Barriers and opportunities for taking a long-term perspective in the financial market

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# Contents

1. **Introduction** ........................................................................................................................................... 4

2. **Explaining different time perspectives: Sustainable development and financial markets** ..... 4
   2.1 Taking a long-term perspective in sustainable development ......................................................... 5
   2.2 The financial system and short-termism .......................................................................................... 6
   2.3 What are the barriers to overcome short-term thinking? ................................................................. 8

3. **A framework of incentives to introduce a long-term thinking** ......................................................... 9
   3.1 Targeting companies for facilitating long-term thinking in the financial market ....................... 10
   3.2 Changing asset managers decision-making practices ................................................................. 10
   3.3 European Commission and national governments ........................................................................ 11
   3.4 Analysts and independent assessment institutions ..................................................................... 12

**References** ................................................................................................................................................. 13
1 Introduction

The overall aim of this case study is to stress the importance of long-term perspectives (as a principle of sustainable development) in financial markets, and to try to identify barriers thereof and opportunities to overcome these barriers. Thus, the study highlights principles related to long-term thinking within sustainable development and, furthermore, explains the rationale of short-term oriented thinking by actors in financial markets.

This case study mainly derives its ideas about financial markets and short-term perspectives from a publication\(^1\) by the Forum for the Future (F4F) and the Friends Provident Foundation in 2011, which identifies the barriers to long-term thinking and presents practical ways that these can be overcome.

2 Explaining different time perspectives: Sustainable development and financial markets

When considering the logic of time horizons understood by today’s financial capital markets within the topic of sustainable development, two contradictory views clash together. Some key assumptions on sustainable development and financial capital markets outlined by Schmidheiny & Zorraquin (1996) illustrate the deep changes that have to be made so that financial markets encourage rather than discourage sustainable development:

| Sustainable development requires investments with long payback | VS. | Financial markets seek short-term payback |
| Efforts towards sustainable development (e.g. eco-efficiency) by companies often reduce present earnings in favour of future potentials | VS. | Financial markets favour companies with high present earnings over those with future potentials |
| Sustainable development is concerned with the importance of the future | VS. | Financial markets discount the future routinely and heavily |
| Accounting and reporting does not adequately convey potential environmental risks and opportunities | VS. | Financial markets are compelled to make decisions based on biased information |

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\(^1\) Overcoming the Barriers to Long-term Thinking in Financial Markets
2.1 Taking a long-term perspective in sustainable development

From the perspective of sustainable development, two related or underlying concepts or principles receive attention when it comes to considering long-term perspectives: inter-generational equity and the precautionary principle. Instead of focussing on various interpretations that try to embrace these concepts in a holistic and condensed way, we try to elicit the different assumptions and principles standing behind it, which form an implicit part of many international policy declarations, plans, and strategies of SD. This overview serves as a basis for understanding the different time horizons taken into account in financial markets, as well as the concept of sustainable development, respectively. This part will enable us to find a common ground of argumentation, and identify levers for introducing long-term thinking into financial markets.

(1) Inter-generational equity

Being an important part of the equity principle (next to intra-generational equity), inter-generational equity is a central principle of sustainable development. Inter-generational equity refers to the long term or futurity aspect of sustainable development, as SD not only aims to meet present human needs and aspirations, but also includes the right of future generations to meet their needs and aspirations (Waas et al., 2011). This perspective on needs and long-term development is captured by one of the most well-known definitions, the Brundtland report, which defines sustainable development as “development, that meets the needs of the present without compromising the ability of future generations to meet their own needs” and clarifies “two key concepts: the concept of ‘needs’, in particular the essential needs of the world's poor, to which overriding priority should be given; and the idea of limitations imposed by the state of technology and social organization on the environment's ability to meet present and future needs” (WCED, 1987). The concept of inter-generational equity was reaffirmed by the Rio declaration in 1992 - one of the most influential political documents for sustainable development - stating that “[t]he right to development must be fulfilled so as to equitably meet developmental and environmental needs of present and future generations” (Rio declaration, principle 3).

First of all, from these definitions we can delineate that the development process has to be sustainable – lasting or continuing for a very long time or even indefinitely. Secondly, inter-generational equity refers to the fairness of distribution of resources and risks between the current and future generations. Thirdly, considering the latter the principle implies that development remains within biophysical limits (i.e. carrying capacity) of the environment in order to fulfil needs of present as well as future generations. Essentially, this relates to another principle underlying the concept of SD: the precautionary principle.

(2) Precautionary principle

The precautionary principle, very much linked to the time perspective of sustainable development, is best captured in Principle 15 of Rio Declaration: “In order to protect the environment, the precautionary approach shall be widely applied by States according to their capabilities. Where there are threats of serious or irreversible damage, lack of full scientific certainty shall not be used as a reason for
postponing cost-effective measures to prevent environmental degradation.” This principle is based on the idea that uncertainty (e.g. with regard to any environmental problems such as biodiversity loss which has biological, ecological as well as economic implications) should be treated with a measure of safeguard – in fact the precautionary principle reflects a “better safe than sorry” principle, “risk averse” or “no regrets” decision-making (Rao, 2000).

To reflect back on the principle of inter-generational equity, the application of this principle safeguards bio-geophysical sustainability against the likelihood of future occurrence of adverse impacts (i.e. taking a long-term perspective on the preservation of biological and geophysical resources; see Holdren et al., 1995) for the benefit of human well-being of current as well as future generations.

In a nutshell, for justifying long-term time perspectives within the concept of sustainable development, these two principles (inter-generational equity and the precautionary principle) form the backbone thereof. The relevance for and implications on the financial system are discussed in the following part of this paper.

2.2 The financial system and short-termism

The following paragraphs elucidate why short-term and profit-oriented thinking in financial markets is problematic for the financial market itself as well as for the economy, the environment, and society as a whole. Furthermore, the chapter highlights some of the most important factors as to why short-termism is a persistent factor in the system, and explains consequences thereof.

Short-term versus long-term: the role of investment

In today’s financial markets, the balance of investment as a whole has moved too far towards short-termism, in the sense that strategies focus (i) on short-term decision-making behaviour of investors for maximising short-term returns (Forum for the Future, 2011) and (ii) on the allocation of investment to financial products or companies that represent short term interests. Taken together, both aspects of short-termism (i.e. investor behaviour and where capital is invested) are underestimating or ignoring the systemic risks, wider impacts, or irreversible consequences of their behaviour.

On the other end of the scale, as described by Emerson & Little (2005), conservative or long-term investment considers potential financial performance while assessing exposure for contingent risks (represented in part by these environmental and social liabilities) that could have a negative effect upon future financial returns: In this sense, sustainable, long-term investing behaviour is both a risk-management strategy and a strategy that positions the investor to exploit emerging opportunities within the market (i.e. it is an investment practice that is simultaneously both offensive and defensive).

Lydenberg (2009) argues that a rather clear-cut and comprehensive definition of long-term investment should address the following issues:
Barriers and opportunities for taking a long-term perspective in the financial market

ESDN Case Study N° 12

- the benefits of holding stocks for long periods of time;
- the incorporation of environmental, social and governance (ESG) factors into investing; and
- the willingness to add value to investments.

Taking into account the consequences of short-term thinking

According to Lydenberg (2007), there is a widespread debate within the financial and business community - including the CFA Institute, the Business Roundtable, the Conference Board, the United Nations, the World Economic Forum, and the Aspen Institute - on the issue of extolling the virtues of long-term investing, and condemning the short-termism in today's financial system. In this regard, short-termism is claimed to have a number of detrimental effects on the financial market itself, the real economy, as well as environment and society overall. Among the dangers for financial as well as corporate communities are (Tonello, 2006):

- At the macro-economic level: short-term visions cause market volatility and the instability of financial institutions.
- At the micro-economic level: short-term investment strategies drive short-term thinking in business
  - undermining management continuity and exposing a public company to the risk of losing sight of its strategic business model, compromising its competitiveness.
  - pressure to meet short-term numbers may induce senior managers to externalize a number of business costs (i.e., the cost of a state-of-the-art pollution system), often to the detriment of the environment and future generations.

One of the main reasons for short-termism to persist as a stable factor in the system (as highlighted by the box-text below), is that while investors can maximise financial return and their actions may have wider impacts on individual companies and the system as a whole, they may not directly be exposed to the consequences thereof.

Box-text: Examples of the consequences of short-termism on the financial market (adapted from Forum for the future, 2011)

- 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.
- 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.

2.3 What are the barriers to overcome short-term thinking?

The reasons for short-term thinking and the barriers to overcome them across the financial system are manifold and systemic. In the following paragraphs we describe some fundamental structural characteristics, actors, and their behaviour and decisions taken that contribute to the persistence of short-term thinking within the financial system. As described by the Forum of the Future (see Box-text below), these barriers can be apportioned to different fields of actions. These include:

- inherent system structures of the financial system (related to behaviour and decision-making)
- companies
- shareholder

Box-text: barriers to overcome short-term thinking (adapted from Forum for the future, 2011)

Inherent system structures of the financial system

- **Legal barriers:** Investors and trustees can perceive fiduciary duty (fiduciary obligation is about ensuring that those entrusted act on behalf of others do so reasonably and responsibly, and do not abuse their position for their own ends; FairPensions, 2011) as a legal barrier to taking account of sustainability and long-term issues in decision-making. In this sense, the primary fiduciary duty when taking investment decisions is perceived to be maximising returns rather than generating real and lasting value over the long term.

- **Problems of agency:** Agency problems are commonly defined as ‘conflicts of interest among stockholders, bondholders and managers’. A number of identified potential agency problems in the investment chain, particularly in relation to stewardship for institutional investors (Wong, 2010) are listed below.
  - separation of ownership from responsibility: The lengthy share ownership chain has short-term incentives at each link, resulting in overwhelmingly short-term behaviour and reducing the connection between asset owner and asset manager;
  - portfolio diversification: Institutional investors are increasingly taking small stakes in a huge range of companies across the world. While this approach helps investors to benefit from diversified risk across the portfolio, it can reduce their level of engagement with boards of directors and therefore their understanding of specific company drivers;

- **Culture of stewardship:** There has been a distinct cultural change in the perception of share ownership, in the sense that a change in mindset may have shifted the culture away from stewardship of shares to a more speculation-based approach.

- **Performance measurement:** Based on Lee (2008) and Sheng (2011), recent events in the banking industry showed that incentive pay for traders facilitates short term speculation results at high risk. Furthermore, equally important is the lack of incentive structures based on...
performance measurement of human capital, social capital, quality, and increased intellectual capital.

**Companies (i.e. associated boards of directors)**

- **Short-term assessment of company performance**: Currently a company’s performance, when taken into account by potential investors, is assessed on the basis of quarterly returns. Moreover, the level of communication of corporate long-term strategies and its relation to sustainable development is insufficient.
- **Difficult to predict long-term drivers of value**
- **Problems to account for and measure natural and social capital**

**Shareholders**

- **Short-term trading**: Investors can hold shares for a short time and make short-term trading gains (Haldane, 2010), rather than sharing in the value added over time by a company pursuing a long-term sustainable growth strategy.
- **Investor disclosures**: Some investors are able to influence decision-making without being required to disclose the existence or nature of their positions or their plans.

### 3 A framework of incentives to introduce a long-term thinking

In order to facilitate a fundamental change in the way institutions and actors on the financial market take into account long-term perspectives in their investment decisions, several recommendations are proposed.\(^2\) These recommendations are not only targeted on actors undertaking investment decisions, but rather try to engage with a broader set of actors directly or indirectly involved and affected by investments, such as companies and fiduciaries. Besides incentives directed towards actors’ behaviour and decisions, some reference is also given to the different investment types necessary to steer long-term thinking.

The examples below provide an overview of intervention measures open to both private and public actors’ initiatives.

\(^2\) This part of the paper has been greatly inspired by and mainly draws on the publication by the Forum for the Future.
3.1 Targeting companies for facilitating long-term thinking in the financial market

Certainly one way to stimulate long-term investment strategies and limit short-term decision making by actors on the financial market (legal or voluntary) is to change the way companies interact with the financial market. Consequently, this point of intervention aims at the following issues:

Corporate performance reporting

The most crucial aspects of corporate performance reporting are: i) how companies inform potential investors about their performance, ii) what is the main focus of their reporting and how comprehensive is it, and iii) what are the means and capabilities of companies to engage in performance reporting. The following activities support implementation corporate performance reporting:

- sector-wide capacity building on measuring and communicating long-term success;
- integrating environmental, social, and governance (ESG) issues within financial reporting;
- developing new valuation techniques for a company’s use of natural and social capital;
- using scenarios or accounting approaches to show that a proposed strategy is resilient against possible future developments.

Communication and understanding between companies and asset managers

As a consequence of better reporting to the financial markets’ actors, companies as well as asset managers have to engage in a dialogue with the mutual understanding that this additional information is of real advantage for asset managers. In general, the understanding needs to change in order to recognize that long-term focus generates outperformance by reducing the volatility of portfolios and reducing transaction costs. Some examples include inter alia:

- evidence where poor ESG analysis has resulted in portfolio loss that could have been avoided;
- high-profile long-term investment strategies that have delivered strong performance;
- data and case studies of how transaction costs erode the value of portfolios.

3.2 Changing asset managers decision-making practices

This part explains the incentive structures required to change asset managers’ decision towards long-term value creation. It is of primary importance to change perceived obligations of fiduciary duty, in terms of only maximizing return of investment towards integrating long-term ESG factors. Unpicking the culture and incentives behind short-termism would support initiatives (such as UN PRI) that facilitate the fiduciary duty in the context of integrating ESG factors. Such activities include:

- providing a detailed analysis on specific incentives at each stage of the value chain – from people as individual investors, to brokers and exchanges, to fund managers and investment consultants. This would lead to a better understanding as to where incentives are and are not
aligned with generating real value for investors, and furthermore, it would highlight the extent to which transaction costs and fees erode financial returns; 
- developing professional training and continuing professional development courses that promote greater understanding about why the long term matters.

Equally important to understanding incentives for short-termism is the reform and application of performance metrics and the criteria used for remuneration decisions including inter alia:

- shifting the balance away from short-term measures towards longer-term metrics;
- linking a portion of an asset manager’s fees to the quality of stewardship activities;
- a transparent and independent process for assessing the quality of stewardship activities by asset managers.

3.3 European Commission and national governments

Actions taken on the political level by national governments or the European Commission can constitute an enabling factor for long-term investment in the financial market. One of the most influential and crucial interventions by governments are the introduction of mandatory procedures by actors on the financial market. These include inter alia:

- mandating reporting by asset managers on their stewardship activities;
- setting requirements for investors to publicly disclose their voting record, and for pension fund trustees to report to beneficiaries on how their ownership rights have been exercised;
- rules to mandate disclosure by all fund managers of how they have assessed ESG issues (see Box-text below);
- tax breaks for companies that align their activities with a long-term strategy for transition to a sustainable economy;
- tax advantages on pension contributions, dependent on whether the pension fund portfolio has been managed in line with effective management of long-term issues.

Box-text: A proposal for European legislation on disclosure of investment products

On 3 July 2012 the Commission adopted a proposal for a regulation for a new Key Information Document (KID) to be produced by investment product manufacturers and provided to retail customers when they are considering buying investment products. The European Commission put forward this proposal to offset asymmetries of information about investment products exist between retail investors and those designing such products. By improving the transparency in the investment market, retail investors can avoid consequences of taking unexpected risks and facing consequent losses.

In this regard, the possibility for including retail investment disclosure on environmental, social and governance (ESG) issues in the investment process, as a natural complement to extra-financial disclosure by companies, would be an important step towards long-term performance and, moreover, growth in SRI.
3.4 Analysts and independent assessment institutions

Analysis and independent assessment institutions are focal points in financial markets since they guide asset managers and owners in their behaviour and investment decisions. The following activities target this group of actors:

- Providing support for an independent process (UN PRI) assessing the quality of asset manager ESG analysis. Essentially, this includes how well or poorly individual investment managers have assessed and managed ESG within their portfolios
- Focussing on long-term issues of corporate performance
References


