Policy options for the development of sustainable and responsible investment

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Financialization and investments' time-horizon

- Financialization process had an impact both on corporations' short-termism and investors' short termism
- The financial crises highlighted the need for longer term investment horizon

Definition of short- termism

- Mullins (1991) defines short-termism in terms of actions to secure short-term results that preclude long-term achievement;
- Laverty (1996): short-termism is about decisions and outcomes that pursue a course of action that is best for the short-term but suboptimal over the long run.
- Haldane (2011): short-termism refers to the tendency of agents in the financial intermediation chain to weight too heavily near-term outcomes at the expense of longer-term opportunities.

Managers'short-termism vs/ investors' short termism

- Stein (1988): temporarily low earnings may cause stocks to be undervalued by imperfectly informed stockholders. This increases the chance of takeover at an unfavourable price, and creates incentives for managers to sacrifice long-term interests in order to boost short-term profits.
- Derrien, Kecskes and Thesmar (2009) analyze the issue of myopia from the investor's perspective: the time horizon of investors becomes important to firm decisions. When a firm is undervalued, the presence of short-term investors is associated with less investment and less R&D spending. By contrast, when a firm has more long-term shareholders, they will be better able to resist underinvestment during times of undervaluation.

Short-termism:
Mc Kinsey and CPPIB survey 2013

- Increased pressure to generate strong short term results over the past 5 years (63%)
- Pressure for strong financial performance ≤ 2years(79%)
- Time horizon of strategies <3years (44%)
- Should use time horizon >3years (73%)

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What can be done?

- Implement appropriate incentives :
- Decreasing capital tax rates with increasing holding period
- Increased voting rights and/or dividends with increased holding period
- Strengthen investor disclosures (Transparency) as “core” shareholders

Impact of long term investment on society

Long-term investors can not only improve long term value of individual companies, but also provide a social good by helping global financial markets to function more efficiently and promoting sustainable global economic growth and creating wider social benefits, by:

- Stabilizing global financial markets (i.e. providing liquidity at critical times, acting as a powerful counter-cyclical force.)
- Promoting sustainable global economic growth and creating wider social benefits:
  - direct benefits (accumulated returns invested in future public work projects, to finance non profit organizations….)
  - indirect benefits (social benefits generated by the investments themselves).

From long-term investment to socially responsible investment

- Long-term investors seek to add value to their holdings in ways that are not solely related to price
- Sustainable investing is an investment approach that integrates long-term environmental, social, and governance (ESG) criteria into investment and ownership decision-making with the objective of generating superior risk-adjusted financial returns.
- These extra-financial criteria are used alongside traditional financial criteria such as cash flow and price-to-earnings ratios

The potential for sustainable investing

- Although not unanimously, empirical evidence indicates that a sustainable investing approach can lead to better risk-adjusted financial returns.

- Sustainable investing has the potential to become a mainstream approach among a broad range investors, especially those who are in a position to take a longer-term perspective.

Key drivers to sustainable investing

- Growing awareness within the investment community that global mega trends such as climate change and natural resource scarcity (and their related externalities) are becoming increasingly financially material
- Increasing demand from large asset owners (as universal owners)
- Increasing demand from retail investors (including high net worth individuals)

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Key barriers for sustainable investing

- Key barriers for investors : restrictions in conventional valuation models, lack of ESG expertise, lack of awareness and/or scepticism regarding the investment case
- Key barriers for corporations : insufficient integration of sustainability factors into core business strategies, lack of formal approach in setting ESG targets and holding senior staff accountable
- Key barriers for investor-corporation interaction : lack of clarity on which ESG factors are financially material and over which time frame, insufficient communication of link between ESG and corporate financial performance
- Key barriers at system-wide level : disproportionate focus on short-term performance and issues with a near-term impact, and the fact that many negative externalities are underpriced

How to accelerate the transition towards sustainable investing

- Functional and mindset changes are needed.
- Functional changes:
  - Linking incentives in the investment value chain more towards superior risk-adjusted financial performance over the long-term – for example, increasing performance assessment periods for fund managers, and including ESG factors as indirect financial performance criteria for corporate executives
  - Buy-and sell-side analysts working with corporate executives to determine key performance indicators for financially material ESG factors at sector level, and asset owners using their mandates to asset managers to encourage the analysis of these factors.
- Mindset changes:
  - ESG indicators are direct and indirect drivers of business value;
  - Sustainability considerations – when effectively integrated into business strategy- have the potential to strenghten financial performance

The role of key stakeholders

- Many of these barriers are interrelated, leading to a classic “chicken and egg” problem, i.e.corporations often do not provide clear information about how their ESG activities contribute to shareholder value creation, investors find it difficult to use ESG information to value companies; they herefore do not sufficiently consider ESG information in their investment decisions, which gives corporations little incentive to provide good ESG information.
- Accounting bodies stimulate integrated reporting
- Public authorities encourage the disclosure of ESG information