2015

LONG-TERM VALUE SUMMIT

Discussion report

Contents

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Dominic Barton, global managing director of McKinsey & Company; Laurence D. Fink, chairman and CEO, BlackRock; and Mark Wiseman, president and CEO, Canada Pension Plan Investment Board, at the Long-Term Value Summit in New York on March 10, 2015.

Introduction

On March 10, 2015, more than 120 executives, investors, board members, and other leaders from around the world gathered in New York City for the Long-Term Value Summit. Their mandate: to identify the causes and mechanisms of the short-term thinking that has come to pervade our markets and profit-seeking institutions and, more importantly, to brainstorm actionable solutions. Thanks to their hard work over the course of numerous small-group discussions, we have been able to distill action steps, ideas, and new topics for exploration. It is with great pleasure that we present these highlights in the pages that follow.

As many of you know, the summit was just a step in our goal of fostering a healthier, longer-term perspective among investors and corporate leaders. That mission began two years ago when we formed Focusing Capital on the Long Term (FCLT). Since then, we have met with investors, executives, and policy makers around the world, conducted research into the sources of short-termism, and published our findings, including new views from institutions and leaders worldwide on what long-term value creation, investing for the long term, and investor-corporate engagement look like in practice. White papers on these topics, as well as *Perspectives on the Long Term,* a journal of essays by leading thinkers and practitioners published earlier this year, and other relevant articles are available on **fclt.org.**

From the beginning, we have studied the interactions at every step in the value chain as we strive to understand the sources of short-termism. We have looked at the expectations of the person saving for retirement and how those expectations are met by the institutional investor who manages his or her pension fund. We've examined how the fund in turn communicates with its investee companies and how the leaders of those companies interact with their boards of directors. We also included in our examination actors who stand just outside the chain: the regulators and policy makers who write the rules and the media and other observers whose reports can profoundly affect these interactions for good and ill. Both in our research and in the discussions held at the summit, we have endeavored to drill down to discover exactly how and why the pressure driving short-term behavior is generated and what can be done about it.

There is no single source of short-termism and thus no simple solution. Instead, there must be concerted effort by all actors on many fronts. Several themes for what form that action should take emerged over the course of the summit. Many felt that CEOs and boards must find the fortitude to place long-term strategy and investment over short-term stock performance. The issue of incentives came up over and over as participants talked about the need to align rewards with a long-term perspective. Others felt that both investors and CEOs should consider the larger social implications of the decisions they make. Most of all, executives, investors, and boards must redouble their efforts to engage one another in meaningful discourse, making long-term strategy paramount in those conversations.

The discussions at the summit were lively and candid as participants worked to uncover the root causes of short-termism and actions that could lead to systemic change. The highlights that follow reflect the views of participants rather than the views of FCLT. We are committed to continuing our work on these important issues, both within our organizations and by continuing to work with all those who have joined us in these efforts. In the meantime, we hope you find these insights of value in your own efforts to focus on the long term.

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CHAPTER ONE

The CEO

To build an organization focused on the long term, corporate leaders must create a vision and communicate it inside and outside the company.

The discussions at the Long-Term Value Summit made two things clear: first, most CEOs truly want to run a company that creates lasting value. Second, actually doing so is an extraordinarily complex undertaking. Creating corporations that are focused on the long term requires CEOs to think multidimensionally. They must focus on the long term yet still demonstrate credible performance in the short term. They must hone and constantly refine a long-term strategy with their boards while persuading their teams to own that strategy—all while selling it to an array of investors who may have vastly different goals and orientations.

As participants dug into the nitty-gritty of this daunting task, they broke it down into smaller pieces, locating the pain points and pointing to potential solutions that CEOs could use in building long-term organizations. Out of the day's conversations, four major building blocks for creating the long-term corporation emerged: the strategy, the board, the culture, and the investor base. Each of these blocks, if managed correctly, should become mutually reinforcing, providing a structure that can support the organization through short-term ups and downs in order to reach attainable and measurable longer-term goals.

BUILDING A LONG-TERM STRATEGY

Although participants stated them in different ways, they arrived at three necessary steps for building a company's long-term strategy:

- ***articulating the values***
- ***understanding the ecosystem***
- ***putting the strategy together***

Values

Some participants referred to the organization's core values as its North Star. These are the beliefs that serve as a compass for measuring all other decisions. They express the highest purpose of the organization. At some organizations, the North Star might include an intertwining of corporate and social goals, such as feeding the world sustainably. At other organizations, the North Star might be more focused on commercial goals, such as building flexible manufacturing platforms. The important thing is to have a value statement that can keep the organization focused. Decisions are often made in the short term, but if they do not fit within the organization's fundamental values, either the values are wrong or the decision is wrong.

One participant from a large retail corporation said her company examined the net present value of actions taken today to see if they fell within the company's core values. In other words, leaders look at the long-term implications as well as the short-term outcomes. That process has helped the organization redefine its core value from helping to lower the cost of living for individuals to helping to lower costs for society as a whole. She gave this example: "We sell a lot of fish. We'd like to sell fish tomorrow, and we'd like to sell fish in five years, so we have to worry about fisheries. That means we have to look at the present value of the actions we take today." Simply selling fish at the lowest possible price today could actually undermine the larger goal of having a sustainable supply of fish in the future.

Ecosystem

The ecosystem is the context or environment in which the company operates. It includes competitors, customers, investors, the overall economy, local markets, the regulatory and political environments—in short, all the shifting forces that affect a company's operations. Understanding how these forces are working today and how they are likely to evolve provides a logical framework for the company's long-term strategy. As the ecosystem evolves, CEOs can hone their long-term strategy to evolve along with it.

It is important to understand that while the ecosystem can change quickly and sometimes dramatically, underlying core values are much more stable. If the core value is to provide sustainable, affordable food far into the future, how you accomplish that could change significantly in the short or medium term. For example, shocks to the system such as drought, disease, or war could force you to find new sourcing. New technologies could increase supplies. New financing mechanisms could bring new and more efficient producers on line. How the organization reacts to those changes, however, must always fit within that overarching core value.

Strategy

Although companies that use generational time horizons were mentioned, many participants hit on ten years as the right amount of time to look ahead when crafting a long-term strategy. One CEO called this the "ten-year strategy compass." It must always correspond to the view of the ecosystem. "Every year, the executive team needs to articulate a ten-year horizon of its ecosystem," he said. "That's the guidepost. You build a strategy around that view of the ecosystem your company operates in. It's very important to have that context." He added that at his company, every presentation to the board and to employees began with a review of the context, followed by a review of the strategy for achieving the necessary growth rates.

Several participants made the point that the ten-year strategy rarely unfolds as originally envisioned, because of changes in the ecosystem. Therefore, they believed it was critical to have discussions about outlooks for the short, medium, and long term with the board. "Today, not many companies have a process that gets the balance of short-, medium-, and long-term discussions right, and boards are not very involved, particularly in the long term," one CEO said. He recommended that CEOs have a one-year budget, a three-year strategy, and a ten-year strategy compass or plan based on long-term macro trends. Another participant said that at his firm, the ten-year strategy was built around the idea that global markets would become dominant. The shorter-term strategy for taking advantage of that insight was constantly refreshed as the ecosystem changed, as it did, for example, after the 2008 financial crisis.

"Today, not many companies have a process that gets the balance of short-, medium-, and long-term discussions right, and boards are not very involved, particularly in the long term."

BUILDING A SUPPORTIVE BOARD

Over the course of the day, participants recognized that CEOs who wanted to successfully execute a long-term strategy needed to engage and win the support of their board:

- ***immersing the board in the strategy***

Communication

Participants believed that it was essential for the CEO to immerse directors in the company's values and strategy. CEOs who fail to build a deep understanding of the long-term goals are less likely to have their board's full support through periods of turbulence. Many participants believed that efforts to build a long-term orientation foundered at exactly this point. The board must understand the organization's core values, its ecosystem, its long-term strategy, and how the medium- and short-term strategies relate to it. Every decision must correspond to these foundational beliefs.

Summit conversations uncovered several steps for making sure that crucial communication happened. One was to designate at least two days a year for the board to go off-site and focus strictly on strategy. Another was to start every meeting with a discussion of the ecosystem and how it had evolved since the previous quarter. Crucially, all strategic decisions should relate to the core values and to the larger business context. To ensure robust discussion of the strategy, CEOs were urged to send all board materials well in advance of meetings to make sure that time in board meetings could be spent on discussion. It's important to carefully manage the agenda of each meeting, ensuring that adequate time is allocated for strategy discussions.

"I've had to really create an educational process so that the board understands the process of transformation and how that works and how the world is changing and the impact of outside forces," said one participant. "That has allowed for much discussion, from strategy to disclosure of earnings."

> "You can articulate a very clear long-term vision, but figuring out the intervening milestones and the things that have to be accomplished is hard."

BUILDING A LONG-TERM CULTURE

Participants identified several factors necessary for ingraining the right beliefs and attitudes in an organization:

- ***evolving the long-term goals***
- ***communicating values and goals to internal teams***
- ***measuring long-term value***

Long-term goals

As the world becomes more globalized and the problems we face grow more complex, the trend has been for organizations to include a larger societal perspective in their long-term goals. CEOs need to review the core values and goals to make sure they remain relevant.

One CEO described how the ten-year goals had evolved at his company. He said that in the 1990s the company was focused on "footprint goals." During that period, it sought to improve the impact of its emissions, landfills, and factories on surrounding communities. The second set of goals, "handprint goals," looked at the impact of products and processes on markets and customers and how transparently those effects were communicated to the marketplace. Today, the company is focused on "blueprint goals." The CEO described them this way: "Our fence line is not the factory. Our fence line is not the product. Our fence line is the planet." With this orientation, the company is identifying business opportunities in helping improve access to water, food, energy, and other resources in communities around the world.

Internal communication

Once the CEO and board have agreed on the foundational values and vision, they must communicate them vigorously and consistently to their internal teams. “Great cultures come from a seamless vision out of the board and the C-suite around the purpose, mission, and strategy. Then there must be relentless communication in every forum at every level,” a participant said.

In living the values they want the company to share, it is essential that the CEO and board not sacrifice long-term sustainable performance for short-term gains. One participant pointed out that a large percentage of company earnings come in just above consensus forecasts. The implication was that, in many cases, rather than risk a drop in the stock price, companies were cutting back on research and development or important capital expenditures to make their numbers. “That clearly has a cost to corporations and a cost to society, and that is the mentality we have to get over,” said one participant.

Measuring long-term value

It stands to reason that if an organization has set goals five or ten years out, progress cannot be determined by looking at quarterly or yearly milestones. That does not mean that short-term performance can simply be ignored; instead, it must be evaluated in light of the longer-term goals. Companies that fail to provide longer-term benchmarks are apt to come under greater pressure if they underperform on, say, earnings per share.

“You can articulate a very clear long-term vision, but figuring out what it takes to get there—in other words, rolling back from that 10-year or 20-year vision to the intervening milestones and the things that have to be accomplished—is hard,” one participant said. “You have to set something out right now and get agreement and have a series of projects that get you over the short, medium, and long term, but there’s got to be a dynamic review process.”

FOR FURTHER DISCUSSION

Quarterly guidance

Some CEOs have opted to cease quarterly earnings guidance for investors, saying that such discussions inevitably focus attention on short-term factors that are irrelevant in the long term and can create pressure to meet earnings forecasts. One CEO put it this way: “I think quarterly calls are nonsense. It’s 90 days. Minus the weekends, it’s 76 days, and you end up explaining when Ramadan is, when Christmas is, if the winter was cold or not, and why you didn’t sell more ice cream. It’s ludicrous.” He said that since the elimination of guidance and quarterly earnings reporting, his shareholder base has become more long-term oriented and the conversations he has with them more substantive. Others suggested that if companies continue to offer quarterly guidance, they should combine it with updates on their five- and ten-year goals.

Another participant said his company had hit on four measures for investors to use in evaluating its performance: return on assets, return on equity, efficiency, and return on capital. The reasoning was that these measures provided insight on both long-term and short-term performance in a way that revenue growth or earnings per share could not. “We appreciated that we still needed to perform in the short term, but we needed longer-term metrics,” he said.

Other participants said they published broad goals with progress to date on their websites. Such goals could include anything from strengthening the balance sheet to making technical improvements in core products. One said: “If you’re reporting in the near term on longer-term goals, and you tell them you are on the right path and there are some credible wait points along the way to tell if you’re on track, investors will honor that even if you miss a quarter.”

To motivate their employees to work toward meeting the company's long-term goals, CEOs must take care to ensure that their compensation schemes appropriately reward the desired behaviors. If they aspire to a company that works toward expansive ten-year goals, but they reward the people responsible for these solely based on one-year benchmarks, they are unlikely to succeed.

Participants believed that each organization needed to find the right mix of long-term and short-term benchmarks; the right mix of cash and deferred, stock-based pay; and the right balance of objective and subjective measures. Several said their organizations had evolved pay packages toward a longer-term focus in recent years and added subjective measures. One participant said his company now puts more emphasis on employee engagement, which it measures based on annual surveys, diversity, and turnover.

"It's really important for large companies to have one or two anchor shareholders who just understand and buy into your long-term strategy and become spokespeople."

BUILDING A STRONG INVESTOR BASE

The idea that companies ended up with "the investors they deserved" arose multiple times. In the discussions that followed, participants outlined steps that CEOs could take for attracting investors who would support their goals, even through short-term turbulence:

- ***identifying the investors you want***
- ***making sure investors understand the long-term strategy***
- ***enlisting the board in reaching anchor shareholders***

CEOs of publicly held companies do not have the same ability to choose their investors as privately held companies, as several participants pointed out. There are, however, strategies they can employ to build a compatible investor base. First, they should understand their company's characteristics and what kind of investors they might appeal to. If the goal is to develop sustainable, consistent growth over the long term, they should seek out funds that look for long-term investments and explain the strategy.

One CEO said that earlier in his career, when he headed a smaller mining company that was expanding in Asia, he sought out sovereign-wealth funds. The relationships he developed in that community helped make the Asian strategy a success. "I think it's really important for large companies to have one or two anchor shareholders who just understand and buy into your long-term strategy and become spokespeople," he said.

Participants believed that CEOs need to develop a strategy for engaging shareholders—both those they have and those they would like to have. All members of the executive team should be prepared to present the company's strategy with a consistent narrative. Some companies have found that designating the chair or another board member to go out and meet with investors is also effective. Others invite key shareholders to headquarters once or twice a year to meet with the executive team and the board, often separately.

One CEO said that after significant

engagement on his part with the investment community, including hundreds of meetings and phone calls, he was able to evolve the shareholder base of his company from more than half short-term investors to less than 10 percent. Another participant said he was asked to help a new CEO develop a strategy for engaging with investors. While the company had been a successful growth company, it had matured and was no longer able to deliver 15 percent annual growth. "We changed the message. We said, 'We're not a growth company. We're going to have revenue growth in the 5 percent range and EPS growth in the 8 percent range.' We ended up with a very different group of investors." The stock price has since doubled from its level when the effort began.

Developing a clear vision of what the company stands for and how it intends to achieve its goals in the near term and far into the future is essential for CEOs who aspire to create long-term sustainable value. Even more important, they must continually restate that vision in conversations with internal teams, the board, and investors. ■

FOR FURTHER DISCUSSION

Share buybacks

Share buybacks and dividend increases have become increasingly common in recent years. Companies in the S&P 500, for example, spent over $550 billion on buybacks in 2014—a 16 percent increase from 2013 levels and a 42 percent increase from 2012 levels. Buybacks and dividend increases are not in and of themselves problematic—they are an important method for distributing gains to shareholders and increasing the value of their holdings. When undertaken imprudently, however, they often diminish a company's investments in long-term growth. In a **letter to CEOs** last year, Laurence Fink, CEO of BlackRock, urged companies to make sure that buybacks and dividend increases are part of a deliberate, forward-looking capital-management strategy, which will help increase shareholder value over the long term.

THE BIG NUMBER

$2.4 trillion

The amount spent by companies in the S&P 500 on share buybacks from 2003 to 2012, equal to 54 percent of earnings. They spent an additional 37 percent of earnings on dividends.

Source: William Lazonick, "Profits without prosperity," Harvard Business Review, *September 2014, hbr.org*

CHAPTER TWO

The institutional investor

For long-termism to prevail, asset owners and asset managers must align the goals of all constituents and set appropriate benchmarks for measuring performance.

Summit discussions exposed the conflicting demands investors face. Although their ultimate beneficiaries may have a time horizon of decades or more, investors are invariably judged by their latest returns. In fact, nothing has a greater effect on new business and the ability to retain existing clients than the annual and quarterly rankings of asset managers, often reported prominently in the press. One investor said bluntly that his clients were expecting zero short-term losses: "We can't take the long-term approach if it means that in the short term there's an issue."

Participants discussed strategies for balancing the need to provide for beneficiaries far into the future with the separate need to post short-term performance. They talked about ways to marry a long-term view of the world with enough flexibility to cope with short-term fluctuations, as well as more fundamental changes in the overall environment. "A long-term view is not actually about being able to predict what the world's going to look like ten years down the road. It's about having a process that allows you to monitor how the world is unfolding and to adjust accordingly," said one participant at the Long-Term Value Summit. Participants highlighted solutions in three broad areas: creating the right incentives, understanding investee companies, and managing for the long term.

CREATING THE RIGHT INCENTIVES

Investors looking to develop a long-term perspective need to be especially thoughtful about the stated and unstated metrics that drive their organizations. Three areas stood out:

- ***negotiating mandates***
- ***choosing performance measures***
- ***structuring compensation***

Mandates

Participants believed that the appropriate time horizon for an investment must be set by the asset owners in conjunction with the asset managers. Asset owners and asset managers must be absolutely clear as to the goals of the fund, and both parties should reflect those goals in every benchmark, evaluation process, and compensation system they employ. Several participants felt that the disconnect between what assets owners say they want and what they end up getting originates here. "If you look at how asset managers are incentivized by some of the asset owners, it's much more on the short term than the long term. They're paying based on short-term performance," said one participant.

Once the goals are agreed on, asset managers need to be clear about how they intend to fulfill those goals. One participant said his firm recently gave two longer-term mandates to private-equity firms because the time horizons on both sides matched up. "What we want is both an appropriate level of returns and duration. We want sustainable long-term results. We don't need to have high-spurt numbers."

Living up to the spirit and letter of the mandate is an ongoing process. It must be reinforced through continual conversation with the asset manager and in interactions between the asset manager and the asset owner.

Performance measures

The heart of the mandate is the measure by which performance is judged. That is true for how the asset owner judges the performance of the fund and its asset managers. Asset managers at the summit thought there needed to be more alignment with the asset owners on goals and on the metrics for measuring performance. Is the goal to maximize the returns of each portfolio for the year? Or is it to provide the level of funding necessary to see the beneficiaries through, say, retirement decades in the future? If it is the latter but the fund is judged on the former, there is an obvious misalignment of interests.

"The hardest thing for me is the fact that we have 30-year liabilities but our board measures our performance on six-month intervals, and certainly the press compares us to other investors on an annual basis, calendar year and fiscal year," said one investor. If the goal is long-term, sustainable performance, asset owners need to adopt performance measures and metrics that will instead reward internal and external asset managers for developing a deeper understanding of their investments, which in turn will give them the confidence to stick with an investment through occasional downturns.

Compensation

The same conflicts inherent in the long-term goals of a fund and the short-term performance measures exist in regard to compensation. Frequently, portfolio managers are asked to take the long view but are rewarded for doing just the opposite. There is no simple answer for solving this conflict. As you go down the ranks of the organization, employees understandably want a sizable chunk of their compensation to be available as they earn it. As one participant put it, "The problem is, we live life a year at a time instead of in ten-year increments."

"The problem is, we live life a year at a time instead of in ten-year increments."

It was clear from summit discussions, however, that investors were grappling with the issue of compensation and incentives in a serious way. A number of approaches emerged. The most common was to evaluate performance over three or four periods, ranging from one year up to eight or ten, and to divide the total compensation between some portion payable immediately and some portion that was deferred. One participant's organization used one-, three-, five-, and eight-year time frames, with the idea that the average market cycle was about four years. Another described a compensation system that measured performance across five time frames, going up to ten years. Many participants said they had started paying a higher proportion in deferred stock. At one organization, for example, the level of deferred compensation ranged from 70 percent for the most senior executives to 10 percent for junior people.

Several participants said they were experimenting with other ways to reinforce a long-term view. One was to build in incentives for specific behaviors, for instance, by rewarding portfolio managers for meeting with executives at their investee companies. Some, however, found that tying such behaviors directly to compensation created new problems by inadvertently rewarding quantity rather than quality.

Other participants were opting to base part of the compensation package on qualitative rather than quantitative measures. Those measures could include personal-development goals, the quality of engagements, or other intangible elements. "We've found there's a bunch of stuff that needs to be formulaic, and there's a bunch that needs to be based on judgment—but you better make sure the decision makers are fair minded," said one participant.

Still others were deemphasizing performance measures to focus instead on outcomes. Do the beneficiaries have enough funds to live on in retirement? Are they able to leave as much as they had expected to their heirs? As one participant put it: "If you can move away from performance benchmarks to outcomes and those outcomes are aligned with the long-term goals of your constituency, then you get to a point where you can start rewarding people."

Conflicts raised by compensation do not just occur within investment organizations. Several participants said it was essential to understand the long-term incentive packages of the executive teams at the companies they invest in to make sure the incentives were in line with the investor's view of where the company should be headed. Others mentioned the potential conflicts raised by intermediaries such as consultants. A fund may need to hire consultants to help select portfolio managers, but depending on how the consultant is compensated, his or her interests may not align perfectly with those of the fund.

"If you get the executives and the chairman in the same room, which doesn't actually happen often, you can immediately tell whether there's a problem in the business."

UNDERSTANDING INVESTEES

A central dilemma for investors who seek to orient their firms to the long term is finding the time and resources to develop a deep understanding of the strategy and long-term outlook of each company they invest in. The larger the portfolio, the more difficult it is to become knowledgeable enough to truly think like an owner. The discussions broke down into three areas:

- ***engaging with companies***
- ***tapping into coalitions***
- ***building a stronger relationship with investees***

Engagement

For many summit participants, engagement tended to take place when there was a specific problem with the company. In that case, the investor might have a conversation with the CEO concerning the strategy for solving the problem, or—if doubts persisted—with the chair or other board director. Some were keen to see the executive team and the board together. "If you get the executives and the chairman in the same room, which doesn't actually happen often, you can immediately tell whether there's a problem in the business," one participant said.

One participant was concerned about what he perceived as an adversarial relationship between investors and corporates and wondered why the default could not be a more collaborative relationship. He thought the problem rested with the tendency to delegate the conversation. Instead of CIOs from institutional investors talking to CEOs, the more likely scenario was for analysts to talk to CFOs or for governance professionals to speak with corporate secretaries. He believed the investor delegates often were not prepared to ask the questions the CIO would most want answered. The solution was to foster more and better communication between the investor's executive team and the managers who actually interact with investee companies.

The problems were compounded for large funds with broad portfolios. One participant said, "If you're a big fund and you have a lot of your assets in index funds, then you're by definition in 5,000 different companies, and there's no way you can engage, no matter how well you have resourced your company."

An executive at one large indexer said his firm believes in vigorous engagement when managers see a problem at investee companies. Indexers, he said, are the ultimate long-term investors and need to monitor companies carefully to protect their clients. "We can't sell those stocks, even if they're terrible companies. As an indexer, our only action is our voice. So we're engaging in a more active dialogue with our companies. Our outlook is endless because we have to own those companies as long as they remain in the index." He said that pressing the long-term case is crucial to representing the interests of the firm's clients because otherwise there is little counterweight to the many short-term pressures corporate management teams face.

FOR FURTHER DISCUSSION

Activist investors

Activist investors have become a hotly debated and fast-growing force in investing. To their critics, they are short-termists out to make a quick gain by forcing moves that might increase profits in the short term while weakening the long-term position of the company. Critics find it particularly galling that they often seem to wield power disproportionate to the size of their holding.

CEOs under pressure from activist investors often view them as a destabilizing force that can weaken the organization—and the CEO's reputation. Indeed, the pressure can be intense. One CEO at the summit described drones buzzing his home and reports on his wife and children leaked to the media as activists sought to undermine his credibility and force through their own agenda. "The personal attacks were acute," he said. "And if you get them on your board, then all shareholders suffer in the long term. All the actions suggested to us were short term in nature."

To their proponents, though, activists can perform a crucial function by addressing problems that have been allowed to fester. By shaking up chronically underperforming organizations, they can usher in new periods of sustained growth and bring a failing company new momentum by forcing changes to the strategy, the board, or the executive team. In some cases, the activist can force a sale of assets or seek an acquirer, unlocking value for all shareholders—decisions that could be difficult to make for an incumbent executive tied to a failing business model. For these reasons, many investors believe in evaluating activists on the specific merits of any given proposal, rather than painting all activist proposals as either good or bad.

The fact that activists are thriving, however, drives home a more important point: other larger and longer-term investors have created a void for them to fill. "My view is the activists are a bit of a red herring," Mark Wiseman, President & CEO of the Canada Pension Plan Investment Board, told forbes.com in a recent article. "Activists own just a small percentage of a stock. In most cases, it's the institutional investors who are the real owners. Frankly, if they were doing a better job engaging with the company as an owner and if the company was doing a better job engaging with the owners, there should be no opportunity for activists." If shareholders with only small stakes manage to push through an agenda, for good or ill, it would have to be because large shareholders either supported the measure or failed to take a stand.

Coalitions

For other investors at the summit, the solution to the conundrum of how to think like an owner when thousands of companies are involved was to take collective action. A number of organizations already exist, including the Canadian Coalition for Good Governance (**ccgg.ca**), the UK-based Investor Forum (**investorforum.org.uk**), and the International Corporate Governance Network (**icgn.org**). They generally act on behalf of institutional investors by engaging with boards and pressing for better governance. Some participants believed a similar concept could be used to create greater clarity about the long-term strategy of companies.

There was also discussion about creating an index of best-in-class, long term–focused companies. It would essentially be a way for investors to invest in companies based on their long-term fundamentals. "If it works, corporates will want to be a part of it and will want to know what's required to become a member. It should create this dialogue among corporates," said one proponent.

THE BIG NUMBER

$112 billion

Assets under management in activist hedge funds as of Q3 2014, up from $36.2 billion in 2009.

Source: *The activist revolution: Understanding and navigating a new world of heightened investor scrutiny,* J.P. Morgan, January 2015, jpmorgan.com

Deeper relationships

Some investors advocated simply taking bigger stakes in fewer companies and developing deeper relationships with those you do invest in. "If you want to be a long-term investor, you need to deepen your understanding of the companies because you can't just use the share price to tell you what's happening. This inevitably means having a more concentrated portfolio," one participant said.

While empirical research suggests that an investor needs only 20 to 30 stocks for diversification, running a concentrated portfolio strategy does require investors to amp up their research capabilities since they will need to have a much greater understanding of their portfolio companies' strategies and prospects. "We've invested a lot in proprietary research. We've built substantial research teams, and we now take relatively big positions," said one participant whose organization had adopted such a strategy.

With a deep understanding comes deep confidence in the position. One participant said, "It really depends on having dialogue, so you know what they're doing. If they're having a period of underperformance, you know whether you should double down or redeem." That understanding of the long-term strategy can also give you the confidence not to sell too soon when the quarterly or annual numbers look especially good, which can be just as serious a risk for the long-term investor as the risk of loss. One participant described a substantial but minority investment his firm holds. So far, the firm has outlasted three private-equity investors. Because the view of the company's long-term prospects has remained positive, the firm increased its stake with each change of ownership. "They all made two or three times their money, but because we hung in there for seven years, we made ten times our money," he said.

Sometimes those relationships with investee companies yield other kinds of benefits. One participant described a long-term, concentrated investor who is so closely entwined with his investee companies that he sends his analysts on six-month internships with many of them and in turn brings their high-potential employees into his shop. The exchanges help to embed a deeper understanding of each organization within the other.

MANAGING FOR THE LONG TERM

Participants considered the ways in which a long-term mind-set changes how you think about and manage both the firm and the portfolio, as well as the new sorts of opportunities that accrue. The discussions fell into three areas:

- ***rethinking risk management***
- ***developing a thematic or narrative view of the future***
- ***infusing long-termism into the organization's culture***

Risk management

Participants agreed that investing for the long term requires a different approach to risk. Events that are unlikely to happen in the short term are much more likely over the long term. Analyzing and preparing for those risks requires a more sophisticated research capability.

In addition, broader, systemic risks, which often seem abstract, can suddenly feel much more real when viewed from a long-term perspective. "If I'm a longer-horizon investor, then I care more about the capital markets. I need to know that they're fair and that they work well. I'm going to engage with regulators, with the listing requirements around exchanges, and I'm going to be active with other public pension plans in trying to ensure a fair playing field," one participant said. Those activities—essential to the long-term functioning of markets—are less likely to seem important to investors with a short-term view.

Many sustainability issues also become more relevant for the same reason. How your investee companies manage resources for their long-term operations and how those decisions affect the well-being of their customers, the communities they operate in, and your beneficiaries become serious considerations when viewed from a long-term perspective.

A view of the future

By definition, long-term investors need to be more concerned with the fundamental drivers of change that can disrupt business models and even industries. This is a more complex analysis than required by a reactive, short-term investor. Several summit conversations centered on the use of themes and narratives as a way of making sense of complexity by distilling the essential details and tying them together in a logical way. One participant put it this way: "I think engaging people on long-term thinking requires storytelling."

Several said they developed themes to help them understand the long-term forces that will reshape the world and to find investments that reflect those forces. A carefully crafted theme may be more effective in doing that than any number of spreadsheets. One investor described the themes his firm looked at. "We know about demographic issues. We know that to feed the growing number of people in the world, we're going to need a lot more water. We know we're facing change in the way we use energy—not immediately but over the long term." Uncovering those longer-term trends and evaluating which companies will be helped or hurt as those trends play out can help build a durable long-term portfolio.

Similarly, a narrative can be used to better understand individual companies. One participant said his firm had developed a set of questions for investigating potential investments. The questions have nothing to do with earnings per share or market capitalization but instead focus on the company's internal culture, how the executive team is selected and how it behaves, and the long-term strategy. The idea is to build a narrative that describes the company and its decision making. Increasingly, management teams are also using narratives to supplement a purely numbers-driven description of company performance in the belief that a good narrative can provide greater nuance and a better description of the strategy. One participant said he thought narratives should be a normal part of the investor-investee discourse.

FOR FURTHER DISCUSSION

The case for engagement

Asset managers are beginning to view engagement with their investee companies as an essential step in protecting their clients' interests. "It's difficult to precisely quantify the value created by shareholder engagement. But it is easy to see the problems created in its absence—evidence of value destroyed or unattained—arguably by disengaged shareholders enabling companies' poor management of ESG[1] matters," wrote Michelle Edkins, global head of corporate governance and responsible investment at BlackRock, in a recent report.[2] Whether to voice concerns or sell shares in a company will depend on the mandate, the investment strategy, and other individual circumstances. Edkins argues that the key is to make thoughtful decisions about how and when to engage.

In the same report, Anne Sheehan, director of corporate governance at California State Teachers' Retirement System (CalSTRS), and Brian Rice, portfolio manager at CalSTRS, spelled out the different formats investors are using for those important communications:

- ***Holding direct conversations with portfolio companies, regulators, and issue experts***
- ***Doing educational outreach with the marketplace***
- ***Collaborating with other investors, companies, and advocates***
- ***Convening summits to identify and reach tipping points***
- ***Soliciting shareholder proposals***
- ***Sponsoring academic and other intellectual analysis on the issues, to increase market-participant awareness***

[1] Environmental, social, and governance.
[2] *21st century engagement: Investor strategies for incorporating ESG considerations into corporate interactions,* BlackRock and Ceres, 2015, blackrock.com.

The culture

Participants talked about the importance of reinforcing long-term values within their own organizations: in conversations with in-house audiences, in structuring compensation packages, and in interactions with investee companies. Participants agreed on the need to articulate their organizations' investment beliefs and risk-appetite statements to cultivate a long term–focused culture. In addition, over the course of the summit, several action steps emerged. Some participants suggested adding a qualitative component to compensation. One participant whose firm had low turnover said that having a less formulaic compensation structure allowed it be more fair over the long term. Besides recalibrating compensation, participants felt it was important to make sure that career paths also rewarded responsible long-term thinking, especially lower down in the ranks.

Several of the organizations represented were also considering new kinds of support materials, such as a guide for analysts and portfolio managers to help ensure they ask the right questions about long-term strategy and a guide to assess the culture at current and potential investee companies. Others urged a more tailored approach to analyzing investment performance. For some companies, quarterly sales figures might be essential. For others, a much longer period might make sense. The important thing is that investors should be fluent enough in the long-term strategy to understand the best way of measuring progress, which could differ significantly from company to company.

Instilling long-termism into an investment organization requires a fundamental shift in mind-set and operations. Organizations that strive to build a long-term mind-set will need to develop a deeper understanding of the culture and strategy of the companies they invest in, as well as a long-term view of the world that is rooted in rigorous analysis yet open to reappraisal as the environment evolves. ■

PHOTO CREDIT: GABE PALACIO

Participants at the LTV Summit broke down into action groups to discuss the challenges of long-termism as well as potential solutions.

CHAPTER THREE

The board

The board sits at the juncture between the corporation and outside constituents. As such, it has a central role to play in the quest to build an organization focused on the long term.

As with other players in the investment value chain, corporate directors must balance multiple interests as they push for a longer-term mind-set. Directors must work to develop a high degree of trust with the CEO. At the same time, they cannot lose sight of the fact that they represent the interests of a diverse group of owners. To exercise appropriate oversight in a constructive manner, board members must immerse themselves in the organization's long-term strategy, testing the thinking and assumptions through vigorous debate with the CEO and executive team.

The board's to-do list is always long. Reviewing performance, overseeing compliance and regulatory matters, and managing CEO succession and compensation alone are enough to take up the bulk of most board meetings. Indeed, discussions at the summit indicated that establishing and maintaining long-term strategy as the ultimate focal point was an enormous challenge. The discussions broke that challenge down into three areas: the role of the board, the development of the strategy, and investor engagement. Organizations that develop a truly long-term orientation are likely to have boards that made a significant effort in all three areas.

COMMITTING TO THE ROLE

An organization focused on the long term will require a bigger commitment from its board of directors than other organizations do. As summit participants discussed how directors could meet the requirements of this expanded role, three steps emerged:

- ***developing the focus***
- ***bringing the right skills***
- ***supporting the CEO***

The focus

Several discussions at the summit touched on a difficult fact in many organizations: the board simply does not spend enough time understanding and engaging with the organization's long-term strategy. The items that do make up the board agenda—government relations, compliance, risk management, and performance, along with the latest crisis—are necessary and in some cases urgent. But they are not, ultimately, as critical to creating sustainable value as understanding and refining the long-term strategy.

In addition, many of those tasks are essentially backward looking or, at best, concerned with the very near term, thus removing the board even further from a sense of the company's long-term aspirations. "There's a remarkable focus on lagging indicators and relatively little focus on leading indicators, those things that would give some sense as to whether or not the long-term vision and strategy are actually making progress," one participant said.

In summit conversations, it became clear that evolving the board so that it takes a long-term focus is critical to building a broad culture of long-termism, in which companies and investors aim for sustainable value creation. This transition will require directors to make a far greater commitment than they have in the past.

The skill set

If the board's most important task is to help the CEO hone long-term strategy, it stands to reason that it must have members who bring deep experience and the skills necessary to test all underlying assumptions. Ideally, each director would bring a unique strength, such as extensive knowledge of the industry or experience in a new product line or geography. "The nucleus of nonexecutive directors must have industry understanding or domain expertise relevant to medium- and long-term strategy. If the board does not have members who can make a meaningful, challenging contribution to the strategy proposed by the executive, the board is not fit for purpose," said one summit participant and veteran board member. Many at the summit believed that this depth of skill was often missing from the boardroom.

In a recent essay in ***Perspectives on the Long Term*** (from Focusing Capital on the Long Term), Julie Hembrock Daum and Edward Speed of Spencer Stuart argued that directors also need other qualities. These include the emotional IQ to work effectively with fellow directors and the executive team, as well as the intellectual stamina to immerse themselves in the nuances of the organization and its strategy and to develop a strong point of view based on detailed analysis, discussion, and help from outside experts, if necessary. Finally, directors must have the confidence to place appropriate bets once that point of view is developed. "Excessive risk aversion," said the authors, "is as dangerous for the business as reckless behavior is at the other end of the spectrum."

"If the board does not have members who can make a meaningful, challenging contribution to the strategy proposed by the executive, the board is not fit for purpose.

While all directors must bring unique expertise, they must also work together as a team, dividing up tasks when necessary to ensure they understand the business model, the culture, and the long-term goals of the company they are meant to govern.

The CEO relationship

A recent study by Focusing Capital on the Long Term found that almost half of the global business leaders surveyed pointed to the board of directors as a major source of short-term pressure. As participants discussed the issue, the primary source for that pressure seemed to be a lack of confidence in the CEO and his or her long-term strategy. Several CEOs felt that unless they posted consistent, positive short-term results, they risked losing the backing of the board. Of course, investing to achieve longer-term goals means at least occasionally accepting some falloff in the short term. One CEO said, "In our business, you get fired when you make changes, but you've got to make changes to improve."

One participant, an experienced board member, suggested that to develop a deep, trusting relationship, the chair and perhaps one or two other board members should spend extra time with the CEO to get to know him or her personally—and, just as important, to fully grasp the long-term plans for the organization. "You need to have a mechanism that gives you full understanding of what the plans are and what the motivations are of the CEO. You can't necessarily do that with the entire board," the participant said. Having those relationships in place is especially useful in the event of a crisis in the corporation or in the CEO's personal life.

Participants believed that unless the board developed the knowledge and confidence to support the CEO, building and executing a long-term strategy was problematic at best. As one participant put it, a major goal of the board must be to become good stewards of the CEO's long-term strategy.

SUPPORTING THE STRATEGY

In building an organization that is capable of focusing on long-term goals, it's essential that the board should understand and thoroughly support the CEO's vision. Summit participants believed that strategy development and review deserved far greater time and attention at the board level than they generally got. They identified three steps that would enable boards to fully understand and commit to the strategy:

- ***setting an agenda for the long term***
- ***debating the strategy***
- ***measuring progress***

The agenda

In general, participants agreed that it was primarily the CEO's responsibility to make sure that the board got adequate background materials for understanding the strategy in a timely manner and that enough time in meetings was spent on the topic.

"There has to be an appropriate balance of time spent in the board agenda on the medium and longer term as opposed to consuming the first three hours with how the last quarter went."

Boards, however, have a great deal of leeway in facilitating the process. Is the board open to such discussion? There was a feeling that at least some CEOs tried to minimize the time spent on strategy discussions because they believed the board would become a source of friction. Others felt that it was hard to get the board's attention when it came to long-term issues in general. "I find boards lose interest when you talk about the long term. When you get into complex variables and start thinking about technology and market variables, they just lose interest," one participant said.

Both CEOs and board members need to fight those tendencies. Directors should ask themselves if they're getting the information they need to be effective in discussing strategy and if they are getting the opportunity to do so. As one board veteran said, "There has to be an appropriate balance of time spent in the board agenda on the medium and longer term as opposed to consuming the first three hours with how the last quarter went and jamming everything else into the last hour."

Along with knowing the particulars of the strategy, directors need to have a thorough understanding of the organization's culture. Some of that will come from interactions with the executive team and in board presentations. But directors should seek opportunities to converse with managers throughout the company's operations via site visits, company programs, and committee work. In this way, the board's agenda extends beyond the designated board meetings.

The debate

One of the balances the board must manage is the need to provide detailed and constructive feedback on the strategy while taking care to stay constructive and avoid straying into operations.

One participant believed the way to achieve that balance was to bring the board into the strategy debate at two specific points: the beginning, as the strategy is being developed, and the end, after it has been put in place and it is time to measure results. The actual implementation is up to the CEO. "It's for the executive to propose the strategy," said one participant. "It's for the board to have a serious, challenging discussion of the strategy. And it's for the chairman to sum up the board discussion and then fully empower the executive to implement. That obviously requires a great deal of trust."

Developing that trust is essential to having a detailed yet constructive conversation. Some directors at the summit believed that CEOs were resentful when faced with probing questions from the board. "I can't tell you the number of times I have held back from asking questions," said one participant and experienced board member. "Sometimes I think 'long term' just becomes an excuse to say, 'You signed up for this, and your only choice is whether you picked the right CEO.'" Participants believed that strategy discussions needed to be supplemented with robust discussions of culture and values. Developing alignment on those issues creates an atmosphere that will allow for vigorous yet positive debate.

Boards that fail to articulate clearly where they have concerns can stymie the organizations they're charged with overseeing. One institutional investor described a disconnect, between board and management, that happened at his company: "Our internal management team and external consultants thought that our board members were more concerned about peer risk than they actually were. It was a very liberating conversation when we cleared that up, because it meant that we could then have a stronger focus on an absolute return and not be benchmarked against our peers in an open competition."

The milestones

There is another crucial component in discussions on strategy, and that is reaching some agreement on how to measure progress. Participants felt that this was an area that generally needed improvement and said it had become a source of short-term pressure. "You have to think hard about what are some indicators that we as a board can look at and study and evaluate to determine if we are making progress or not," said one participant, an experienced board member. "That's hard work, and relatively few boards do it."

"You have to think hard about the indicators that we as a board can look at to determine if we are making progress. That's hard work, and relatively few boards do it."

As participants worked through this problem, the principle that emerged was to focus on longer-term results but measure progress frequently. One participant described the process this way: "You set a clear long-term vision but then work out what it takes to get there. You're rolling back from that 10-year or 20-year vision to the intervening milestones and the things that have to be accomplished. It can't be static. There has to be a dynamic review process." In reviewing results, the board must get assurance that the appropriate steps were taken and that the operations are performing well as a result.

The bigger and longer term the strategy, the more deeply enmeshed the board must be. One participant described a transformational strategic initiative at his company: a $20 billion investment in the Middle East. "We made the decision between 2004 and 2007, spread over 30 board meetings. We had huge, intense integrated dialogues with every known constituency, from government to people of broad experience. These board members were intensely engaged in that conversation."

As the board assesses the milestones in the long-term strategy, it's important to set those conversations up with detailed discussions of the ecosystem. Inevitably, short-term conditions will change and events will occur that could not have been foreseen. Deviations from the plan must be explored. With the right context and an explanation of any short-term gyrations that occur on the way to the longer-term goal, the board can have the confidence to support management through the ups and downs.

FOR FURTHER DISCUSSION

Board pay

In an era of long-termism, the job of corporate director has to become just that: a job. This will require a substantially greater time commitment than the position previously entailed—perhaps as many as 50 days a year, but at least 35. Since board members will be asked to understand, help refine, and support the strategy, and then explain it to outside investors, they will also have to be highly skilled and experienced. To get the time and experience required from the board, companies should consider the requisite compensation level.

In an article that appeared in ***Harvard Business Review*** in early 2015, Dominic Barton of McKinsey & Company and Mark Wiseman of the Canada Pension Plan Investment Board said that more important than how much to pay the board was how its members were paid. Barton and Wiseman believe that a greater percentage of pay should be in the form of equity and that board members generally should have more skin in the game. "This could be achieved by giving them a combination of incentive shares, a portion of which vests only some years after directors step aside, and requiring incoming directors to purchase equity with their own money." The goal: a material investment—perhaps as much as 10 percent of net worth—on the part of board members to encourage them to think and act like owners.

ENGAGING INVESTORS

Conversations at the summit underscored the importance of the relationship between corporations and their investors to the investors' willingness to hold onto their shares for the long term. Many, however, believed that a lack of communication and understanding of one another's roles was a source of short-term pressure in general. They outlined two parts of a process the board could follow to improve the level of understanding:

- ***starting the conversation***
- ***grasping the practicalities of engagement***

The conversation

In some cases, the conversation with investors should take place with the CEO or CFO. But as investors at the summit made clear, there are also occasions when it is important for the board to interact and to show unanimous and unwavering support for management. "What the board has to do is build a conviction, in those who are ready to listen, that the company actually has a strategy and that the board has metrics to explain the strategy and is able to account for progress thus far with a decent narrative," said one board veteran.

Some participants believed that any member of the board should be able to articulate the company strategy and express support. Obviously, directors will feel better able to engage with investors if the directors have a thorough grounding in the organization and the strategy, and if they are confident the plan makes sense. "Board members should be deeply involved in the entire strategy and then be tasked with talking to big shareholders, to analysts, and to be out there in the world," said one participant. Many others, however, believed that engagement with shareholders should be delegated to the chair, the lead director, or another designated director.

The goal of conversations with investors is twofold. The first is to present a united front to shareholders as the board explains the strategy, outlines the thinking behind it, and expresses support for the executive. The second is for the board to understand the concerns of shareholders and to build a sense of confidence that they, too, support the organization and executive team. Participants saw a lack of communication on these two points as a source of short-term pressure. "The independent directors don't have enough exposure to what the shareholders are thinking, and the shareholders therefore don't have enough confidence in the board," one participant said. "CEOs feel a huge amount of pressure coming from their boards—not the investors, the boards—to produce short-term returns. Part of the reason is that the boards themselves don't feel they have a real mandate from shareholders, because they've never met a shareholder and the shareholders have not met them."

The practicalities

Although many conversations between board members and investors take place by phone, some organizations facilitate meetings or luncheons. They may invite investors to their offices to meet with both executives and directors. "We find that people who opt to come in have higher engagement levels," one participant said.

Conversations with investors become especially important when there is a crisis or when the company is in the midst of a fundamental transformation. The participant whose company was making a $20 billion investment in the Middle East said that he needed his board to be completely knowledgeable on the strategy and to help refine it. "These board members were intensely engaged. I would trust them to have a conversation with any investor on that topic, and some of them did. Investors were asking tons of questions, and I wanted the lead director talking to them."

In those periods, investors will want reassurance from the board that the company has a viable plan for coping with the complexities. In the case of transformation, investor engagement is also an opportunity to relay a narrative of the company's new goals as a way to set expectations and, if necessary, to transition the investors base.

Board members have an enormous opportunity to help their CEOs develop and implement a strategy for creating long-term, sustainable value. As conversations at the summit made clear, that means communication must vastly improve—both between the board and the executives running the organization and between the board and the investors who buy its shares. ■

THE BIG NUMBER

34%

The share of directors surveyed by McKinsey in spring 2013 who believed that the boards they served on fully comprehended the company's strategy.

Source: Dominic Barton and Mark Wiseman, "Where boards fall short," Harvard Business Review, *January–February 2015, hbr.org*

CHAPTER FOUR

Regulators

Fine-tuning regulation could enhance the prospects for widespread long-term thinking among both investors and companies.

The purpose of financial regulation is to ensure the smooth functioning of markets for the benefit of market participants and society as a whole. In the aftermath of a crisis, however, the rule-making process can evolve quickly. This sometimes results in rules that discourage the kinds of long-term market behavior they were meant to foster.

That is the situation described by participants at the Long-Term Value Summit. They discussed two main areas in regard to regulation and policy: coping with the financial crisis and encouraging long-term value creation.

THE FINANCIAL CRISIS

The current regulatory framework has been shaped, more than anything, by the global financial crisis that ignited in 2007. The discussion of crisis-era regulation at the summit broke down into two areas:

- ***the regulatory response***
- ***the need for remedy and review***

Regulatory response

In a globalized world, a widespread financial crisis has the potential to cripple markets on every continent. Participants acknowledged that the regulatory response to the recent global financial crisis was both necessary and effective, at least in staving off immediate catastrophe. The markets were reassured by swift and vigorous action, and the most serious excesses were addressed. Participants pointed to outcomes such as greater transparency, increased liquidity, decreased leverage, and greater cash reserves to cushion against future crises as examples of positive change that resulted from the response. “I think that we have made significant progress in reestablishing a much more secure level of stability in much of the financial system,” one participant said.

Need for remedy and review

At the same time, the speed and urgency that were essential to addressing the crisis meant that not every rule was thoroughly stress tested. As an example, some participants pointed to the Solvency II Directive (the EU rule meant to harmonize regulations for insurance companies across the European Union), which will take effect in 2016. They were concerned that the new rule would unduly limit the exposure that insurance funds could have to equities, inhibiting the funds’ reach as long-term investors.

Participants urged regulators to weigh the effects of all rules—both those in place and those that are imminent—carefully. “We’re going to have to do some serious housekeeping on all of these new regulations to clean up the things that were not done efficiently and effectively. And ironically, that lack of efficiency and effectiveness could be the cause of the next crisis if we don’t fix this,” said one participant.

Others saw the need to review the existing state of regulation as a chance to create conditions that truly foster and reward long-term thinking. “Regulatory reform presents an opportunity not just to fix the problems of the past but to adopt a broader growth agenda,” one participant said. Discussions centered on the need to evaluate the effectiveness of rules, trade policies, and tax reforms in helping organizations to compete globally. Participants from both Europe and the United States also cited the need to address regulations that discouraged investment in infrastructure upgrades needed to maintain competitiveness.

LONG-TERM VALUE CREATION

It was clear that many participants were trying hard to build a long-term orientation into their organization’s culture. When it came to regulation, as with other elements in the ecosystem, current conditions seemed to be pushing them relentlessly in the opposite direction. Participants discussed four areas where they thought government policies and rules could be reworked to provide stronger incentives for the long term:

- ***capital gains and dividend tax***
- ***disclosure rules***
- ***fiduciary duty***
- ***mark-to-market accounting***

Capital gains and dividend tax

Throughout the summit, participants expressed a keen desire to differentiate among investors, by rewarding those who were willing and able to stick with an investment over the long term, in contrast to those whose strategy was to trade on short-term price fluctuations. The treatment of capital gains was an especially popular topic. “We should change tax policy to incentivize long-term holding,” said one participant. He suggested a plan under which income from an investment sold within the first three years of ownership would be treated as ordinary income. The tax rate would decrease as the investment was held longer, until it was phased out entirely after ten years. “Having a continuum would lead to more socially responsible investing and a greater trend toward long-termism,” he said.

“There needs to be some work on the definition of fiduciary duty. The reward system that has developed in the markets today seems bent toward the short term.”

Others advocated treating dividend income in a similar manner. They called for a scheme in which the longer an investment was held, the lower the tax rate would be on any dividends it paid.

Full and fair disclosure

Several participants believed that fair-disclosure rules, which were meant to put individual investors on an even footing with institutions, in fact discriminated against long-term investors. The rules require companies to release material information to all investors at the same time. Long-term investors who make a point of engaging with their investee companies are limited, as a result, in what they can discuss with CEOs. “The rules have made it more difficult to continue to be a long-term investor,” said a participant. “If I take a 5 percent stake, that’s quite a bit of money, and if I then lose direct contact with the strategy of the company because the CEO can’t say anything, that makes it difficult.” Participants called for a loosening of the rules in order to allow candid investor–investee conversations.

Fiduciary duty

Some participants were troubled by rules—or at least the prevailing interpretation of rules—that force companies to put the interests of shareholders above those of other stakeholders, including employees, communities, and society at large. In practice, these rules often mean that the interests of short-term shareholders become paramount. “There needs to be some work on the definition of fiduciary duty,” one participant said.

"Somehow, the reward system that has developed in the markets today seems to be bent toward the short term."

Other participants, however, believed that CEOs had the leeway to interpret their legal obligations more broadly. "No business is created to enrich the shareholder," said a proponent of this view. "The business is created to solve an issue in society, which then ultimately gives a return to shareholders. It makes it attractive for them to participate." The topic recurred throughout the day, making it clear that participants were eager for more discussion and greater clarity on the issue.

Mark-to-market accounting

Many participants said that regulators often failed to distinguish adequately among different types of investors when making rules. Several participants pointed to market-to-market accounting as a case in point. They said the rules, which require investments to be valued at the latest market prices, were particularly irksome for those taking a long-term view of their portfolios. Participants argued that if an investment that is going to remain in the portfolio for a decade or more loses value in the course of a quarter, that temporary decrease in value is immaterial. Rules that were designed to cut down on leverage and increase cash reserves at more volatile institutions that do much more lending and trading of securities should not apply to long-term institutional investors. "The mark-to-market issue is a very, very big challenge," said a participant.

Financial regulators, as one investor described them, are the traffic cops who keep the cars and trucks moving on the global investment grid. But doing so with optimal results for the long term requires a careful balance. Too much regulation and the traffic backs up at every intersection; too little and you get massive pileups. To avoid either extreme requires constant fine-tuning. ■

FOR FURTHER DISCUSSION

Infrastructure

For long-term investors, infrastructure should represent a rich opportunity. After all, much of the world has a great need for roads, ports, and other engineering projects with predictable income streams and time spans measured in decades. But as participants at the Long-Term Value Summit discussed, the sector often presents challenges—many of which result from adverse public policy and regulation.

Some participants said that outdated accounting rules, government red tape, and a failure to embrace public–private partnerships can make it difficult to get infrastructure projects off the ground. Projects may be subject to overlapping jurisdictions, making the approval process cumbersome, or there may not be a clear framework for how a public–private partnership might work, increasing the risks for investors. "When you think about the $20 trillion to $30 trillion of underinvested infrastructure we have globally, there's a long-term investment opportunity. But governments have not done what they need to do to provide returns on some of these investment products," a participant said.

Participants believe that a fundamental rethinking of the sector by policy makers and regulators could bring new funding to the sector—and much-needed infrastructure to areas in need.

Engaging the value chain

Our mission of instilling a long-term perspective depends on every actor in the ecosystem working to create organizations and investments of lasting value.

Individual savers

Institutional investors
(asset owners and asset managers)

Corporate boards

CEOs and
corporate management

Regulators, media, and other market participants

Highlights from the summit

INSTITUTIONAL INVESTORS

- ***Create the right incentives*** *by negotiating mandates, choosing benchmarks, and aligning compensation to long-term goals.*
- ***Develop deeper understanding*** *of investee companies by engaging with companies and tapping into coalitions for greater reach.*
- ***Manage for the long term*** *by rethinking risk, developing a thematic view of the future, and infusing long-termism into the organization's culture.*

CORPORATE BOARDS

- ***Commit to the role*** *by developing focus and skills and by supporting the strategy, once debated and approved.*
- ***Know and challenge the long-term strategy*** *by setting an agenda for the long term, debating the elements of the plan, and measuring progress.*
- ***Engage investors*** *and show support for the executive team in discussions with major shareholders. Be prepared to discuss and defend the long-term strategy.*

CEOS AND CORPORATE MANAGEMENT

- ***Build a long-term strategy*** *by carefully articulating values and understanding the ecosystem.*
- ***Create a supportive board*** *by communicating the long-term strategy and defining milestones.*
- ***Build a long-term culture*** *by evolving goals as necessary, communicating them internally, and aligning compensation.*
- ***Build an investor base*** *by identifying appropriate investors and communicating goals and values.*

REGULATORS AND OTHERS

- ***Remedy policies and regulations*** *that unintentionally encourage short-term behaviors. For example, some regulations have forced long-term investors to limit their exposure to equities.*
- ***Encourage long-term value creation*** *by promoting longer holding periods through changes to corporate structures and tax rules.*
- ***Reinforce a broad understanding of fiduciary duty****, encouraging investors and corporate directors to consider long-term implications of actions for all stakeholders.*