Overcoming the barriers to long-term thinking in financial markets

Financial markets' decisions on the allocation of capital influence behaviour across the economy. Currently, short-term thinking predominates, which results in some significant negative impacts that are not factored into share prices. This research, by Forum for the Future, identifies the key barriers to long-term thinking in financial markets, and recommends three critical areas of focus where interventions could be most powerful. It proposes specific, practical actions to support a shift to longer-term thinking within the sector.

Background

Why is short-term thinking a problem?

Long- and short-term investment strategies both play a role in an efficient financial market. However, strategies that focus on maximising short-term returns can undermine long-term economic value by ignoring important risks and opportunities and driving short-term thinking within businesses. This makes it more difficult to address the challenges of sustainability, and can also act to the detriment of companies themselves – research has shown that 80 per cent of chief financial officers would sacrifice future economic value to satisfy investor expectations for short-term returns. The systemic risks, wider impacts or irreversible consequences of short-termism are being underestimated or ignored, and are not reflected in share prices.

The rise in short-term thinking

Short-term thinking has come to dominate financial markets over the past few decades. There has been an increasing rate of turnover, or 'churn rate', of shares; a growth in high-frequency trading (made possible through technological improvements); and CEOs are spending less time in their roles. Structural changes within the sector (for example, lower transaction costs, use of intermediaries in investment management) have reinforced the trend towards short-termism, which has lessened the sense of accountability between the investor and the companies in which they invest.

Barriers to reversing the trend

There has been slow progress in embedding longer-term approaches, despite a range of recent initiatives from businesses, investors, NGOs and policy-makers. The key reason for this is that barriers to change are systemic and sector-wide – often embedded within incentive structures, established behaviours and organisational cultures. Companies and investors have tended to wait for public policy interventions (for example, carbon prices or regulatory interventions) that change the market as a whole. Yet for companies and investors that identify the opportunities and shifts in business models required, there are great opportunities to seize the competitive advantage.

About the research

This research was carried out by Forum for the Future. Its key aim was to find practical, constructive ways to shift financial markets' thinking to a longer-term perspective. The research objectives were:

- To identify specific, practical changes in incentives, information or communication that could shift attitudes and behaviour.
- To identify areas where companies, asset managers and asset owners can take action in their own organisations and scale up these changes within the sector.

The team drew on the experiences of recent initiatives that link to long-term thinking, and the approaches that they are taking. These included a wide range of activities involving government, financial institutions, companies and the pension fund community. Forum for the Future's recommendations were developed to complement or build on these established activities, so that lasting and meaningful change can be achieved.

The focus was on the actions that companies, asset managers and asset owners can take to move the agenda forward, rather than relying only on public policy, which has been slow and unpredictable. The study involved a literature review, a review of research into cultural and behavioural change and discussion with experts on long-term thinking.

Barriers to long-term thinking

Critical barriers to long-term thinking include poor information flow between businesses and asset managers, the cultural and financial incentives for asset managers, the legal obligations of fiduciary duty (the need to ensure that those entrusted to act on behalf of others do so reasonably and responsibly), and the remuneration criteria used within businesses.

The legal obligations of fiduciary duty are a key barrier to longer-term thinking for **asset managers**, particularly as they may feel that short-term approaches create the greatest value for their clients. Additionally, the performance of asset managers is often assessed on a quarterly basis. Cultural incentives are also important: asset managers or consultants may feel they are unlikely to be criticised for 'missing' significant environmental, social and governance (ESG) issues that could have an impact on long-term value because their peers

EXAMPLES OF THE IMPACT OF SHORT-TERMISM

- Investors in fossil fuel companies can gain attractive short-term returns from high oil prices. However, carbon emissions will have an impact on the long-term health of the economy as well as the environment, and the value of investors' portfolios could suffer unless they shift out of these carbon-intensive companies and into alternatives in a managed way.
- In the run-up to the financial crisis, many financial institutions recognised that there were risks in the complex financial products they were selling, but they were competing with peers to deliver superior short-term returns and underestimated or dismissed the longer-term impacts.
- The Deepwater Horizon explosion and oil spill in the Gulf of Mexico killed 11 people and damaged the environment. It also resulted in significant financial losses for BP. Evidence suggests that it stemmed at least in part from decisions to cut corners in pursuit of short-term returns.
- Private investment in unsustainable 'drag' fishing technology drove the cod population in Newfoundland, Canada to near-extinction in the 1990s and resulted in permanent damage to local communities with the loss of 40,000 jobs. A longer-term perspective would have yielded greater returns for more investors over a longer period of time, and would have avoided these catastrophic ecosystem and community impacts.

are likely to miss them too. Finally, investment mandates often do not include sustainability considerations (even when set by pension funds, which might be expected to have a long-term perspective).

For **asset owners**, it is easier to monitor the short-term performance of an investment manager than their long-term results, and asset owners or their trustees may not feel qualified to question their investment strategies. Within **businesses**, there may be a perceived lack of interest from investors in more detailed long-term information, and unclear evidence on the benefits of this in driving long-term success. For business leaders, the focus on shorter-term results can make longer-term thinking difficult, and the criteria used for remuneration may also have the effect of incentivising short-termism.

Critical areas of focus

Forum for the Future identified three critical *areas of focus* where interventions to tackle these barriers to long-term thinking could be most powerful. The boxes below outline how investors and companies can explore these areas of focus and take action in their own organisations.

AREA OF FOCUS 1: Companies provide improved strategic information on long-term drivers of value, and asset managers see the benefit in demanding it

A key barrier to long-term thinking and sustainability is poor information flow, including the amount and nature of communication between asset managers and companies.

Key recommendation for action

Companies should communicate the opportunities and risks of their sustainability performance in a way that is more relevant to mainstream investors and more integrated with financial reporting. A two-phase approach would tackle both the supply and demand of information between companies and investors (both asset owners and asset managers):

- Phase 1: equip companies to make better decisions by evaluating the financial contribution of sustainability to their success and give them the tools to report effectively on this.
- Phase 2: work with investors to help them understand the financial and social value of sustainable business practices.

Forum for the Future has successfully developed and trialled these approaches in earlier work (see Better Decisions, Real Value at www.forumforthefuture.org).

What behavioural or cultural shifts would this intervention encourage?

Asset managers would make decisions informed by better communication on long-term business strategies, risks and opportunities. Others in the system would support and reinforce this shift:

- Companies would provide better communication and information to asset managers and analysts on their long-term business strategies, risks and opportunities. This would also widen the debate around long-term risks, and strengthen the evidence base for future policy interventions to help integrate true ESG costs and benefits into market prices.
- Asset managers, sell-side analysts and credit rating agencies would demand this information and integrate it into research or ratings.

AREA OF FOCUS 2: Asset managers provide evidence that the incentives throughout the investment supply chain serve the long-term interests of asset owners, or pilot new approaches to ensure this

Financial/cultural incentives can lead to a misalignment between the expectations of asset owners and the behaviour of financial institutions. By making asset owners aware of how short-term gains might benefit others involved in their investment but potentially disadvantage themselves, it will lead them to question more closely the value of short-term investment strategies.

Key recommendation for action

To support existing initiatives on fiduciary duty and the approaches within the UK Stewardship Code, we recommend actions and pilot projects to highlight the incentives behind short-termism and the cultural barriers underlying these. These would include:

- Asset owners should take a detailed look at the specific incentives at each stage of the value chain – individual investors, brokers, exchanges, fund managers and investment consultants.
- Share evidence of how integrating ESG issues has helped asset managers to outperform mainstream peers. Support the development of new analytical tools that will differentiate long-term thinkers in the market.
- Challenge the language and culture that equates success with short-term deal-doing rather than longer-term contribution to wealth generation.

What behavioural or cultural shifts would this intervention encourage?

Asset managers would be incentivised (both culturally and financially) to make decisions based on long-term value creation. This would be supported by greater demand from asset owners for evidence that the incentives throughout the investment supply chain serve their long-term interests.

AREA OF FOCUS 3: Companies show greater transparency and innovation on how the performance of the Board, the CEO and other staff is judged and remunerated

Performance criteria and remuneration within companies can disincentivise longer-term decision-making and influence how success is judged. Increased transparency, supported by demand for this information, should encourage a shift in both the cultural and financial incentives for long-term thinking within businesses.

Key recommendation for action

Companies should be transparent about how executive remuneration is structured, in particular the criteria used to judge success and the type of remuneration involved. Actions would include:

- Companies should specify what proportion of remuneration is linked to short-term or long-term criteria. This would identify links to key drivers of long-term value, such as innovation and efficiency.
- Further research should be carried out on how the structure of remuneration influences executive decisions, to create an evidence base and develop ‘best practice’.

What behavioural or cultural shifts would this intervention encourage?

Business CEOs, boards and managers would be incentivised through performance criteria and/or remuneration to make business decisions based on long-term value creation. This would be supported by demand from investors for transparency on this type of information.

Key actions now and in the future

Based on this analysis and supporting the three areas of focus, Forum for the Future recommend that the following key actions should be prioritised:

COMPANIES

	NOW	IN THE FUTURE
COMPANIES	1 Communicate strategically on environmental, social and governance issues, in a way that appeals to mainstream investors and the media. 2 Measure and report the financial benefits of longer-term strategy. 3 Be transparent about how CEO and Board remuneration is structured.	1 Explore the value of natural and social capital to the business. 2 Find ways to report on a range of possible outcomes to reflect uncertainty. 3 Find ways to judge and reward CEOs and Boards in non-financial terms.
ASSET OWNERS	1 Demand transparency on how all agents along the supply chain are remunerated. 2 Demand information on the quality of ESG analysis by fund managers (signatory to UN Principles for Responsible Investment (UNPRI) is not enough).	1 Ensure that a wider definition of fiduciary duty is reflected in mandates. 2 Undertake research into how returns are affected by short-term perspectives, taking transaction costs and systemic risks into account. 3 Support the UNPRI in developing a meaningful independent process for assessing the quality of asset manager ESG analysis.
ASSET MANAGERS	1 Commit more resources to research into the financial and systemic implications of ESG, including scenarios for the future. 2 Review the existing cultural and financial incentives within the organisation, to better understand how they relate to clients and wider society. 3 Share stories, examples and evidence of how ESG has helped (or could have helped) investors to outperform peers. 4 Continue and scale up training for asset managers on the materiality of sustainability issues, how these can be valued, and how to interpret fiduciary duties.	1 Develop new analytical tools to assess systemic risk and to explore a range of possible future outcomes. 2 Engage more closely with businesses on ESG issues and demand more precise data. 3 Engage companies on the composition of remuneration packages for CEOs and Boards.
GOVERNMENT AND POLICY-MAKERS	1 Intervene (where possible on a regional or global basis) to correct market failures that encourage investors to seek short-term returns that are not aligned with a sustainable economy, or pose long-term risks to the financial system as a whole.	1 Only provide tax breaks and subsidies to investors who can demonstrate that their investment strategy includes detailed consideration of long-term and systemic impacts.

Get involved in implementing these actions

Forum for the Future will now work with a range of organisations to implement the actions recommended in this research, and to gather and highlight best practice. This will build evidence and case studies around the benefits of long-term thinking and create the momentum for change. Forum for the Future welcomes enquiries from individuals and organisations that would like to be involved. Contact the project at R.Curran@forumforthefuture.org or find out more at http://www.forumforthefuture.org/projects/overcoming_barriers_long-term_thinking

Further information

This summary and the full report, *Overcoming the Barriers to Long-term Thinking in Financial Markets* by Ruth Curran and Alice Chapple of Forum for the Future, are available in print and as a pdf from Friends Provident Foundation (foundation.enquiries@friendsprovident.co.uk and www.friendsprovidentfoundation.org).

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