunity set, from 1999-2017. Long-term performance was measured in terms of the five-year return-on-invested-capital (ROIC).

While we are proud of the rigor of this approach, no method is perfect. Our focus on factors with broad data prevented us from evaluating aspects of talent and culture that we know are vital to the long-term prospects of corporations, asset managers, and asset owners. These include customer satisfaction and employee engagement, both of which have been shown to be connected to long-term success. Similarly, although our minimum 80 percent data completeness standard limited some of the biases associated with missing data, it also eliminated whole dimensions of information from our purview, such as greenhouse gas emissions or executive compensation duration—both of which have been linked to long-term performance in some academic work but where global data is currently incomplete.

Results. We found that long-termism is in decline among corporations. When we look across all the measurable predictors of long-term success identified in our analysis, we find that global corporations have grown less long-term in recent years, and remain substantially less long-term-oriented than they were before the financial crisis. One big reason is the rising tendency to distribute—and sometimes overdistribute—capital to shareholders.

The factor most strongly bound to long-term performance was actually a negative factor—something to avoid—namely overdistribution of capital in the form of dividends and buybacks that exceed the free cash flow generated by the company. Naturally, efforts to return money to shareholders can and do make sense when companies don't have more attractive investments to pursue. But our analysis shows that capital distributions to investors in excess of free cash flow are associated with weaker return on invested capital (ROIC).

Another factor that weighs on long-term value creation is excessive leverage—though again this is not a blanket dismissal, as leverage can be vital to businesses. As a general tendency though, more leverage among companies in our dataset has translated into lower ROIC.

Environmental, social, and governance (ESG) controversies can also be a drain on long-term ROIC, an effect that is most meaningful for larger firms with more extensive media coverage. And consistent with prior research, issuing short-term guidance also portends weaker performance. We will expound on the question of company issued forward-looking guidance further below.

Lastly, it is a good sign when a company's shares are held by long-term investors, which we measure as the portfolio-wide holding period of the investor base. In our analysis, we defined long-term investors as firms with less than 50% dollar turnover (effectively a portfolio-wide holding period greater than two years).

Evidence from large data sets analyzed by FCLTGlobal members

Our members McKinsey and KPMG's analyses of large data sets suggests that longer-term-oriented companies created significantly more jobs and generated significantly greater market capitalization, revenue, and earnings growth than shorter-term-oriented companies. While these studies highlight evidence of the benefits associated with long-termism, the inverse is also true: that short-termism is correlated with fewer jobs, lower market capitalization, revenue, and earnings growth.

McKinsey's Corporate Horizon Index.[1] McKinsey analyzed 615 large and mid-cap US publicly listed companies from 2001 to 2015, examining patterns of investment, growth, earnings quality, and earnings management. Its three noteworthy findings are detailed below.

First, long-term firms invested more than other firms from 2001 to 2014. Cumulatively by 2014, long-term companies on average spent almost 50% more on R&D than other companies. More important, they continued to increase their R&D spending during the financial crisis while other companies cut R&D expenditure; from 2007 to 2014, average R&D spending for long-term companies grew at an annualized rate of 8.5% vs. 3.7% for other companies.

Second, on average, the market capitalization of long-term companies grew $7 billion more than that of other firms between 2001 and 2014. They were also 50% more likely to be top decile or top quartile in terms of total return to shareholders by 2014.

Third, long-term firms added nearly 12,000 more jobs on average than other firms from 2001 to 2015. Had all US publicly listed firms created as many jobs as the long-term firms, the US economy would have added more than five million additional jobs over this period.

While the analysis was not replicated for European markets, we believe the findings are useful for other geographies to consider.

KPMG.[2] KPMG constructed a dataset consisting of 335 listed mid- and large-cap companies from Germany (DAX + MDAX), the Netherlands (AEX), the United Kingdom (FTSE 350) and the United States (S&P 500), with a minimum reported average annual revenue greater than US$250m. Companies were selected based on random uniform selection across all sectors in the economy. Financial services companies were excluded. The dataset spanned 2003 to 2017. Its two key takeaways follow.

First, according to KPMG, long- vs. short-term-oriented companies showed revenue 130% vs. 77% growth 2003-2017 (6.1% vs. 4.2% per year). Long-term oriented companies also had higher revenue growth rates 2008-2017 (post-financial crisis).

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[1] https://www.fcltglobal.org/research/reports/article/measuring-the-economic-impact-of-short-termism

[2] https://assets.kpmg/content/dam/kpmg/xx/pdf/2019/05/winning-strategies-for-the-long-term.pdf

Second, KPMG saw 212% vs. 92% earnings growth 2003-2017 (8.5% vs. 4.6% per year) for long- vs. short-term-oriented companies. Moreover, in all in-between years, the growth in earnings per year was higher for long-term oriented companies than their short-term counterparts.

Survey-based evidence from FCLTGlobal member McKinsey & Company[3]
(Institutional investors' engagement)

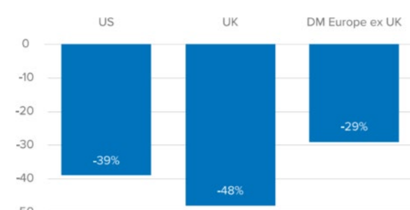
Approach. Similarly, FCLTGlobal member McKinsey analysis of survey data suggests that taking a long-term view has a positive impact on corporate financial performance. In late 2015 and early 2016, McKinsey & Company surveyed over 1,000 McKinsey Quarterly panelists globally. Many of the questions were a repeat of those asked in a 2013 survey of the same panel.

Results. Of the 37% of top management (chief executive officers, chief operating officers, and chief operating officers) and board members who reported that long-termism is a major part of their management teams' cultures, 88% said the long-term view has had a positive effect on financial performance. When asked what their companies would do if it were near the end of an earnings reporting period and it seemed they would miss their earnings targets, executives who reported that long-termism is a major part of their companies' cultures said their companies were 26% less likely than other companies to decrease discretionary spending in this scenario. Perhaps more strikingly, these executives reported that their companies were 22% less likely than others to delay a new project and sacrifice some value to hit short-term earnings targets. Executives at long-term companies are also likelier than others to take no action at all: 61% of these respondents said their companies would likely make no changes in behavior in this situation, compared with just 33% of all other respondents. Changing behavior would indicate sacrifice long-term value creating investments to alleviate short-term earnings pressure, ultimately leading to lower returns and economic growth. Such lower returns and economic growth represent the harm caused by short-termism.

Survey respondents said the sources of this pressure are evolving. They still said that board members and C-level executives—in other words, they themselves—exert the most pressure to demonstrate short-term results. Boards also seem to play an outsized role in decisions to increase dividends or buy back shares: 49% percent of respondents said their boards played a large role in their companies' most recent decisions to distribute cash or buy back shares, compared with 30% who said the same for shareholders and one-quarter who say so of senior managers.

Respondents blamed the increased pressure on more-vocal activist investors twice as often as they did before. Specifically,14% of respondents in 2016 blamed the pressure on activists, up from 7% in 2013.

Short-termism in public markets[4]
(Institutional investors' engagement)



Tackling short-termism in public markets has significant potential benefits.

From 1993-2017, the number of publicly listed companies has fallen precipitously across developed markets: 39% in the US, 48% in the UK, and 29% in Europe ex-UK. This is due in part to the cost of going and staying public. Going public is expensive: it entails an underwriting fee of 4-7% of gross proceeds and other fees often totaling over $4 million. Companies also bear a significant cost to stay public due to ongoing regulatory and reporting requirements, as well as annual listing fees. Although these

[3] https://www.fcltglobal.org/research/reports/article/rising-to-the-challenge-of-short-termism
[4] https://www.fcltglobal.org/research/reports/article/publicmarkets

costs are real, they are dwarfed by the potential gains to public ownership for large, innovative companies and the broader societal benefits derived from a robust public equity market.

Short-term investors can encourage volatility and management turnover as they push for near-term shortcuts at the expense of long-term strategy. By contrast, a long-term investor base reduces a company's cost of equity, in part due to the superior monitoring these investors provide and the strong match between their goals and the companies in which they invest. The presence of long-term investors also reduces stock price volatility, encourages greater fixed investment, and is even associated with higher returns.

In terms of academic evidence, Brochet, Lumioti and Serafeim (2012) [5] found that the stocks of companies exhibiting short-term behavior – including issuing short-term earnings guidance – were more volatile than the market as a whole and that the cost of capital for those firms was 0.42% higher than for the average firm. In a follow-up study, Brochet et al (2015) [6] found that firms with greater emphasis on the short-term in their disclosures and investor communications experience lower return on equity (ROE) over the following two years vs. their peers.

Lastly, in the US, the SEC has already begun to investigate the potential costs of short-term guidance and reporting practices and their potential contribution to corporate short-termism.

Short-term guidance[7]
(Institutional investors' engagement)

Although only 0.7% of Euro Stoxx 300 companies issue quarterly guidance, it's worth briefly touching upon its harmful effects before segueing into our recommended alternative: the long-term roadmap.

A 2007 study found that "regular guiders" (public companies that consistently offer guidance for periods of less than one year) spend nearly 10% less on R&D each year than "occasional guiders." The interplay between the issuance of short-term earnings per share guidance, the attraction of short-term-oriented investors, and the pressure exerted on managers to meet investor demands does indeed undermine long-term investment and growth.

The same 2007 study found that regular guiders suffer significantly lower long-term earnings growth rates when compared with their occasionally guiding or non-guiding peers.

Finally, a 2016 study found firms that stopped issuing quarterly earnings guidance saw their investor bases become more long-term oriented, with greater proportions of long-term institutions as investors, more weight placed on long-term earnings in valuation, and lower sensitivity to short-term analyst forecasts relative to firms that did not end quarterly earnings guidance.

[5] F. Brochet, M. Loumioti and G. Serafeim, "Short Termism: Don't Blame Investors," *Harvard Business Review*, June 2012, https://hbr.org/2012/06/short-termism-dont-blame-investors?referral=03759&cm_vc=rr_item_page.bottom.

[6] F. Brochet, M. Loumioti and G. Serafeim, "Speaking of the Short-Term: Disclosure Horizon and Managerial Myopia," *Review of Accounting Studies*, Volume 20, Issue 3, pp. 1122-1163, 2015, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1999484.

[7] https://www.fcltglobal.org/research/reports/article/guidance

In addition, FCLTGlobal analysis of the S&P 500 found that issuing annual range guidance reduces volatility around earnings reporting periods relative to issuing quarterly guidance, alleviating one potential source of short-term pressure (namely undue stock-price volatility).

Long-term roadmap[8]
(Institutional investors' engagement)

Just as short-term guidance is detrimental to long-term value creation, the inverse is also true: long-term roadmaps, a form of investor communication that includes a company's 3+ year objectives alongside the strategic plan for achieving those objectives, tend to enhance long-term value creation.

Current snapshot. On a global basis, long-term forecasts have a small following: 8.7% of MSCI All Country World Index (ACWI) constituents issued longer-term guidance in 2017 (guidance for periods greater than one year into the future), far fewer than the 44% of constituents that issued annual guidance. Meanwhile, in 2017, 21.8% of MSCI ACWI constituents offered annual or longer capital expenditure (capex) guidance.

Why long-term roadmaps matter. According to McKinsey & Company, 70-90% of company value is related to cash flows three or more years out. Investor communications that don't speak to that horizon leave markets to fill in the blanks, often incorrectly. This disclosure gap increases the uncertainty of stock valuations by analysts, making it more likely that the market could get a company's future earnings potential—and stock market valuation—very wrong.

The benefits of long-term guidance aren't all financial. In addition to freeing investor relations departments from addressing the short-term "noise" that doesn't help their investors, research published by Timothy Youmans and Brian Tomlinson in MIT Sloan Management Review suggests companies that use long-term plans have also reported better success at attracting and retaining personnel.

Similarly, managers from 66 organizations in the International Integrated Reporting Council reported that developing and communicating a long-term strategy delivered meaningful internal benefits – 79% of managers reported business decision-making had improved and 78% reported better collaboration between the board and management.

If the European Supervisory Authorities were to consider mandating long-term roadmaps, please note the following. First, a survey of investment decision makers conducted by FCLTGlobal indicated that more than 86% of respondents would like companies to use a minimum three-year time horizon for forward-looking targets. Second, investment decision makers in FCLTGlobal's Investor Guidance Preferences Study were in broad agreement about the top elements most important for inclusion in long-term roadmaps:

- 62% wanted company commentary around competitive advantages.
- 52% identified capital allocation priorities.
- 52% look for companies to share their long-term objectives.
- 48% cited company-identified core drivers of growth.

Lastly, the UN PRI, with signatories that represent over EUR 70 trillion in investable assets, urges companies to "focus on communicating issues and metrics that are relevant to the long-term success of the business."[9]

We thank the European Supervisory Authorities for providing FCLTGlobal with the opportunity to provide evidence of undue short-term pressure from the financial sector on corporations. We are keen to assist the

[8] https://www.fcltglobal.org/research/reports/article/roadmaps
[9] https://www.unpri.org/sustainable-financial-system/investor-recommendations-for-managing-market-short-termism/2716.article

European Securities and Markets Authority in honing its report and are happy to answer any questions or provide further information at any time.

Sincerely,

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