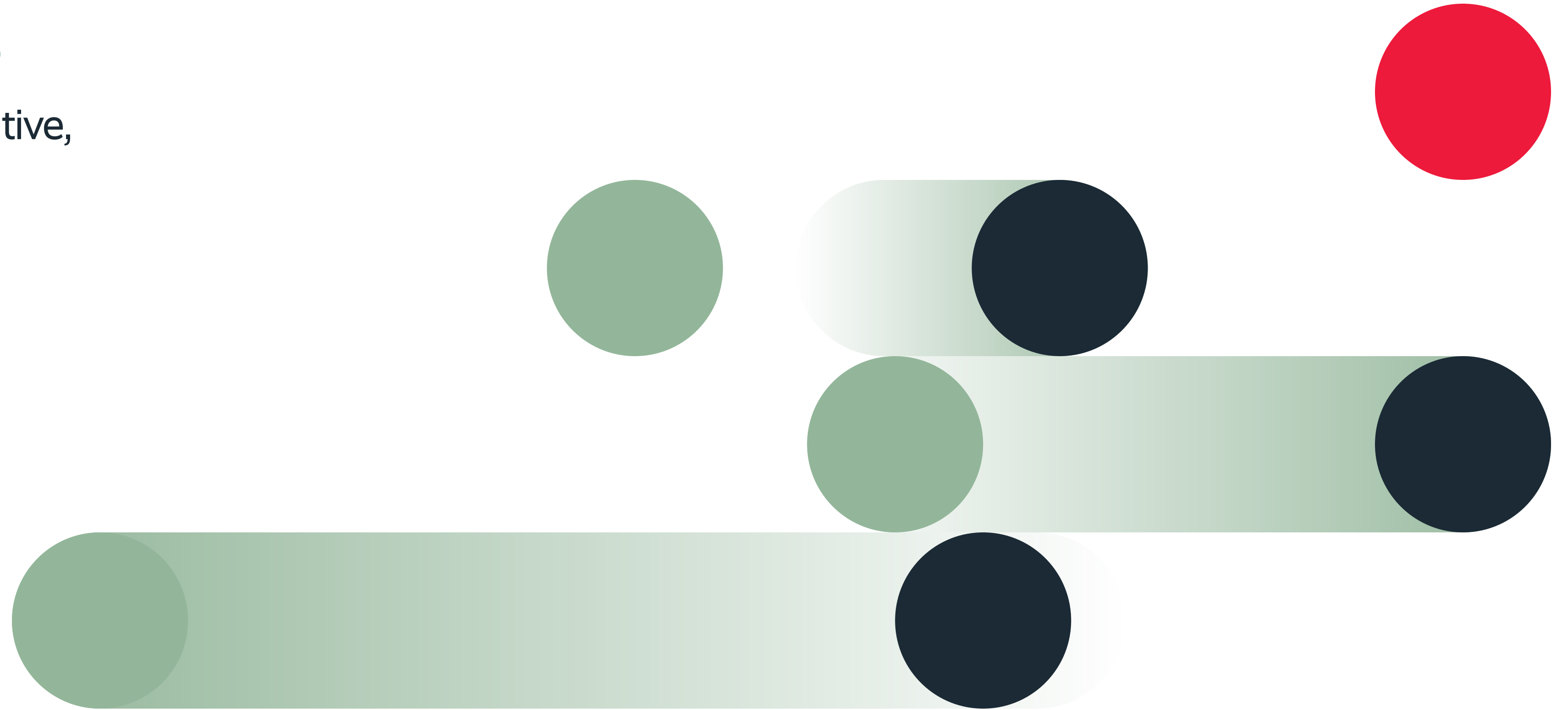
A ten minute read

How investment became short-term – and drained belief in business

Reporting's role in promoting a positive, proactive, long-term perspective

By Sean Bride



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Perhaps one trend above all has dominated investor behaviour over the last couple of decades: the rise and rise of short-termism.

Structural changes and incentives have contributed to the average length of shareholding falling from six years in the 1950s to around six months today – with far-reaching implications for belief in business. More recently, new rules and trends are compelling investors to take more responsibility as owners and how companies report will play a key role.

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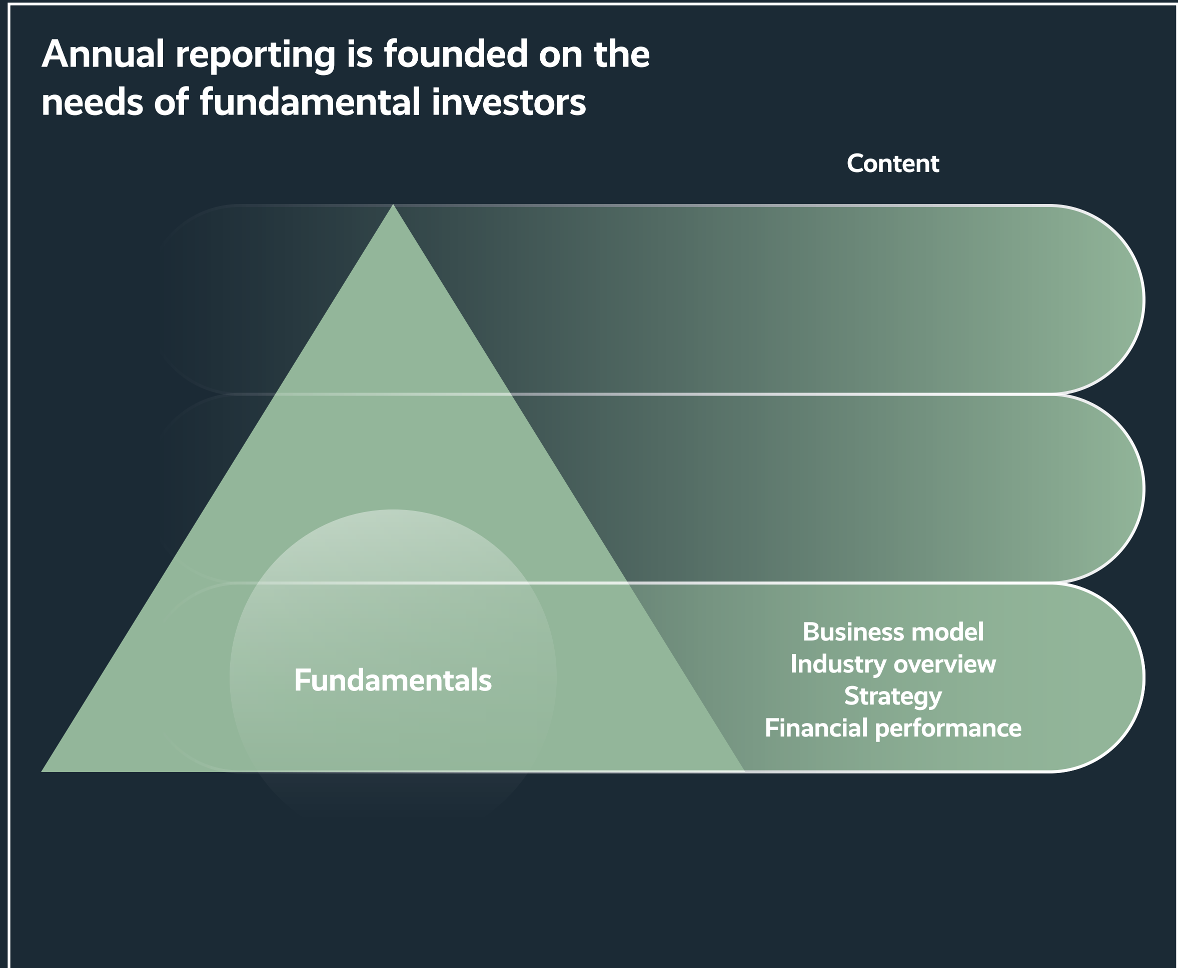
Investors who base their decisions on technical analysis (dominated by charts and other tools) have always been somewhat short-term. Typically they only invest in companies for a few months before their charts throw up a better opportunity. They have no real interest in the detail in annual reports.

But 'fundamental' analysts – whose investment philosophy informs the content found in reporting - have become prone to short-termism, too.

These investors are interested in anything that can affect a company's market value including economic factors, industry conditions and the effectiveness of strategy.

They calculate a valuation and compare it to a company's current share price in order to judge whether it is under or overvalued. If the investor believes the company is undervalued, they will buy shares and wait for the share price to rise as the rest of the stock market comes to the same conclusion.

So why has short-term thinking become so prevalent?



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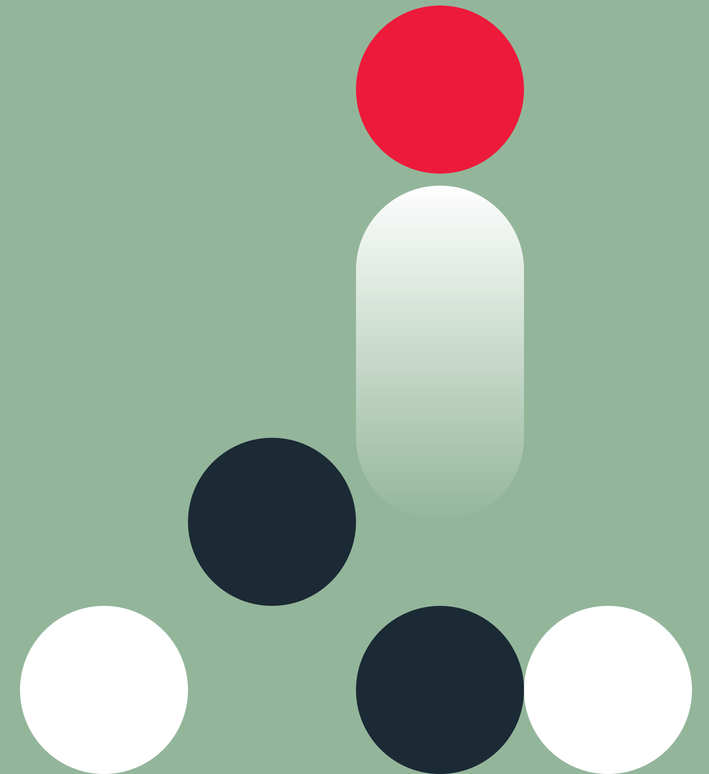
Structural changes have seen the asset manager dominate

The number of retail shareholders holding direct investments in companies has fallen as more people have chosen to delegate this responsibility to professionals via investment or pensions funds. These are ultimately the responsibility of an asset manager. Elsewhere, pension funds and insurers have also reduced their investment in equities in response to changing regulation and demographic changes. This led them to search out investments that offer a better match to their long-term liabilities.

Another factor has been the globalisation of financial markets and a general increase in foreign shareholders. These changes, over many years, have resulted in asset managers becoming dominant players.



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They’ve become more dominant, but not more influential

Asset managers, whose performance tends to be judged on short-term performance relative to a benchmark index, are subject to significant scrutiny. An asset manager that underperforms will quickly see outflows from their funds or lose their mandate to manage money.

And yet, as the dominant player in the investment chain, responsibility for the stewardship of a company falls on their shoulders. The trouble is this: the same changes that elevated them to their dominant position have resulted in greater fragmentiation of share registers.

The biggest shareholders in companies today often own only a very small percentage – and this has diluted asset managers’ influence on company management. When combined with short-term scrutiny, it’s often easier for them to sell their stake in a company when it goes through a difficult patch rather than commit to the alternative: engage with it to solve a problem for the long-term benefit of all stakeholders.

Result: dramatically shorter horizons in investment decision making.

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Far-reaching negative consequences

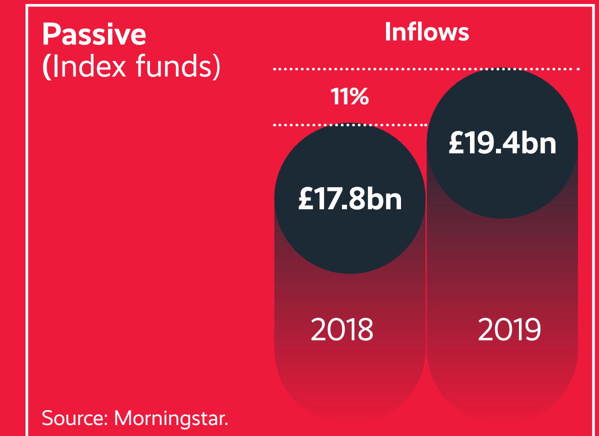
It's not hard to see how the pressure on short-term performance among asset managers and a disincentive to proactively engage with companies to boost performance has had a knock-on effect on company decision making itself.

It is easier to boost the market value of your company (and attract investors focused on short-term returns) by cutting costs or taking on more debt than by driving growth through developing its fundamental operational capabilities.

This kind of short-termism has become infective and insidious, making a significant contribution to the crisis of belief in the value business offers to the world around us as revealed in our 'Belief in business, state of the nation' research last year.

Worse still, it acts as a barrier to companies playing their part in tackling the biggest challenges facing their marketplace, society and the planet in the long-term.

Individuals and pension trustees are losing faith in asset managers who struggle to outperform the stock market over a longer period. It is easier, cheaper and less risky for individuals and pension funds to invest in passive funds that track the market (such as exchange traded funds and index trackers) rather than managers that take active decisions on which companies to invest in.



Source: Morningstar.

But all is not lost. Changes we're seeing in annual reporting reflect wider moves that could address these negative outcomes - and make equity markets work more productively for all participants and stakeholders.

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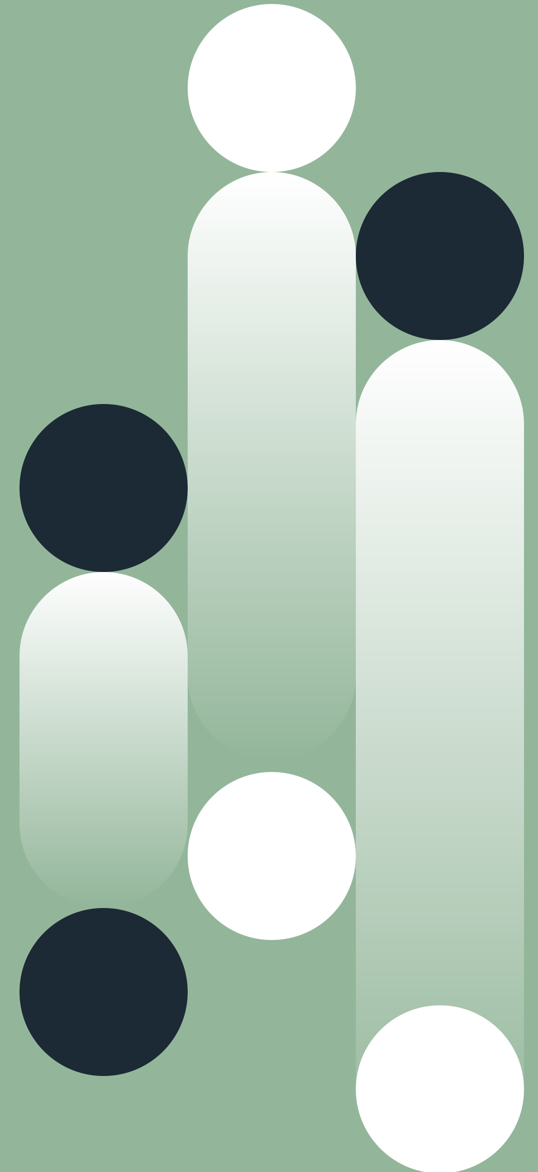
The rise of passive investing

Passive investing shouldn't mean a passive role for investors. On the contrary, it should actually drive long-term engagement.

When Larry Fink, BlackRock CEO, talks about purpose, he's not representing a new cuddly form of capitalism. As the largest manager of passive investments, the success of Blackrock is inextricably linked with the long-term success of the companies it owns.

BlackRock cannot sell its shareholdings when the going gets tough: it has to engage with leaders and make sure they focus on the long-term. Increasingly, this means greater emphasis on the really tricky, long-term issues such as climate change.



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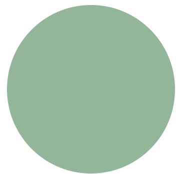
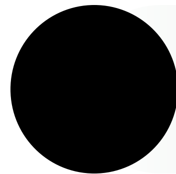
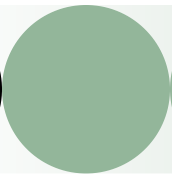
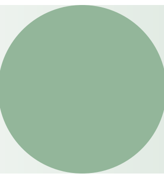
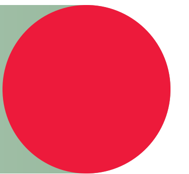
A resurgence in long-termism – and the implications for annual reporting

This focus on long-termism is the driving force behind the expectations of new disclosures in reporting.

Blackrock - which is also an active investor - now expects the companies it invests in to report against Sustainability Accounting Standards Board guidelines (or similar data relevant to their business) and climate-related risk in line with the Task Force on Climate-related Financial Disclosures (TCFD).

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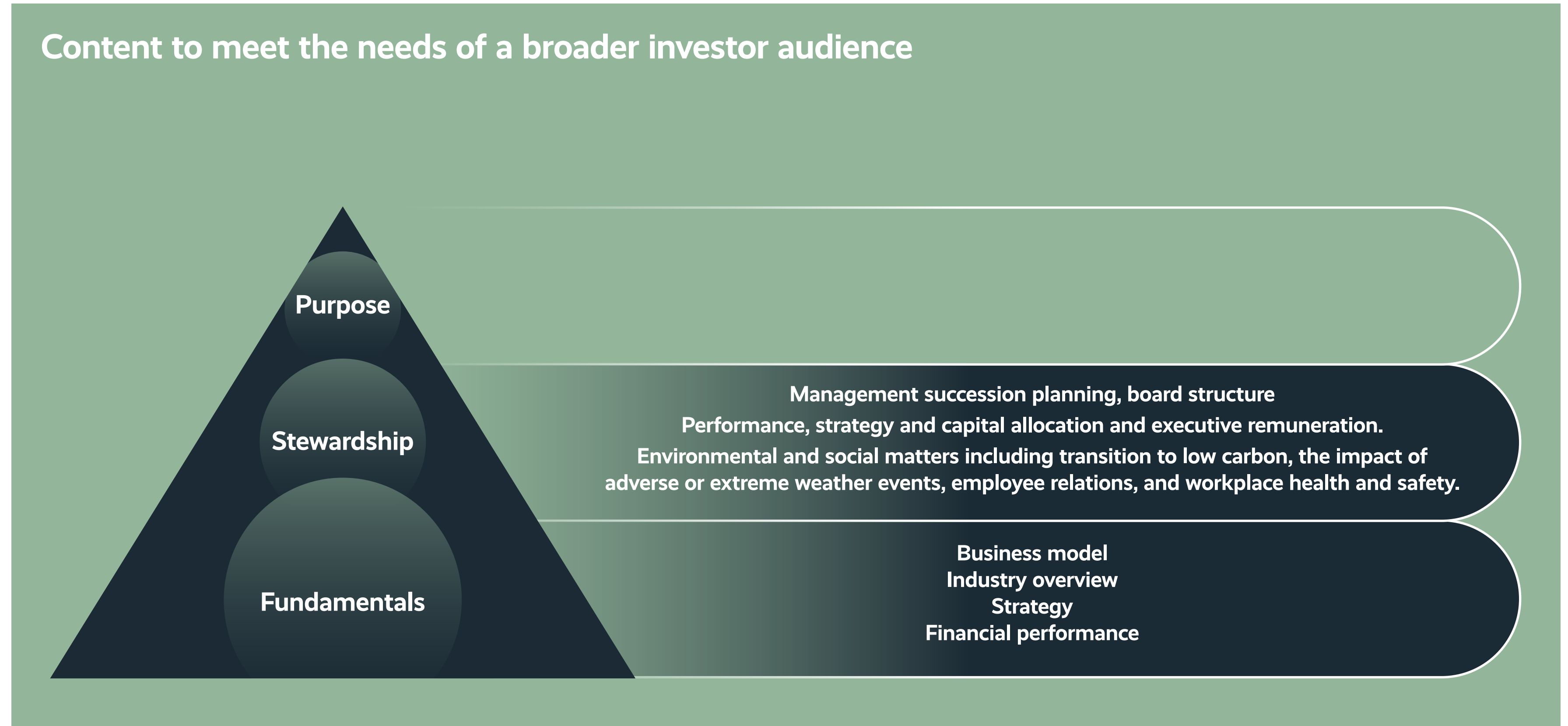
A resurgence in long-termism – and the implications for annual reporting
Continued

Annual reports will need to disclose this information, which will be read by sustainability and governance experts employed by long-term investors including BlackRock and the likes of Federated Hermes and Norges Bank that also adopt a long-term view. In fact, more and more active investors are looking at social and environmental factors to seek out companies that are managed well. Their calls for better, more consistent and comparable non-financial metrics from reporters will become louder.



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The Stewardship Code

Elsewhere the 2020 Stewardship Code represents a fundamental shift from the 2012 Stewardship Code in that it focuses on outcomes and effectiveness rather than policy statements. It calls on the investment community to engage more actively on the stewardship of the assets in which they invest. In addition, it requires signatories to take into account material environmental, social and governance (ESG) factors and make sure investment decisions are aligned with the needs of clients.

While the Stewardship Code is aimed at the investment community, it also has implications for reporters. It is imperative that companies take a fresh look at their ESG reporting to make sure it's fit for purpose and provides a clear picture to investors. The benefits of doing so are clear: it will help investors and asset managers satisfy themselves that they are fulfilling their own stewardship responsibilities; raise the level of engagement; and make it easier for them to fulfil their own reporting obligations.

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Conclusion

All too often, annual reporting is seen as a compliance exercise. But when we see **new disclosures** in the context of the wider challenges they're seeking to address, you realise how important reporting is to contributing to a resurgence in vital long-termism. Better communications on long-term issues is set to drive engagement. There is a growing acceptance that this will not only identify the best managed companies, and therefore long-term returns, but also create a stock market that works for all stakeholders and help business tackle the biggest long-term problems.

And ultimately: restore belief in business.

Key disclosures

1 Purpose

In every initiative we've seen, purpose has assumed greater importance. Companies need to state a purpose beyond shareholder value that they believe in and one that stands up to scrutiny.

2 Wider value creation

Including a broader view on social and environmental responsibilities. We expect new initiatives to bring consistency and comparability to this area, which will make companies more accountable to a wider audience.

3 Governance

A true insight into how companies are managed and how they treat stakeholders.

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To learn more about these disclosures and what they mean for your reporting, get in touch. We'd love to chat.

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