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Briefing Paper

Short-termism, Stewardship and the Kay 'Review'

The final report of the review undertaken by Professor John Kay of investment in UK equity markets and its impacts on the long term performance and governance of UK companies was published on 23 July 2012 (www.bis.gov). It aimed to put forward proposals to foster the long term 'stewardship' of large share-holder owned companies in order to counter 'short-termism' and improve corporate governance, thereby increasing the level of investment and net returns to UK savers. Short-termism is perceived to be a problem in the UK, where capital market financing of larger companies dominates bank financing; in contrast to mainland Europe.

Short-termism arises when shareholders have little incentive to 'vote' their shares at annual shareholder meetings because it is time consuming and costly and to do so and cheaper and easier to simply sell shares in companies they no longer wish to invest in. The emergence of electronic trading platforms makes it cheap and easy for small investors to trade their shares. Meanwhile, large UK institutional shareholders, such as pension funds and insurance companies, increasingly trade shares automatically in response to changes in stock price indices, rather than view their shareholdings as long term strategic investments. Further, exchange traded funds (ETFs) have become increasingly popular. These package shares into funds that are traded on a stock exchange and these shares are more likely to be lent out for a fee, than voted.

The proportion of UK shares owned by foreign institutional investors, who are more likely to engage in index linked portfolio management strategies, has increased significantly.

Further, the growing tendency to remunerate senior management with stock options leads them to focus on the share price as a measure of their performance and can encourage hyperactivity in the form of restructuring and mergers and acquisitions. This creates a bias towards short-termism, given that chief executives rarely stay in post for more than five years. Finally, 'hedge funds' have increasingly used shares borrowed from institutional shareholders and ETFs to engage in short term share trading using 'shorting' strategies for financial gain.

In the UK, institutional shareholders progressively became the dominant shareholders over the last few decades. Consequently, successive UK governments have encouraged institutional shareholders to become good 'stewards' of the companies in which they invest and to fully utilise their shareholder voting rights. These initiatives have culminated in the voluntary 'UK Stewardship Code', overseen by an independent regulator, the Financial Reporting Council (www.frc.org.uk).

It was against this background that the Kay Review was commissioned to make recommendations to benefit UK investors and wealth holders, including households through better returns on their savings and pensions. Its recommendations were generally well received by politicians, but were less enthusiastically received by the investments industry. There was no clear cut 'silver bullet' solution to short-termism and most of the seventeen recommendations will be difficult and take time to implement. Concerns about excessive remuneration and over reliance on performance and sales related fees are already being addressed in banking and can be expected to be addressed in the investments industry; where 'conflicts on interest' in fund management remain a concern because fund managers are rewarded for winning mandates for pension management from firms whose shares they can 'vote'.

The Review also concluded that there are too many links, and consequently fee earning opportunities, in the investments chain, and argues that this undermines the trust of savers and wealth owners in the industry. However, savers are more likely to be wary of the financial products in the light of the numerous recent miss-selling scandals (endowment mortgages, pensions, payment protection insurance (PPI) etc) and to be put off by the size of the fees charged to them. The FSA's Retail Distribution Review (www.fsa.gov/rdr) has already addressed the issue of incentives to miss-sell and is likely to have knock-on effects on fees up the investment chain. Consumer protection is also to be bolstered by the new Financial Conduct Authority (www.fca.gov) and initiatives to stamp out miss-selling led by the European Securities Markets Association (ESMA).

As regards encouraging better stewardship, the government could make adherence to the UK Stewardship Code compulsory and require fund managers to vote their shares and to announce how they have done so. In the 'Shareholder Spring' of 2012, there were encouraging signs that disgruntled institutional shareholders were beginning to exercise their voting rights, instead of relying on informal 'engagement' via conference calls. In an attempt to curb the growing influence of stock borrowing by hedge funds, the Review recommends that income earned by stock lenders should be disclosed and rebated to investors. The ESMA is in the process of drafting rules that will implement this.

Perhaps the most controversial recommendation was that fund managers should hold more concentrated shareholdings in order to focus their engagement with companies. This contradicts finance theory, which generally advocates risk reducing portfolio diversification. Concentrated shareholder funds do however sometimes outperform the stock market index. The Berkshire Hathaway investment vehicle associated with Warren E. Buffett, the 'Sage of Omaha', has famously done for many years. The idea seems to be that managers with more concentrated portfolios will behave more like owners; but Warren Buffett is in fact renowned for his 'hands off' investment approach, and active engagement is time consuming and costly. Simply voting shares is much easier.

A more fundamental criticism of UK corporate culture is that too small a proportion of profits are re-invested, leading to 'under investment', and too much is distributed as dividends to investors. However, capital hoarding by established firms should not be encouraged. Recipients of dividends can choose to re-invest in established firms, or to invest instead in new innovative firms. In this way, innovation and growth can be encouraged through the recycling of capital to firms not yet quoted on the London Stock Exchange. If however, dividends payments are deemed too high, they can be taxed accordingly, and investment by companies and smaller enterprises encouraged by a Capital Gains Tax (CGT) set at a lower rate than tax on profits.

Innovative internet-based 'peer to peer' lending, saving, investing and share trading is already flourishing outside the mainstream banking and investments industry. If the established players in the finance industry wish to retain their custom, they must restore trust, reduce fees and pay higher returns. There is a tendency to cut out expensive middle-men, and fund managers, the dominant players in the share trading and investment chain, will increasingly have to demonstrate their usefulness.

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