Overcoming the Barriers to Long-term Thinking in Financial Markets

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Forum for the Future

Further information
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Forum for the Future
Forum for the Future is a non-profit organisation working globally with business and government to create a sustainable future. It aims to transform the critical systems that we all depend on, such as food, energy and finance, to make them fit for the challenges of the twenty-first century. It has 15 years' experience inspiring new thinking, building creative partnerships and developing practical innovations to change the world. In its work with the finance sector, Forum for the Future's aim is to shift financial resources towards sustainable activities and away from unsustainable ones.
www.forumforthefuture.org

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Contents

Acknowledgements *4*

Executive summary *5*

1 Why is short-term thinking a problem? 18
2 Research aims and method 25
3 The barriers to long-term thinking 27
4 Initiatives by other organisations 42
5 Themes and recommended actions 45
6 Conclusion 64

Appendices
I Experts who provided input to this research 66
II Summary of themes from expert round-table meeting 68
III Summary of recommendations from other reports 73
IV Recommendations for pension funds 81
V Setting a framework of policy, regulation and taxation that supports longer-term investment 84

References *86*

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Executive summary

Why is short-term thinking a problem?

Short-term investment strategies play a role in an efficient financial market. Market prices for shares need to be driven by information on both short-term and longer-term factors. And certain investors may have specific short-term investment horizons, for example because of imminent retirement.

However, many sources now show that the balance of investment in the market as a whole has moved too far towards short-termism. So the markets are now dominated by strategies that focus on maximising short-term returns, while underestimating or ignoring the systemic risks, wider impacts or irreversible consequences of this behaviour. This may not deliver the best outcomes for the investor, either from a financial or from a wider social and environmental perspective.

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.[1] 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.

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1 http://archive.greenpeace.org/comms/cbio/cancod.html (accessed 3 May 2011).

Short-term investment strategies drive short-term thinking in business. And the pressure for quick returns can undermine long-term economic value by ignoring risks and opportunities.

The examples on page 5 highlight one of the principal reasons why short-termism persists. A short-term approach can maximise financial return for an individual investor who gets in and out at the right time. While their actions may have wider impacts on individual companies and the system as a whole, the investor may not directly feel the consequences of this.

This helps to explain why there has been slow progress in embedding longer-term approaches, despite a range of recent initiatives from businesses, investors, NGOs and policy-makers. The barriers to change are systemic and sector-wide. Existing ways of thinking are often embedded within incentive structures, established behaviours and organisational cultures.

Structural support for short-termism

Evidence also suggests that specific structural changes within the finance sector have reinforced the trend towards short-termism over the past two decades:

- Increased trading activity has been made possible by lower transaction costs, largely as a result of information technology. This has led to a tendency towards shorter average holding periods.
- The increasing use of intermediaries in investment management – investment consultants, 'funds of funds', external asset managers, and others – has lengthened the ownership chain of companies.
- The increasingly international ownership of shares and the lengthening of the investment chain both lead to a separation between companies and investors, resulting in less detailed analysis of the drivers of longer-term value.
- Institutional investors also manage an increasing amount of investment. Between 1975 and 2009, institutional investor ownership in the US rose from 35 per cent to 70 per cent (Wong 2010: 3).

This increased short-termism 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 (Network for Sustainable Financial Markets 2009: 5).

Yet for companies and investors that identify the opportunities and shifts in business models required, there are also great opportunities to seize the competitive advantage. Increasingly, voices are beginning to call for change within the business community.

> Unilever has been around for 100-plus years. We want to be around for several hundred more years. So if you buy into this long-term value-creation model, which is equitable, which is shared, which is sustainable, then come and invest with us. If you don't buy into this, I respect you as a human being, but don't put your money in our company.
>
> (Paul Polman, Unilever)

With the support of particular interventions to reduce the barriers to long-term thinking, a greater focus on the long term would help to avoid negative outcomes for businesses, the wider economy and society as a whole.

SIGNS OF SHORT-TERMISM

Over the last few years, many sources have drawn attention to the rise in short-term thinking. One sign of this is that the rate of turnover of shares has increased:

> The annual turnover or 'churn rate' for shares of the New York Stock Exchange: The turnover for listed companies increased dramatically from a range of 10–30 per cent during the 1940–80 period to more than 100 per cent in 2005.
>
> (CFA/BRICE 2006: 15)

There has also been strong growth in high-frequency traders (HFTs), who are now able to operate in microseconds or less due to technological improvements. According to Andrew Haldane:

> High-frequency trading firms are believed to account for more than 70 per cent of all trading volume in US equities. In Europe, high-frequency traders account for around 30–40 per cent of volumes in equities and futures.
>
> (Haldane 2010: 17)

Haldane also highlights the reducing duration of CEO positions:

> In 1995, the mean duration of departing CEOs from the world's largest 2,500 companies was just less than a decade. Since then, it has declined. By 2000, it had fallen to just over eight years. By 2009, it had fallen to around six years. This pattern is replicated across regions, but is marked in North America and non-Japan Asia.
>
> (Haldane 2010: 20)

Research aims and method

This report aims to identify the barriers to long-term thinking and identify practical ways that these can be overcome. It builds on our work on rethinking capital (Forum for the Future 2009),[2] assessing the reasons why the finance system as a whole does not support sustainable development and highlighting actions that can be taken. It is supported by the Friends Provident Foundation.

2 Available at: www.forumforthefuture.org/projects/rethinking_capital

We had two clear project aims to ensure that our results were constructive and added new elements to the field:

- To look beyond the trends and barriers to change, finding *practical constructive solutions*, particularly involving cultural or behavioural change. Our objective was to identify three or four very specific and practical changes in incentives, information or messaging that could change, 'nudge' or 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.

Our research involved a literature review, interviews and consultations, and we drew from practitioners in the finance sector as well as experts in culture and behaviour change. We also drew on our own experience of organisational change.

Key research findings

The barriers to long-term thinking

Our research identified a number of critical barriers to long-term thinking. These included the lack of information between businesses and asset managers, the cultural and financial incentives for asset managers, the legal obligations of fiduciary duty, and the remuneration criteria used within businesses.

Table 1 summarises Forum for the Future's research on the barriers to change. These barriers are linked to our three recommended *areas of focus (*described in more detail in Chapter 5):

1. Companies provide improved strategic information on long-term drivers of value, and asset managers see the benefit in demanding it.
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.
3. Companies show greater transparency and innovation on how the performance of the board, the CEO and other staff is judged and remunerated.

There are many opportunities for investors and companies to identify ways to implement these recommendations in their own organisations. Forum for the Future will support organisations in taking action around these areas of focus, and will draw evidence and case studies together to highlight best practice. This will create real momentum for change.

Table 1
Summary of barriers for particular groups.

Key barriers to long-term thinking	*Recommendation*
For asset managers: ■ Lack of information from companies on their strategy for long-term business success. ■ Perceived risk for asset managers of moving from tried and tested measures of success – due to skills, the 'herd' effect, perceptions of what is material[3] or their own financial or performance incentives. ■ Asset managers or consultants may feel they are unlikely to be criticised for 'missing' material environmental, social and governance (ESG) issues because their peers are likely to miss them too. ■ An increased separation between companies and investors, due to IT and globalisation trends. **For companies:** ■ Perceived risk for companies of communicating and reporting on strategic and long-term issues, rather than short-term success. ■ Lack of measures for long-term factors, and perceived lack of evidence on the importance of these issues in driving long-term business success of these issues. ■ Hard for individual companies to take the lead without peer action or demand from asset managers, because of the challenges (cost, time, skills and standards) of reporting the information that investors may want to know. ■ There is a perceived lack of interest from investors in more detailed long-term information, partly driven by the average length of shareholding.	**Recommendation for 'area of focus 1':** Companies provide improved strategic information on long-term drivers of value, and asset managers see the benefit in demanding it.

3 Material issues are issues for which disclosure would be substantially likely to be considered important to a reasonable investor in making an investment decision.

Key barriers to long-term thinking	*Recommendation*
For asset managers: ■ Fiduciary duty is often interpreted as applying predominantly to financial value. ■ Asset managers may currently feel that short-term approaches create the greatest value for their clients. ■ When mandates are set (even by pension funds, which might be expected to have a long-term perspective), they often do not include sustainability considerations. ■ Investments are often assessed on a quarterly basis and the risks of underperforming are seen as high when making decisions that are different from peers. There are challenges (cost, time, skills) in understanding the benefits of long-term investments. ■ Performance may also be assessed on a quarterly basis. ■ More broadly, the culture of investment has tended to shift towards 'speculation' and away from 'stewardship'. ■ Some trends have increased the separation between companies and investors: shorter average holding periods, increasing media speed and technology. **For asset owners:** ■ It is easier to monitor the short-term performance of an investment manager than their long-term performance, and satisfactory results relative to a benchmark give assurance to the asset owner or trustee. ■ There are no independent and credible ways of judging the relative ESG performance of different investment managers, so this is not a strong element of the criteria for their selection. ■ The investment management world can be complex and opaque, and asset owners or their trustees may not feel qualified to question the investment strategy adopted by the investment managers.	**Recommendation for 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.

<table>
<tr><th>Key barriers to long-term thinking</th><th>Recommendation</th></tr>
<tr><td>For CEOs and boards:
■ Company performance is almost invariably measured by reference to short-term indicators, particularly quarterly returns. This means that boards of quoted companies feel pressure from the market to announce increasing short-term profits.
■ These short-term indicators are often used to measure individual performance and reputation, and executive remuneration. Remuneration practices can give a perverse incentive for risk-taking or short-term behaviour.

For all managers throughout the company:
■ If senior management and board pay are dictated by short-term considerations, then junior managers may be encouraged (financially or culturally) to do this to progress:
□ their objectives and remuneration will be aligned to corporate strategy, so will probably include more short-term than long-term measures of success;
□ within the culture there may be unspoken rules that discourage managers from proposing ideas which deliver over the longer-term;
□ during periods when short-term measures are under-performing, managers may feel pressure to stop or cut initiatives that do not meet immediate goals.</td><td>Recommendation for 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.</td></tr>
</table>

Exploring initiatives from other organisations

Throughout our research, we looked at other initiatives that link to long-term thinking, and the approaches that they are taking. These are explained in more detail in Chapter 4, and fall into four main categories.

- Initiatives with a strong cross-sector focus. These include the Prince of Wales's Accounting for Sustainability Project, the Aspen Principles, the Network for Sustainable Financial Markets and Long Finance.
- Initiatives from the UK Government and policy-makers, such as the UK Stewardship Code and a consultation by BIS (the UK Government's Department for Business, Innovation and Skills) on 'a long-term focus for corporate Britain'.

- Initiatives focused on institutional investors, including the UN's Principles for Responsible Investment. This is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact, aiming to improve inclusion of environmental, social and governance (ESG) factors into decision-making. Reports such as the Freshfields report (UNEP FI, 2005) have also been influential.
- Initiatives focused on the pension fund community. These include FairPensions (a charity that promotes responsible investment by pension funds and fund managers) and the UKSIF Sustainable Pensions Project.

We have ensured that our recommendations complement or build on these established activities and emerging trends, so that lasting and meaningful change can be achieved.

Looking into behavioural and organisational change theory

Behavioural change theory helped us to understand the personal, social and external factors that influence behaviour.

- We drew on research findings from **behavioural economics**, particularly ideas from *Nudge: Improving Decisions About Health, Wealth, and Happiness* (Thaler and Sunstein, 2008), on how small changes in the way choices are presented to people can have a huge impact on behaviour, and research on how people weigh up decisions between the present and the future.
- Research on **social influence** also informed our recommendations, particularly on the cultural factors that influence change.
- The WWF report *Common Cause: The case for working with our cultural values* (Crompton 2010) also provided insights on how a culture of stewardship or speculation can be influenced by the **values and frames** used within an organisation and the language used.

We also drew on Forum for the Future's knowledge of **organisational change**, informed by our practical experience and our past research into systems thinking and behaviour change. The Forum's past work in this area has looked at innovation and how new approaches become mainstream within organisations and throughout a sector. Chapter 3 of this report outlines our six steps to significant change, and how our recommendations and other initiatives fit within this (page 28).

Recommendations for action

Forum for the Future have identified three critical areas of focus that are necessary to tackle the systemic barriers to long-term thinking. Within each area of focus, we also propose a key recommendation to tackle the barriers to change.

By piloting new approaches, these can help to catalyse change and share best practice throughout the sector. These recommendations can also ensure that the benefits of long-term thinking are realised by businesses, financial institutions and the wider economy.

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

Key recommendation for action

Companies 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. This involves the type of approach that Forum for the Future has developed and trialled in our *Better Decisions, Real Value* work.[4] This work involves two phases, which combine to 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: engage investors so they value sustainability.

What behavioural or cultural shifts would this intervention encourage?

- Asset managers would be able to make decisions informed by better communication and information on long-term business strategies, risks and opportunities.

This behaviour would be supported and reinforced by behaviour from others within the system:

- Companies would provide better communication and information to asset managers and analysts on their long-term business strategies, risks and opportunities.
- Asset managers, sell-side analysts and credit rating agencies would demand this information and integrate it into research or ratings.

What are the benefits of this intervention?

Our research identified that a key barrier to long-term thinking and sustainability is the amount and nature of communication between asset managers and companies. Helping businesses to communicate more about long-term strategy will begin to widen the debate around sustainability and long-term risks. This will catalyse wider change, as businesses, analysts, asset managers, asset owners and the finance media begin to shift the balance of their communication towards longer-term issues.It will also create greater investor demand for this information from other companies.

Although we recognise that this has been a recommendation for several years, with relatively low material uptake, we believe that a combination of factors mean that this will now create more momentum. In the current business context, companies are increasingly seeing the materiality of these issues, and institutional investors are beginning to report (through initiatives such as UNPRI, soon to be tightened) on how they use ESG data.

4 More details are available at: www.forumforthefuture.org/projects/better-decisions-real-value

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*

Key recommendation for action

While many initiatives are looking at fiduciary duty in the context of integrating long-term ESG factors into decision-making,[5] incentives and cultural factors still provide a barrier to longer-term thinking for asset managers.

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

- Asset owners taking a detailed look at the specific incentives at each stage of the value chain, from people as individual investors to brokers to exchanges to fund managers and investment consultants.
- Sharing stories, examples and evidence of how integrating ESG issues has helped asset managers to outperform mainstream peers. Also supporting the development of new analytical tools that will differentiate long-term thinkers in the market.
- Challenging 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

What are the benefits of this intervention?

This will highlight the financial or cultural incentives that lead to a misalignment between asset owners and financial institutions (including asset managers, consultants, brokers and exchanges). This will then mean that asset owners are more aware of where their interests diverge from those of people along the investment supply chain. This will lead them to question more closely the value of short-term investment strategies.

5 Most notably, the Freshfields report (UNEP FI 2005) and UNEP Fiduciary II report (UNEP FI 2009), recent work for the Network for Sustainable Financial Markets (2011) and recent work by FairPensions (2011).

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***

Key recommendation for action

Companies provide transparency on how executive remuneration is structured. This would focus on the criteria used to judge success and the type of remuneration involved. Actions would include:

- Providing greater transparency about the structure of remuneration, for example the proportion linked to short-term or long-term criteria. This would show how compensation is linked to key drivers of long-term value, such as innovation and efficiency, rather than share price.
- Further research on how the structure of remuneration influences executive decisions, in order to draw together an evidence base, and development of '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.

What are the benefits of this intervention?

Within companies, performance criteria and remuneration can often disincentivise longer-term decision-making. These also influence how success is judged within companies, both at board level and for decisions throughout the business. If there is more transparency, this should encourage a shift in both the cultural and financial incentives for long-term thinking within businesses. However, this will depend on companies and investors believing that long-term thinking delivers economic value, so the changes recommended for areas of focus 1 and 2 are also critical.

Chapter 5 of this report gives more detail on each of these recommendations, and also outlines some actions that would support this change.

Conclusions

Seizing the opportunity for change

Our aim through this project has been to identify practical recommendations that can help create a meaningful shift towards longer-term thinking. Forum for the Future has been working on financial markets for 15 years and we know well that recommendations to encourage longer-term thinking have been put forward during that time and not been taken up.

We have looked beyond the structural barriers into some key systemic, behavioural and cultural barriers that prevent change. We reviewed a range of current initiatives and we feel that the time is right to build on the successes, to explore new processes through which change might happen, and ultimately to make these approaches mainstream.

Key actions now and in the future

Our research showed that companies, asset owners and asset managers are faced with a daunting range of actions to take to enable greater sustainability and long-term success.

Based on our analysis and supporting the *areas of focus*, here are the actions they should prioritise now and in the future.

Companies

Now:

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.

And going forward:

1. Explore in more detail 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

Now:

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).

And going forward:

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

Now:

1. Commit more resource 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.

And going forward:

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

Now:

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 long-term risks to the financial system as a whole.

And going forward:

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.

Future plans

Overcoming the barriers to long-term thinking in financial markets is crucial to the shift towards a more sustainable economy and society. This project aimed to build on existing work and to identify new ways to tackle this challenge and make long-term thinking mainstream.

Forum for the Future now wants to work with a range of organisations to implement the actions recommended in this report, and to gather and highlight best practice. By working in collaboration with others we aim to build evidence, case studies and interest in the benefits of long-term thinking and create the momentum for change.

We welcome interest from individuals and organisations who would like to work with us. You can find out more about us, the project and how to contact us through our website: http://www.forumforthefuture.org/projects/overcoming_barriers_long-term_thinking

Chapter 1
Why is short-term thinking a problem?

SUMMARY

The decisions of financial markets on the allocation of capital influence behaviour across the economy. Currently, short-term thinking predominates in the financial markets, with the result that natural resources are being exhausted and climate change could reach a dangerous tipping point.

And yet, the risks associated with this behaviour are not factored into the price of shares. Structural changes within the finance sector have instead reinforced the trend towards short-termism over the past two decades, lessening the sense of accountability between the ultimate investors and the companies in which they invest.

The preferences of investors for sustainability and long-term approaches are not being clearly transferred into drivers for individual businesses, which restricts the ability of business as a whole to tackle long-term challenges. If businesses take a very short-term approach, this not only makes it more difficult to address the challenges of sustainability, but can also act to the detriment of businesses themselves.

While there are signs of leadership, a greater mainstream focus on the long term is required. This could help to avoid negative outcomes for businesses and for society as a whole.

Introduction

Short-term investment strategies play a role in an efficient financial market. Market prices for shares need to be driven by information on short-term and longer-term factors. And certain investors may have specific short-term investment horizons, for example because of imminent retirement.

However, many sources now show that the balance of investment in the market as a whole has moved too far towards short-termism. So the markets are now dominated by strategies that focus on maximising short-term returns, while underestimating or ignoring the systemic risks, wider impacts or irreversible consequences of this behaviour. This may not deliver the best outcomes for the investor, either from a financial or from a wider social and environmental perspective.

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 'dragging' 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.

Short-term investment strategies drive short-term thinking in business. And the pressure for quick returns can undermine long-term economic value by ignoring important risks and opportunities.

The examples above highlight one of the principal reasons why short-termism persists. A short-term approach can maximise financial return for an individual investor who gets in and out at the right time. While their actions may have wider impacts on individual companies and the system as a whole, the investor may not directly feel the consequences of this.

This helps to explain why there has been slow progress in embedding longer-term approaches, despite a range of recent initiatives from businesses, investors, NGOs and policy-makers. The barriers to change are systemic and sector-wide. Existing ways of thinking are often embedded within incentive structures, established behaviours and organisational cultures.

The impacts of short-termism

When companies take a short-term approach, this not only makes it more difficult to address the challenges of sustainability, but can also act to the detriment of the companies themselves. White (2006: 6) suggests that an excessive focus on earnings per share 'leads to management decisions that engineer earnings and drain resources from profitable, longer-term uses of the firm's capital in order to artificially smooth and steadily increase performance'.

Research has shown that 80 per cent of chief financial officers would sacrifice future economic value to satisfy short-term return expectations from investors (Network for Sustainable Financial Markets 2009: 5). This is borne out by our daily conversations with individuals within companies, trying to position their company to respond to sustainability challenges and generate economic value into the future.

An increasing move towards short-term investment also has a wider impact on the economy. When investors hold shares for shorter periods, this often reduces their appetite and need for research into the long-term fundamental drivers affecting a company. It can lead to a greater focus on the short-term movements in market prices caused by more ad hoc information or events, and this in turn leads to short-term pressure on boards to stabilise returns for investors.

As the rest of this report shows, however, for those companies and investors that identify the opportunities and shifts in business models required, there are also great opportunities to seize competitive advantage. With the support of particular interventions to reduce the barriers to long-term thinking, greater mainstream focus on the long term could help to avoid negative outcomes for businesses and society as a whole.

Structural support for short-termism

The reasons for short-term thinking across the economy are various and systemic. No one organisation, sector or government is responsible.

Marketeers promote the latest products, consumers ask for them, and financial institutions provide credit for them. Staff are rewarded for meeting short-term targets. Capital markets demand quick returns and quarterly results, increasing the pressure on senior executives to provide short-term growth. Incentive structures for asset managers (including the awarding of mandates and payment of performance bonuses) are often based on short-term financial performance. The techniques used to compare current and future returns deliver outcomes that do not properly reflect real value.

> To break free of the tyranny of short-termism, we must start with those who provide capital. Taken together, pension funds, insurance companies, mutual funds and sovereign wealth funds hold $65 trillion, or roughly 35 per cent of the world's financial assets. If these players focus too much attention on the short term, capitalism as a whole will, too.
>
> (Barton 2011)

This report looks particularly at the role of the capital markets in short-term thinking. The capital markets have a vital part to play because their decisions on the allocation of capital influence behaviour across the economy. Their actions affect both the rewards received by companies that consider their long-term impact, and decisions on providing credit for consumers.

Evidence also suggests that specific structural changes within the finance sector have reinforced the trend towards short-termism over the past two decades:

- There has been a tendency towards shorter average holding periods (Haldane 2010: 16). This has been made possible by lower transaction costs, largely as a result of information technology. The increasing speed of media and online data access also contributes to this, providing real-time information which facilitates and can encourage more frequent transactions
- The increasing use of intermediaries in investment management – investment consultants, 'funds of funds', external asset managers, and others – has lengthened the ownership chain of companies.

What we cannot afford is more short-sighted approaches. The global economy needs more than a quick fix. It needs a fundamental fix. If we have learned anything from the financial crisis, it is that we must put an end to unethical and irresponsible behaviour and the tyrannical demand for short-term profit.

United Nations Secretary-General
Ban Ki-moon, May 2009
(cited by UNEP FI 2009: 11)

SIGNS OF SHORT-TERMISM

Over the last few years, many sources have drawn attention to the rise in short-term thinking. One sign of this is that the rate of turnover of shares has increased:

> The annual turnover or 'churn rate' for shares of the New York Stock Exchange: The turnover for listed companies increased dramatically from a range of 10–30 per cent during the 1940–80 period to more than 100 per cent in 2005.
>
> (CFA/BRICE 2006: 15)

There has also been strong growth in high-frequency traders (HFTs), who are now able to operate in microseconds or less due to technological improvements. According to Andrew Haldane:

> High-frequency trading firms are believed to account for more than 70 per cent of all trading volume in US equities. In Europe, high-frequency traders account for around 30–40 per cent of volumes in equities and futures.
>
> (Haldane 2010: 17)

Haldane also highlights the reducing duration of CEO positions:

> In 1995, the mean duration of departing CEOs from the world's largest 2,500 companies was just less than a decade. Since then, it has declined. By 2000, it had fallen to just over eight years. By 2009, it had fallen to around six years. This pattern is replicated across regions, but is marked in North America and non-Japan Asia.
>
> (Haldane 2010: 20)

- The increasingly international ownership of shares and the lengthening of the investment chain both lead to a separation between companies and investors, resulting in less detailed analysis of the drivers of longer-term value.
- Institutional investors also manage an increasing amount of investment. Between 1975 and 2009, institutional investor ownership in the US rose from 35 per cent to 70 per cent (Wong 2010: 3).

The combination of these factors has lessened the sense of accountability between the ultimate investors and the companies in which they invest. As investor preferences for sustainability and long-term approaches are not clearly transferred into drivers for individual businesses, this restricts the ability of business as a whole to tackle long-term challenges. There is also an increased risk of instability – more investors responding to short-term information increases the 'herding' effect and means that crashes are more likely.

The financial markets context

From Forum for the Future's work with both businesses and the finance sector, we have seen signs that short-term perspectives predominate in the financial markets. We have also seen that this results in investment decisions that may not deliver the best returns for investors in the long run.

Paul Polman at Unilever and Ian Cheshire at Kingfisher are just two of the leaders who have made high-profile statements about how the tyranny of the equity markets, in their quest for short-term returns, stifles innovation and longer-term strategic positioning.

Taking a broad view of how capital is currently allocated to economic activities through the equity markets, we can see that there are flaws. As a global society, we are allocating capital

A DEFINITION OF LONG-TERM INVESTING[6]

According to Lydenberg (2007), a comprehensive definition of long-term investing must address three issues:

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

The definition of long-term investing proposed here incorporates these three elements. It is as follows:

> Long-term investors speculate on the value of corporations to society and the environment, while simultaneously seeking to enhance that value at the company, industry, and societal level.

6 S. Lydenberg (2007) *Long-Term Investing: A proposal for how to define and implement long-term investing*, Summit on the Future of the Corporation, Paper No. 5.

to activities that are using up our natural assets at a rate that cannot be replaced.[7] We are also contributing to climate change, which could reach a dangerous tipping point. [8] And yet the risks associated with this behaviour are not factored into the price of shares.

There are several possible reasons for this, and these can be categorised in three ways:

1 Imperfect information.
2 Flawed investor responses to good information.
3 Perfect information and rational investor responses but market failure.

Taking these in more detail, we can identify a number of possible drivers within each of the three categories:

1 Imperfect information

- Companies provide investors with information that focuses heavily on short-term profits.
- Companies position environmental, social and governance (ESG) issues as 'socially responsible', not strategic.
- ESG issues are reported in narrative form, making it difficult for analysts to benchmark and use the information.
- There is a cultural bias away from reporting on 'softer' issues because of credibility.

2 Flawed investor responses to good information

- Good information on material ESG is ignored because personal incentives are geared towards identifying very short-term price movements.
- Good information on material ESG is ignored by analysts because they perceive that limited time is better spent analysing other, more immediate drivers of value – believing that this will add more value to portfolios.
- Good information on material ESG is ignored by analysts because they take a different view of key challenges such as resource constraints and climate change.
- Fund managers do not improve on ESG analysis because they are not criticised/penalised for failing to predict a company disaster (such as Enron, BP) if their peers failed to predict it too.
- Misplaced confidence in the 'efficient markets hypothesis', which assumes that freely functioning markets will determine a price that leads to efficient allocation of resources.

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7 There are many relevant sources here, including the Millennium Ecosystem Assessment and the TEEB project (The Economics of Ecosystems and Biodiversity).

8 There are many relevant sources here, including the Intergovernmental Panel on Climate Change assessments.

3 Perfect information and rational investor responses but market failure

- In ignoring ESG issues, investors are responding rationally to good, well-presented information on drivers of value for the company. The commercial rationale for a company to embed ESG is not strong because market prices do not reflect true ESG costs and benefits.
- Longer-term investors are aware of the market failure and want to understand how future public policy interventions to correct this failure will play out. But they have limited data to enable them to do this.

These different reasons for ignoring long-term factors may all contribute in different ways and at different times. They will also have different effects on the many individuals operating within the financial sector. Our research sought to establish the most powerful drivers, in order to then identify the most successful interventions.

Chapter 2
Research aims and method

SUMMARY

The aim of this research was to consider why sustainable, long-term approaches to investment have been unable to gain a strong foothold in financial markets, and how these could be scaled up. It explores barriers to change, identifies practical changes that could be made, and highlights recommendations to address these barriers.

Its methodology focused on the financial system as a whole. Together with literature reviews, discussions were held with experts on long-termism and on behavioural change, and with expert representatives from companies and financial institutions. The findings from this research will form the basis of future work in this area by Forum for the Future.

Research aims

This report aims to identify the barriers to long-term thinking and practical ways that these can be overcome. It builds on our work on Rethinking Capital (Forum for the Future 2009),[9] assessing the reasons why the finance system as a whole does not support sustainable development and highlighting actions that can be taken. It is supported by the Friends Provident Foundation.

We had two clear project aims to ensure that our results were constructive and added new elements to the field:

- We aimed to look beyond the trends and barriers to change, finding *practical constructive solutions,* particularly involving cultural or behaviour change. Our objective was to identify three or four specific and practical changes in incentives, information or messaging that could change, 'nudge' or shift attitudes and behaviour.
- We also focused on identifying areas where companies, asset managers and asset owners can take action in their own organisations and scale up these changes within the sector. This will be one of Forum for the Future's key focus areas within the finance system, working with others inside and outside the finance sector to support and create change.

9 Available at: www.forumforthefuture.org/projects/rethinking_capital

Methodology

Short-termism is a problem that needs a system-focused approach, looking at interactions and structures across the whole system:

> Short-termism is not limited to the behavior of a few investors or intermediaries; it is system-wide, with contributions by and interdependency among corporate managers, boards, investment advisers, providers of capital, and government. Thus, effective change will result from a comprehensive rather than piecemeal approach.
>
> (Aspen Institute Business and Society Programme 2009: 4)

Because of this we considered it important to engage with people with expertise and experience across the system. Forum for the Future's expertise in systems thinking approaches also helped us to explore and identify 'leverage points' – the key places within a system where a small change could lead to a large shift in behaviour.

The project used a four-stage process to meet these objectives.

1. Scoping and set-up (including literature reviews).
2. Research and analysis:
   - We interviewed experts in the issues around long-term thinking, both during the research and to test out our recommendations. Appendix I lists the experts we spoke to.
   - We convened an expert round-table meeting in collaboration with UK Sustainable Investment and Finance (UKSIF) and the Aldersgate Group. This event involved senior representatives from a range of companies and financial institutions (listed in Appendix I). The aim was to inform our research and open a discussion before a recent consultation launched by the UK Government's Business, Innovation and Skills department (BIS). Appendix II summarises the key points raised during the round-table meeting (this was originally produced as an annex to Forum for the Future's response to BIS).
3. Producing this report, to summarise the project research and conclusions.
4. Taking forward these recommendations through a launch event, and subsequent activities to put the recommendations into practice.

Chapter 3
The barriers to long-term thinking

SUMMARY

There is increasing recognition that changes to financial markets are needed in order for them to deliver long-term value for society. However, many of those involved in this sector either may not acknowledge this, or may consider that their responsibilities are only to themselves and their clients. The legal and organisational structure of the sector may work against change. Our research showed that the barriers to long-term thinking are at several levels: the organisational structure, social and cultural factors, and individual decision-making.

Findings from behavioural economics show that people do not always act 'rationally', but are strongly influenced by default options, the information available, and the actions of their peers. For example, social factors can affect decision-makers in financial markets; market bubbles can be the result of a social pressure of conformity that means that people tend to follow the social norms of a group.

The social barriers to new behaviour could be encouraged by emphasising positive actions by peers to undertake long-term thinking; and encouraging influential individuals and local champions who support long-term thinking.

Current legal and structural arrangements on how company directors and shareholders operate and how directors are remunerated have a profound impact on short-term versus long-term thinking, and changes would be needed in all these areas. It might also be valuable to explore the prevailing culture and values associated with either stewardship or speculation approaches, as such debate could help to clarify the cultural barriers that hold back long-term thinking.

Introduction

Our research explored the barriers to long-term thinking for people in key roles in the business and finance sectors, and how these barriers may limit their ability or willingness to undertake such thinking. The research focused on three areas:

- We carried out a literature review on the different theories of change.
- We reviewed literature on the specific barriers to longer-term approaches within the finance sector. We interviewed experts and practitioners about these barriers.
- We summarised the specific barriers for particular groups within the finance sector.

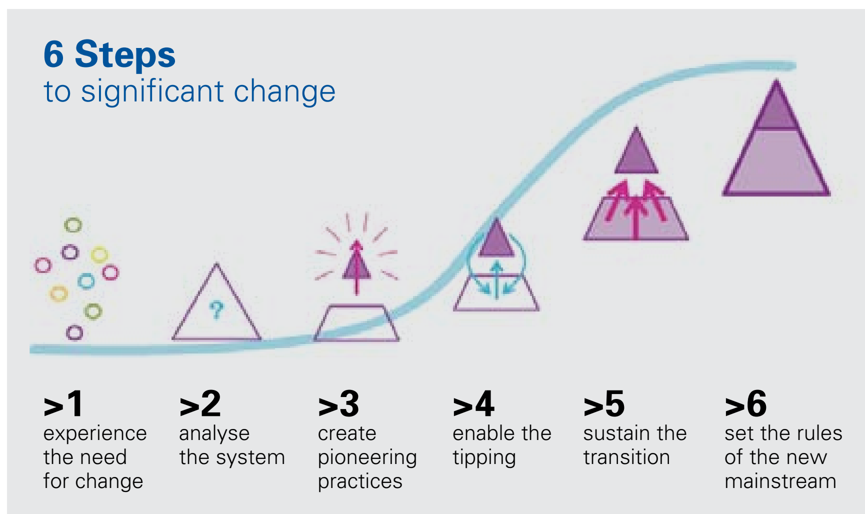

Figure 1
Forum for the Future's six steps to significant change: the approach required to embed sustainable behaviour

Recommendations for change outlined in Chapter 5 are based on our exploration of these barriers.

Theories of change

Organisational and system change

Forum for the Future has worked extensively on organisational change, and how new approaches become mainstream. Based on our past research and experience with leading businesses, we have developed a model of six stages of organisational change, which can be applied at organisational or system level (see Figure 1).

While many in the finance sector do not feel change is needed, and might be content to retain current practices, there is a wider recognition – following the recent financial crisis – that flaws in the financial markets need to be addressed (stage 1). There have been many attempts to analyse the system (stage 2).

If we are to overcome the barriers to long-term thinking, however, we believe that the main focus should now be on the transition between stages 3 and 4:

- First, creating and supporting pioneering practices that enable, and prove the benefits of, longer-term thinking for a range of different individuals and organisations within the economy (stage 3).
- Second, spreading knowledge of these pioneering practices among businesses and more widely. This will involve finding ways to engage with people and the culture of the organisations they are in. This often involves strong leadership and the establishment of new networks. A strong sense of permission and legitimacy is also needed to facilitate innovation, coupled with mechanisms for engagement – including powerful stories (step 4).
- The aim is to enable the tipping so that longer-term thinking becomes the norm and policy-makers can set rules that sustain it.

Behavioural change

Many areas of behavioural change theory were relevant to this project, particularly research on behavioural economics, social influence and cultural values. The new economics foundation (nef) summarised the main findings of behavioural economics and psychology in seven principles, highlighting the main shortfalls in the standard model of human behaviour (see box).

For the issue of long-termism, principles 1, 4, 6 and 7 are particularly relevant. Our recommendations in this report drew on nef's research in these areas.

THE SEVEN PRINCIPLES OF BEHAVIOURAL ECONOMICS (new economics foundation 2005: 2)

The standard (neoclassical) economic analysis assumes that humans are rational and behave in a way to maximise their individual self-interest. Whilst this 'rational man' assumption yields a powerful tool for analysis, it has many shortfalls that can lead to unrealistic economic analysis and policy-making.

The seven principles are:

1. **Other people's behaviour matters:** people do many things by observing others and copying; people are encouraged to continue to do things when they feel other people approve of their behaviour.
2. **Habits are important:** people do many things without consciously thinking about them. These habits are hard to change – even though people might want to change their behaviour, it is not easy for them.
3. **People are motivated to 'do the right thing':** there are cases where money is de-motivating as it undermines people's intrinsic motivation. For example, you would quickly stop inviting friends to dinner if they insisted on paying you.
4. **People's self-expectations influence how they behave:** they want their actions to be in line with their values and their commitments.
5. **People are loss averse** and hang on to what they consider 'theirs'.
6. **People are bad at computation when making decisions:** they put undue weight on recent events and too little on far-off ones; they cannot calculate probabilities well, and worry too much about unlikely events; and they are strongly influenced by how the problem/information is presented to them.
7. **People need to feel involved and effective to make a change:** just giving people the incentives and information is not necessarily enough.

Social influence

Research on social influence informed our recommendations. Studies by Cialdini (2007) have shown that people are often highly influenced by 'social norms' (ways of behaving within a certain group). This influence is particularly strong when people see the positive actions of other 'people like me'. People generally do not realise how much they are influenced by their peers, but recent behaviour change campaigns that emphasise positive social norms have been very successful.

Behavioural finance literature often talks about 'herd behaviour', which is the tendency for individuals to mimic the actions (rational or irrational) of a larger group, where individually they would not necessarily make the same choice. Phung (2010) discusses why this can happen. First, the social pressure of conformity means that people tend to follow the social norms of a group. There is also a common rationale that it's unlikely that such a large group could be wrong.

This pressure can also affect financial professionals, leading to investment strategies that follow the 'herd', rather than focusing primarily on creating long-term value. Herd behaviour can also contribute to market bubbles, leading to financial volatility or instability.

Some recommendations for encouraging shifts in behaviour, based on social influence research, are:

- Within the investment community, increase awareness that investments favoured by the herd can easily become overvalued, with the result that high values are based on optimism rather than fundamentals. Support those who avoid following the herd approach.
- Emphasise the positive actions of peers and make hidden actions visible: when actions are not seen by others, this makes it harder for social norms within a group or organisation to shift.
- Encourage influential individuals, and empower champions at the local level. Encourage testimonials from people who have shifted towards longer-term approaches.
- Create pilot programmes and help groups to form to tackle these issues.

Culture and values

The report *Common Cause: The case for working with our cultural values* provides insights into how culture can be influenced by the *values* and *frames* used within an organisation, including the language used:

> Values can be activated[10] (for example, by encouraging people to think about the importance of particular things), and they can be further strengthened, such that they become easier to activate. It seems that one way in which values become strengthened is through their repeated activation. This may occur, for example, through people's exposure to these values through influential peers, in the media, in education, or through people's experience of public policies.
>
> (Crompton 2010: 11)

While Crompton's report focuses mainly on civil society organisations, there are implications that could be very important in understanding the cultural aspects of longer-term thinking. In order to help people think about longer-term issues, it might be valuable to explore the prevailing culture and values associated with either stewardship or speculation approaches. One definition of stewardship (Tomorrow's Company 2010: 5) is 'the process through which shareholders, directors and others seek to influence companies in the direction of long-term, sustainable performance that derives from contributing to human progress and the well-being of the environment and society.' Table 2 (page 34) discusses the culture of stewardship in more detail.

By opening a debate about how the values of stewardship or speculation are activated and reinforced within businesses and the finance sector, we could begin to understand the cultural barriers that hold back longer-term thinking and how these could be shifted.

Some limitations to decision-making

The new economic foundation's research (2005: 10) summarised some of the tendencies that can lead to 'irrational' decision-making. When people make choices, the way those choices are presented can have a big impact.

One tendency, often called *discounting*, means that we tend to underestimate the importance or relevance of something that might happen in the distant future. This is clearly very relevant for long-term thinking. People tend to find it conceptually difficult to think of the future, and studies have shown that people are inconsistent in their future preferences. Behavioural economists have studied the role that discounting future rewards plays, with immediate reward often being preferred to a greater benefit that is delayed (Irving 2009). For example, people tend to prefer being given £100 now to receiving £110 in a week. But if they are asked to consider the same choice in a year's time (i.e. being given £100 in a year in comparison to £110 in a year and a week), they are more likely to prefer to wait an extra week.

People are also strongly influenced by the *default options* set for them by authorities. When money is transferred into a voluntary pension scheme by default, for example, few people choose to opt out – even if the pension contributions are much higher than people can choose if they opt in. In the book *Nudge* (2008), Thaler and Sunstein argue in favour of using this

10 Within the report, 'activation' refers to the process of eliciting particular 'frames' or ways of understanding the world. Once culturally established, a frame can be activated very easily through the use of just a few words (for example, the phrases 'war on terror' and 'tax relief' activate deep frames that relate to a whole understanding of security and the proper role of government).

SAVE MORE TOMORROW

One intriguing example of the potential to 'nudge' people towards behavioural change is the Save More Tomorrow programme devised by economist Richard Thaler. The essence of this programme is that people commit in advance to putting a portion of their future salary increases into a retirement savings account. When a worker signs up, he or she makes no sacrifice of lower consumption today but, instead, commits to reducing consumption growth in the future.

When this plan was implemented in several firms in the United States, it had a large impact. A high proportion of those offered the plan decided to join (78 per cent). Of those enrolled, the vast majority (80 per cent) stayed with the programme through at least four annual pay rises. The average saving rates for those in the programme increased from 3.5 per cent to 13.6 per cent over the course of 40 months.

bias when designing policy. A 'nudge' changes how choices are presented, to influence people's behaviour without forcing a particular outcome. Examples show that very small changes in the way choices are presented to people can have a huge impact on behaviour.

For example, the success of the Save More Tomorrow scheme has shown how a 'nudge' can prompt people to save more over the long term (see box).

Some recommendations from this research on decision-making are:

- Present choices to people in a way that takes into account the challenges of longer-term thinking.
- Provide more sustainable default options.
- Give clear information at the point of decisions.
- Provide feedback on actions.

Barriers to long-term thinking within the finance sector

Through our literature review and discussions with experts, we explored some important themes that have particular influence on behaviour within the finance sector. These are presented in Table 2.

Table 2
Summary of barriers to long-term thinking within the finance sector.

<table>
<tr><th>Type of barriers</th><th>Key points from research and discussions</th></tr>
<tr><td>Perceived legal barriers that prevent long-term thinking</td><td>Investors and trustees can perceive fiduciary duty as a legal barrier to taking account of sustainability and long-term issues in decision-making. Many papers that we reviewed discuss the role of government in clarifying fiduciary duty.

A report by FairPensions (2011: 5) summarised these issues:

<blockquote>Fiduciary obligation is about ensuring that those entrusted to act on behalf of others do so reasonably and responsibly, and do not abuse their position for their own ends. But, in an investment context, this core protective purpose often seems to have been forgotten, replaced by the myth of a single, monolithic ‘fiduciary duty to maximise returns’.</blockquote>
Chapter 4 summarises a range of reports and initiatives that have looked at the implications of fiduciary duty for wider sustainability considerations.</td></tr>
<tr><td>Agency problems</td><td>Agency problems are commonly defined as ‘conflicts of interest among stockholders, bondholders and managers’. Our research and discussions identified a number of potential agency problems in the investment chain, particularly in relation to stewardship for institutional investors (Wong, 2010). These challenges include:
the separation of ownership from responsibility, with lengthening share ownership chains that weaken the ‘owner mindset’;
portfolio diversification, with institutional investors 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 also reduce their level of engagement with boards of directors and therefore their understanding of specific company drivers;
the perception that pursuit of short-term returns is an overriding fiduciary duty, so that pension fund trustees feel that they are acting beyond their remit if they try to bring in consideration of longer-term social and environmental risks;
inadequate performance metrics, based on short-term relative performance.</td></tr>
</table>

Type of barriers	*Key points from research and discussions*
The culture of stewardship	There has been a distinct cultural change in the perception of share ownership: Fuelled by an array of ancillary forces such as executive stock options and real-time media reporting of minute-by-minute stock performance, the market's speculative quality has led to a steady decline in the mentality of trusteeship, and steady upward trends in shifting and skimming wealth instead of creating it. (White 2006: 4–5) Over time, these trends and a change in mindset may have shifted the culture away from stewardship of shares to a more speculation-based approach. While guidance such as the UK Stewardship Code helps to address this, further interventions may be needed to achieve a wider change in culture. Although some influential voices have spoken out on this, short-termism is still the norm. Much more needs to be done to encourage a stewardship approach. This forms a key part of our recommended interventions for area of focus 2.
Performance measurement (particularly incentive structures)	Our research found that pay and incentives are a strong barrier to change, but could also become a motivation for longer-term thinking. This came up in many reports and also in one of our phone interviews: Recent events in the banking industry have demonstrated all too well the risk that incentive pay will focus on the wrong time-period. Too many traders made very significant annual bonuses for deal-making in relation to instruments whose (lack of) profitability was only visible much later. As the credit crunch has bitten, banks have lost huge sums on transactions for which they have already paid out bonuses. (Lee 2008: 7) There are opportunities for creating incentive systems more diverse than financial bottom line. Compensation would be demonstrated by increases in things like human capital, social capital, quality, increased intellectual capital, value of brands. (Comment from phone interview) Our recommendations for areas of focus 2 and 3 include a focus on performance measurement.

Type of barriers	*Key points from research and discussions*
Providing education on longer-term thinking	While interviewees often mentioned the role of education, this tended to be seen as playing a supporting role. Our recommendations, however, will suggest that education can make a big contribution to providing the skills and knowledge needed for longer-term approaches to take root, and to supporting a cultural shift within organisations.
Demand from investors	Our research identified that for businesses a main barrier to sustainability is the perceived lack of demand from investors. Research by Mercer and IRRC Institute found that mixed signals from investors were a barrier to long-termism: Most of the fund managers felt that there is a relatively low level of interest from clients in portfolio turnover and that end investors often send conflicting messages about their expectations in regard to the investment horizon. (Mercer and IRRC Institute 2010: 16) During our research, one interviewee commented that many CEOs would like to achieve a greater long-term focus but feel that this is difficult because there is such a strong appetite among analysts for shorter-term information. For a corporate leader it is difficult to promote long-term strategy when investors often hold shares for less than a year.

Barriers to long-term thinking for companies and shareholders

As well as within the finance sector, our research also explored the barriers for boards of directors, shareholders, and on directors' remuneration. Tables 3–5 summarise these key barriers and possible solutions to address them.

Table 3
Tackling barriers to long-term thinking among boards of directors.

Feature of current system	*Potential changes suggested by research*
1 Company and individual performance are assessed on the basis of quarterly returns.	■ Companies could report annually or less often, rather than quarterly, but communicate better with investors to emphasise their long-term strategy and how it addresses sustainability. ■ Remuneration (see Table 5) could also play a part in rewarding longer-term performance.

Feature of current system	*Potential changes suggested by research*
2 Long-term drivers of value are very difficult to predict with any accuracy, and are therefore discounted.	■ Companies could relay to investors the uncertainties associated with the long term by presenting more than one set of projections to show a range of possible outcomes.
3 Companies find it hard to value natural and social capital adequately, and underestimate their dependence on these resources.	■ Companies and investors could develop better ways of valuing natural and social capital.
4 Boards are often composed of like-minded individuals whose views are not challenged, and/or who may feel peer pressure.	■ Boards could be recruited from a wider pool of people with different areas of expertise. ■ More boards can be trained in sustainability concepts.

Table 4
Tackling barriers to long-term thinking among shareholders

Feature of current system	*Potential changes suggested by research*
1 Investors can hold shares for a short time and make short-term trading gains, rather than sharing in the value added over time by a company pursuing a long-term sustainable growth strategy.[11]	■ Government could revise capital gains tax provisions or implement a transactions tax to discourage excessive share trading (e.g. capital gains tax rates based on a descending scale, depending on how long security has been held). ■ Government could remove limitations on capital loss deductibility for very long-term holdings. ■ Government regulation is needed to enhance shareholder participation rights after a minimum holding period. ■ Government could offer tax incentives to longer-term investors.
2 Some investors are able to influence decision-making without being required to disclose the existence or nature of their positions or their plans.	■ There is a need to strengthen investor disclosures and update disclosure rules to take account of complex arrangements.

11 It is clear that investors in general are concerned about changes in this area, as ill-designed interventions could well be worse than the status quo.

Feature of current system	*Potential changes suggested by research*
3 Fund managers feel pressure to deliver short-term returns to investors even if they know they are based on unsustainable practices.	■ Disseminate better information to shareholders on what a long-term sustainable risk-adjusted rate of return might be. ■ Introduce regulation to reduce the asymmetry of risk, so that investors that benefit from the upside of risk-taking also bear the consequences of the downside.
4 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.	■ Encourage alternative measures of performance and long-term investment success. ■ Improve disclosure of the costs associated with the lengthy share ownership chain, and ensure that investors are aware of the cost of different options. ■ Develop better metrics to assess the performance of agents.
5 Fiduciary duty can be interpreted more in the context of maximising short-term financial returns than in generating real and lasting value over the long term.	■ Re-emphasise the legal position outlined in the Freshfields reports: that fiduciary duty requires consideration of social and environmental issues. ■ Ensure that this is reflected in investment mandates. ■ Support this through training and education.
6 Some perceive that 'investment churn' offers the best return to shareholders.	■ Undertake a thorough analysis of what delivers the best returns over the long term, taking all transaction costs into account.
7 Earnings per share (EPS) is the most accessible metric, and this means that it gets the broadest media coverage.	■ Businesses could significantly reduce their emphasis on EPS and communicate strategic issues better. ■ Analysts could build new/different valuation models. ■ Cross-sector initiatives are needed to develop new metrics for success, and to provide education and support.

Feature of current system	*Potential changes suggested by research*
8 The discounted cash flow model for assessing a company's return on investment encourages a focus on short-term returns.	■ Develop different ways of assessing the value of future cash flows, so that there is not always a bias in favour of quick – but potentially unsustainable – returns.

Table 5

Tackling barriers to long-term thinking in relation to directors' remuneration.

Feature of current system	*Potential changes suggested by research*
1 Directors' remuneration practices, combined with the short length of tenure and generous provisions on termination, result in risk-taking and short-termism.	■ Pursue regulation or policy to base the compensation of companies and fund managers on long-term performance. ■ Ensure that new regulation/policy requires detailed compensation disclosure.
2 Directors' remuneration is assessed largely in relative, rather than absolute, terms. It is compared with the level received by peers and with previous years' payouts, and this leads to remuneration inflation.	■ Groups of similar companies could agree to limit remuneration in collaboration, to prevent movement of people from those companies that are restricting remuneration inflation. ■ Businesses could be more transparent about the criteria that determine director remuneration, and the way that this is structured.
3 The effect of directors' remuneration may result in shorter-term objectives and performance incentives for managers at all levels within businesses.	■ Encourage measures of success that incentivise long-term value creation at all levels of the business.
4 There is insufficient recognition of the status and intrinsic satisfaction that is conferred by creating great products, great service, or a great place to work, so money remains the key factor by default.	■ There needs to be more reporting on these elements of a company's performance. ■ There should also be greater public recognition of the role of directors in achieving these objectives.

Summary of barriers

Based on this research, Table 6 gives a more detailed summary of the most critical barriers within the system. It also shows how these are linked to our three *areas of focus* (detailed in Chapter 5) which would address these barriers.

Table 6
Summary of barriers for particular groups.

Key barriers to long-term thinking	*Recommendation*
For asset managers: ■ Lack of information from companies on their strategy for long-term business success. ■ Perceived risk for asset managers of moving from tried and tested measures of success – due to skills, the 'herd' effect, perceptions of what is material[12] or their own financial or performance incentives. ■ Asset managers or consultants may feel they are unlikely to be criticised for 'missing' material environmental, social and governance (ESG) issues because their peers are likely to miss them too. ■ An increased separation between companies and investors, due to IT and globalisation trends. **For companies:** ■ Perceived risk for companies of communicating and reporting on strategic and long-term issues, rather than short-term success. ■ Lack of measures for long-term factors, and perceived lack of evidence on the importance of these issues in driving long-term business success of these issues. ■ Hard for individual companies to take the lead without peer action or demand from asset managers, because of the challenges (cost, time, skills and standards) of reporting the information that investors may want to know. ■ There is a perceived lack of interest from investors in more detailed long-term information, partly driven by the average length of shareholding.	**Recommendation for area of focus 1:** Companies provide improved strategic information on long-term drivers of value, and asset managers see the benefit in demanding it.

12 Material issues are issues for which disclosure would be substantially likely to be considered important to a reasonable investor in making an investment decision.

Key barriers to long-term thinking	*Recommendation*
For asset managers: ■ Fiduciary duty is often interpreted as applying predominantly to financial value. ■ Asset managers may currently feel that short-term approaches create the greatest value for their clients. ■ When mandates are set (even by pension funds, which might be expected to have a long-term perspective), they often do not include sustainability considerations. ■ Investments are often assessed on a quarterly basis and the risks of underperforming are seen as high when making decisions that are different from peers. There are challenges (cost, time, skills) in understanding the benefits of long-term investments. ■ Performance may also be assessed on a quarterly basis. ■ More broadly, the culture of investment has tended to shift more towards 'speculation' and away from 'stewardship'. ■ Some trends have increased the separation between companies and investors: shorter average holding periods, increasing media speed and technology. **For asset owners:** ■ It is easier to monitor the short-term performance of an investment manager than their long-term performance, and satisfactory results relative to a benchmark give assurance to the asset owner or trustee. ■ There are no independent and credible ways of judging the relative ESG performance of different investment managers, so this is not a strong element of the criteria for their selection. ■ The investment management world can be complex and opaque, and asset owners or their trustees may not feel qualified to question the investment strategy adopted by the investment managers.	**Recommendation for 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.

Key barriers to long-term thinking	*Recommendation*
For CEOs and boards: ■ Company performance is almost invariably measured by reference to short-term indicators, particularly quarterly returns. This means that boards of quoted companies feel pressure from the market to announce increasing short-term profits. ■ These short-term indicators are often used to measure individual performance and reputation, and executive remuneration. Remuneration practices can give a perverse incentive for risk-taking or short-term behaviour. **For all managers throughout the company:** ■ If senior management and board pay are dictated by short-term considerations, then junior managers may be encouraged (financially or culturally) to do this to progress: □ their objectives and remuneration will be aligned to corporate strategy, so will probably include more short-term than long-term measures of success; □ within the culture there may be unspoken rules that discourage managers from proposing ideas which deliver over the longer-term; □ during periods when short-term measures are under-performing, managers may feel pressure to stop or cut initiatives that do not meet immediate goals.	**Recommendation for 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.

Chapter 4
Initiatives by other organisations

SUMMARY

Many organisations are already tackling the issue of short-termism through practical initiatives, either directly or via an indirect link that helps to encourage a longer-term perspective. Research has also been carried out, and reports published, on long-term thinking. Some of this material includes clear recommendations for what can be done to tackle these issues. Appendix III summarises a selection of these.

Introduction

Our examination of previous research has informed our views on the barriers to long-term thinking and how to tackle these (discussed in Chapter 5). We have ensured that our recommendations complement or build on these established activities and emerging trends, so that lasting and meaningful change can be achieved.

Initiatives with a strong cross-sector focus

- The Prince of Wales's Accounting for Sustainability project works with businesses, investors, the public sector, accounting bodies, NGOs and academics to develop practical guidance and tools for embedding sustainability into decision-making and reporting processes. It has recently been instrumental in establishing the International Integrated Reporting Committee.

- In the USA, a range of leading businesses and financial institutions signed up to the Aspen Principles in 2009. These are summarised in the report *Long-Term Value Creation* (Aspen Institute Business and Society Program 2009).

- Also in the USA, the CFA Institute[13] and the Business Roundtable Institute for Corporate Ethics co-sponsored the 'Symposium Series on Short-Termism'. This work involved the publication of a report in 2006, *Breaking the Short-Term Cycle* (CFA/BRICE 2006).

13 CFA Institute is the global, not-for-profit association of investment professionals that awards the CFA and CIPM designations.

- The Long Finance Initiative (Z/Yen Group in conjunction with Gresham College) aims to 'improve society's understanding and use of finance over the long term', in contrast to the short-termism that defines today's financial and economic views. The immediate objective of the initiative is to establish a foundation that can ignite global debate on long-term finance, by examining how commerce should enable and encourage environmental and social sustainability.

Initiatives from the UK Government and policy-makers

- The UK Stewardship Code was published in July 2010. This aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities. It seeks to do this by setting out good practice on engagement with investee companies. Our research found that the Stewardship Code is generally viewed positively, but people feel it needs 'more time to bed down' (BIS 2011). Much will depend on how seriously asset managers view the requirement to 'comply or explain', and the quality of the voluntary reporting.
- In January 2011 the UK government's Department for Business, Innovation and Skills (BIS) ran a consultation on 'a long-term focus for corporate Britain'. Forum for the Future made a submission to this consultation, which included the key findings from our project research.
- The UK's Green Investment Bank is expected to be operational in late 2012. The UK Government is currently working up the details of its remit, but it will invest alongside the private sector to share the risk of new technologies.
- A Big Society bank is also planned. According to Francis Maude, Minister for the Cabinet Office, the bank's aim is to 'massively expand finance for social ventures, creating a new source of finance alongside philanthropy and public service contracts'.

Initiatives focused on institutional investors

- Several reports have explored the implications of fiduciary duty for wider sustainability considerations. The most influential of these has been the Freshfields report (UNEP, 2005), sponsored by the United Nations Environment Programme's Finance Initiative (UNEP FI). Many of its conclusions have begun to be adopted by leading financial institutions. For example: 'Financial professionals worldwide have a duty to act in the best interests of their clients and ultimate beneficiaries. There is an increasing recognition of the need to include the analysis of environmental, social and governance (ESG) factors in order to more completely fulfil this duty' (CFA Manual for Investors cited by Network for Sustainable Financial Markets 2011).
- The UN's Principles for Responsible Investment (UNPRI) is an investor initiative in partnership with the UNEP Finance Initiative and the UN Global Compact. This has involved a network of international investors working together to put six principles into practice. These include incorporating ESG issues into investment analysis and decision-making processes, seeking appropriate disclosure on ESG issues and promoting acceptance and implementation of the principles within the investment industry.

- Some influential reports and recommendations have been produced by institutions such as the CFA Institute, Mercer and Business for Social Responsibility (BSR).

Initiatives focused on the pension fund community

- FairPensions is a charity that promotes responsible investment by pension funds and fund managers. Bringing together leading charities, trade unions, faith groups and individual investors, the aim is to 'catalyse a shift in awareness and conduct at each level of the investment chain, so that Responsible Investment becomes the norm'. The charity's recent report, *Protecting Our Best Interests: Rediscovering fiduciary duty* (2011), aimed to 'explore whether investors' fiduciary duties to the people whose money they manage are fit for purpose in the 21st century, particularly in light of the financial crisis'. The report concluded that the UK Government should conduct a review of investors' fiduciary obligations, and made some specific recommendations for the UK Government, regulators and pension funds.
- The UKSIF Sustainable Pensions Project encourages occupational pension funds to adopt more sustainable and responsible investment strategies, with the aim of enhancing long-term shareholder value and improving financial returns for fund members.
- The Marathon Club is a direct follow-up project to a competition entitled 'Managing pension funds as if the long-term really did matter'. The club is comprised of approximately 20 members, ranging from institutional fund trustees to senior executives and senior specialists. The overall aim is to stimulate pension funds, endowments and other institutional investors and their agents to be more long-term in their thinking and actions; to place a greater emphasis on being responsible and active owners; and to increase knowledge about how their investment strategy and processes can improve the long-term financial and qualitative buying power of fund beneficiaries.

The findings from these reports have strongly influenced our own recommendations. We summarise them in Appendix III.

Chapter 5
Themes and recommended actions

SUMMARY

Forum for the Future have identified three critical areas of focus that are necessary to tackle the systemic barriers to long-term thinking. Within each area of focus, we also propose a key recommendation and supporting actions to tackle the barriers to change.

Many of these recommendations and actions will provide benefits for companies and financial institutions. Additionally, piloting and implementing these approaches will help to catalyse change and share best practice throughout the sector.

For area of focus 1 (which looks at the supply and demand of long-term strategic information), the key recommendation is:

> Companies need to 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.

For area of focus 2 (which looks at incentive structures), the key recommendation is:

> A set of pilot projects to unpick the culture and incentives behind short-termism. These would include:
>
> - asset owners taking a detailed look at the specific incentives at each stage of the value chain;
> - supporting the development of new analytical tools that will differentiate long-term thinkers in the market;
> - sharing stories, examples and evidence of how integrating ESG issues has helped investors to outperform mainstream peers;
> - challenging the language and culture that equates success with short-term deal-doing rather than longer-term contribution to wealth generation.

For area of focus 3 (which looks at the performance criteria and incentives by which business executives and boards are judged) the key recommendation is:

Provide transparency about how executive remuneration is structured. This would not necessarily include the amount of remuneration, but would detail the criteria used to judge success and the type of payments involved. Actions would include:

- Providing greater transparency about the structure of remuneration, for example the proportion linked to short-term or long-term criteria.
- More transparency on how compensation is linked to fundamental drivers of long-term value, such as innovation and efficiency, rather than share price.
- Further research on the way that the structure of remuneration influences executive decisions, with the aim of drawing together an evidence base.

Introduction

Forum for the Future have identified three critical areas of focus that are necessary to tackle the systemic barriers to long-term thinking. Within each area of focus, we also propose a key recommendation and supporting actions to tackle the barriers to change. It is important to note that these are not just separate interventions, but that they reinforce each other to catalyse wider change. As well as the three key areas of focus, we also propose actions in two further areas that focus on government and pension funds. These are summarised in Appendices IV and V.

Table 7 shows the three recommendations, the groups that they apply to, and how relevant each area is to each group (i.e. whether it is a key focus, a secondary issue or a supporting concern).

Table 7
Summary of recommendations and the groups to which they apply.

	Recommendation for area of focus 1 *Companies provide improved strategic information on long-term drivers of value, and asset managers see the benefit in demanding it.*	***Recommendation for 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.*	***Recommendation for 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.*
Businesses			
Boards and CEOs	✓ **Key focus**		✓ **Key focus**
Managers throughout the business			✓ Secondary
CSR/ sustainability teams	✓ **Initial focus, but less after emphasis shifts to strategy**		
Investor relations	✓ **Key focus**		
Finance sector			
Independent investors		✓ Supporting	✓ Supporting
Asset owners	✓ **Key focus**	✓ **Key focus**	✓ **Key focus**
Fund managers	✓ **Key focus**	✓ **Key focus**	✓ Secondary
Asset managers	✓ **Key focus**	✓ **Key focus**	✓ Secondary
Sell-side analysts	✓ Secondary	✓ Secondary	
Credit rating agencies	✓ Secondary	✓ Secondary	
Investment consultants	✓ Secondary	✓ Secondary	
Pension fund trustees		✓ Secondary	
Political			
Government shifts in regulation/ taxation	✓ Supporting	✓ Supporting	

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

This critical area of focus relates both to the supply of long-term information from businesses, and the demand for that information from investors.

Behaviour aims

This theme requires behavioural/cultural change from investors:

- Asset managers would be able to make decisions informed by better communication and information on long-term business strategies, risks and opportunities.

However, this behaviour is supported and reinforced by behaviour from others within the system:

- Businesses need to provide better communication and information to investors on their long-term business strategies, risks and opportunities.
- Sell-side analysts and credit rating agencies can demand this information and integrate it into research or ratings.

Barriers to this behaviour

There are currently barriers to this behaviour for the key groups involved.

For investors:

- There is a lack of information from companies on their strategy for long-term business success (versus extensive data on short-term success, and media focus on relatively short-term information).
    - SRI data is not always helpful to communicating material ESG issues.
- Investors are operating in a market where they have historically been able to make strong financial returns while ignoring longer-term ESG data. While this may not generate the best outcomes for society, it may generate the best financial outcomes for individual investors. It is possible that addressing this systemic risk requires regulation to prevent individual companies and financial institutions making short-term returns at the expense of long-term economic stability and sustainability.
- There is a perceived risk for investors of moving from tried and tested measures of success. Factors influencing this perception of risk include the new skills required to integrate longer-term issues in decision-making, the ‘herd’ effect, a short-termist mindset about what is material, and investors’ own financial or performance incentives.
- Even when investors identify sustainability problems that could potentially be material, they may not flag them or may spend time analysing them because:

  - they are unlikely to be criticised for ‘missing’ material ESG issues because their peers are likely to miss them too;
  - they are concerned that this will reduce their access to the company in the future and reduce their ability to analyse more central financial issues.
- A number of trends have increased the separation between businesses and investors:
  - a tendency towards shorter average holding periods. This is made possible by lower transaction costs, largely as a result of information technology;
  - the increasing speed of media and online data access provides real-time information, which can encourage more frequent transactions;
  - partly driven by technology, the increasingly international ownership of shares and the lengthening of the investment chain.

For businesses:

- There is a perceived risk of communicating and reporting on strategic and long-term issues, rather than short-term success (influenced by herd effect, media focus).
- There is a lack of measures for long-term factors, and perceived lack of evidence on the materiality of these issues.
- It is hard for individual businesses to take the lead without peer action or demand from investors:
  - there are challenges (in terms of cost, time, skills and standards) in reporting the information that investors may want to know;
  - there is a perceived lack of interest from investors in more detailed long-term information, partly driven by the average length of shareholding.

Key recommendation: A nudge or catalyst for change

Companies need to 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.

This will require the types of approach that Forum for the Future has developed and trialled through our *Better Decisions, Real Value*[14] work. The two phases within this workstream correspond to the two key behavioural and cultural changes for this theme:

- 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: engage investors in the long-term value of sustainability.

14 More details are available at: www.forumforthefuture.org/projects/better-decisions-real-value

CASE STUDY

Forum for the Future's 'Better Decisions, Real Value' (BDRV) toolkit helped Sainsbury's Energy and Environment team to develop and articulate the clear business case for making its stores more energy efficient and to identify financial benefits that had been overlooked. They found that the business's decision-making process for large investments did not factor in some of the main incentives for energy-saving. The information gathered in this exercise can be used both for internal purposes and for communication with investors.

What is a successful outcome of this recommendation?

Aim 1: Pilot projects to provide sector-wide learning on measuring and communicating long-term success

Forum for the Future aims to run pilot projects in four businesses by the end of 2012, and we hope these will be supported by a range of other pilots throughout the business community. These pilots will provide sector-wide learning on measuring and communicating long-term success. For example:

- integrating sustainability within financial reporting;
- developing and testing Key Performance Indicators (KPIs);
- 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.

Aim 2: Build understanding between businesses and investors

These pilot projects will aim to building understanding between businesses and investors. The investor benefits of this information advantage should lead to greater demand from investors for more communication.

These pilots will have been accompanied by research and collaboration, convening groups on these issues and spending time with investors to understand the way they use data.

Why is this a key area of focus and how will it catalyse change?

Our research identified that a key barrier to long-term thinking and sustainability is the amount and nature of communication between investors and businesses. Helping businesses to communicate more about long-term strategy will begin to widen the debate around sustainability and long-term risks. This will also strengthen the evidence base for future policy interventions that would help to correct market failures and integrate true ESG costs and benefits into market prices. It will catalyse wider change, as businesses, analysts and investors begin to shift the balance of their communication towards longer-term issues. There should also be greater investor demand for this information over time from other businesses.

What other actions are helping or might help to support and reinforce this behaviour?

Priority of action	Who does this action involve?	Supporting action
Critical	Business leaders	Business leaders could shift the balance of their communication with investors. Paul Polman's communication of Unilever's long-term perspective is an example of this: 'Unilever has been around for 100-plus years. We want to be around for several hundred more years. So if you buy into this long-term value-creation model, which is equitable, which is shared, which is sustainable, then come and invest with us. If you don't buy into this, I respect you as a human being, but don't put your money in our company'.[15]
Critical	All market participants	Better training of market participants on the materiality of sustainability issues and how these can be factored into valuation analysis. This could also be accompanied by training on potential risks and opportunities in the future.
Critical	Analysts	Analysts are incentivised to increase their focus on longer-term issues (this links to the recommendation for area 2): ■ Analysts could explicitly include a valuation of long-term strengths and risks for the companies they are analysing. ■ Our research found that some analysts feel that the focus on short-term measures takes the differentiation out of their work, and see opportunities in greater information on long-term issues. But incentive structures are not conducive to this.
Critical	All	Collation of evidence that a long-term focus generates outperformance by reducing the volatility of portfolios and reducing transaction costs: ■ Examples of where poor ESG analysis has resulted in portfolio loss that could have been avoided. ■ High-profile examples of long-term investment strategies that have delivered strong performance (e.g. Berkshire Hathaway). ■ Examples of how transaction costs erode the value of portfolios.

15 http://www.responsible-investor.com/home/article/davos1/

Critical	Government policy-makers	Government intervention (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 management of long-term risks to the financial system as a whole, and not aligned with a sustainable economy.
Critical	Asset owners	Demand from asset owners for information on the quality of ESG analysis by fund managers (being a signatory to UNPRI is not enough).
Critical	Independent assessors	Supporting the UNPRI in developing a meaningful independent process for assessing the quality of asset manager EG analysis. This may also involve independent assessment and rating of how well or poorly individual investment managers have assessed and managed ESG within their portfolios.
Important	Government	Government can take regulatory action on a number of fronts: ■ Rules to mandate disclosure by all fund managers of how they have assessed ESG issues. ■ 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.
Important	Financial Services Authority (FSA) in its capacity as UK Listings Authority, and other regulators	Global listing rules to mandate the disclosure of strategic sustainability reports.
Important	All	Continue to highlight and reward good practice on analysis of long-term drivers – for example through publicising the reports available on the London Accord website and ensuring that awards such as the Farsight Award are given significant media attention.
Important	All	Developing better measures of long-term value, risks and opportunities through cross-sector collaboration and research (Accounting for Sustainability is an example of this).

Moderately important	Media	A media shift in focus from short-term to longer-term business success would support these actions, but this may be difficult to achieve unless the demand for information changes.

CASE STUDY

Companies can use tools such as the World Business Council for Sustainable Development's Corporate Ecosystems Valuation Toolkit to understand how to value ecosystems. For example, international paper and packaging company Mondi used the toolkit to understand the value of mapping water dependencies in and around its tree plantations in South Africa, to enable it to manage its exposure and plan future strategy.

CASE STUDY

A FairPensions campaign on tar sands was designed to highlight the financial risks for investors associated with investment in the controversial tar sands in Canada. Although social and environmental damage were areas of concern, the campaign deliberately downplayed these elements. It asked investors to question the returns on an investment in that asset in the light of carbon prices, the technical challenges and cost of carbon capture and storage, and the impact of climate change on other assets in their portfolio.

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

This critical area of focus is around changes in incentive structures throughout the investment supply chain, and also in culture.

Behaviour aim

Investors need to 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 through the investment value chain serve their long-term interests. As well as financial interests, this includes the wider interests of asset owners.

Barriers to this behaviour

There are both cultural and financial barriers to longer-term thinking among asset owners and asset managers.

For asset managers:

- Fiduciary duty is often interpreted as applying predominantly to financial value.
- Asset managers may currently feel that short-term approaches create the greatest value for their clients.
- When mandates are set (even by pension funds – see Appendix IV), they often do not include sustainability considerations.
- Investments are often assessed on a quarterly basis and the risks of underperforming are seen to be high, particularly when making decisions that are different from those of peers.
- Performance may also be assessed on a quarterly basis. Although this may be done using performance measures over different timeframes (up to five years), the overall balance and frequency of assessment discourages longer-term perspectives.
- There is no clear evidence that integrating ESG factors into investment processes is likely to result in outperformance of conventional benchmarks.
- More broadly, the culture of investment has tended to shift more towards ‘speculation’ and away from ‘stewardship’.
- Investment consultants who advise institutional investors on which asset manager to select are often paid on the basis of a retainer for ongoing advice, with an additional higher fee in return for running a tender. This incentivises consultants to move their clients to alternative fund managers more often than is desirable, resulting in lower returns to their clients net of fees.
- Engagement with companies is expensive, so it is easier for fund managers to ‘free ride’ on initiatives by the asset managers who place engagement at the heart of their offering.

- Asset managers are not incentivised to control transaction costs because they don't bear them, so these nibble away at performance.
- There are specific additional challenges (in terms of cost, time and skills) involved in understanding the benefits of long-term investments.
- A number of trends have increased the separation between businesses and investors:
  - A tendency towards shorter average holding periods. This is made possible by lower transaction costs, largely as a result of information technology.
  - The increasing speed of media and online data access provides real-time information, which can encourage more frequent transactions.
  - Partly driven by technology, the increasingly international ownership of shares and the lengthening of the investment chain have added to these pressures.

For asset owners:

- It is easier to monitor the short-term performance of an asset manager than the long-term performance, and satisfactory results relative to a benchmark give assurance to the asset owner or trustee.
- There are no independent and credible ways of judging the relative ESG performance of different asset managers, so this is not a strong element of the criteria for their selection.
- The asset management world is opaque, and asset owners or their trustees may not feel qualified to question the investment strategy adopted by asset managers.

Key recommendation: A nudge or catalyst for change

New approaches can be difficult for institutional investors because of the perceived obligations of fiduciary duty. While many initiatives are looking at fiduciary duty in the context of integrating long-term ESG factors into decision-making, incentives and cultural factors still provide a barrier to longer-term thinking for asset managers.

To support these initiatives on fiduciary duty and the approaches within the UK Stewardship Code, we recommend a set of pilot projects to unpick the culture and incentives behind short-termism. These would include:

- Asset owners taking a detailed look at the 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 enable a clear view of where incentives are and are not aligned with generating real value for investors. It would also highlight the extent to which transaction costs and fees erode financial returns.
- Supporting the development of new analytical tools that will differentiate long-term thinkers in the market. While these tools will be developed readily if analysts see a lucrative market for them among asset owners, the evidence (from the Enhanced Analytics Initiative and others) shows that asset owners do not generally demand them. Leading organisations therefore need to give their analysts time, resources and incentives to experiment.
- Sharing stories, examples and evidence of how integrating ESG issues has helped investors to outperform mainstream peers.

- Developing professional training and continuing professional development (CPD) courses that promote greater understanding of the reasons why the long term matters.
- Challenging the language that equates success with short-term deal-doing rather than longer-term contribution to wealth generation.

What is a successful outcome of this recommendation?

By 2012 evidence from a range of pilot projects in this area should have helped to identify where stewardship approaches are disincentivised, either because of specific structural incentives or because of success being defined in terms of short-term profits. Pilot initiatives will thus enable a different perspective on best practice and help to precipitate a change in the way investment management mandates are awarded and assessed.

Why is this a key area of focus and how will it catalyse change?

Some current incentive structures may result in a misalignment between investors and financial institutions – including investment managers, consultants, brokers and exchanges. If these are more transparent, then investors may seek more assurance for alignment, for example through better information on the rationale for short-term investment strategies. In particular, clearer information on how returns to investors are eroded through transaction costs and fees could lead to more scrutiny of the merits of short-term trading approaches. However, investors may continue to believe that a short-term perspective delivers the best financial performance for their clients, so other activities will be necessary to address the risks of this behaviour for the system as a whole.

What other actions are helping or might help to support and reinforce this behaviour?

Priority of action	Who does this action involve?	Supporting action
Critical	Institutional investors, government	Articulating the importance of integrating ESG factors. Continuing and scaling up existing initiatives to interpret fiduciary duties, and helping to educate institutional investors and their advisors about the issue of short-termism.[16] This would also involve supporting education and awareness-raising initiatives for individual investors, to help them integrate these factors into decision-making and focus on long-term value creation.
Critical	Asset owners	Ensure that a wider definition of fiduciary is reflected in mandates.
Critical	Asset managers	Reform asset manager performance metrics and the criteria used for remuneration decisions This could include: ■ 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 (requiring additional government action outlined below). ■ A transparent and independent process for assessing the quality of stewardship activities by asset managers. ■ Reviewing the frequency of performance monitoring of investments.

16 Most notably, the Freshfields report (UNEP FI 2005) and UNEP Fiduciary II report (UNEP FI 2009).

<table>
<tr><td>Important</td><td>Government and regulators</td><td>This could also include action by government to make these approaches mandatory:
Government intervention 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. This will reduce the tendency for asset managers to ‘piggy-back’ on the activities of the fund managers that engage effectively with companies on ESG issues.
Government requiring that fee structures do not reward investment consultants for moving clients between fund managers.</td></tr>
<tr><td>Important</td><td>Wider finance community</td><td>Consider how to develop appropriate financial incentives or penalties that encourage longer shareholding.

This should involve taking into account experience of what has and has not worked in the past and recognising that short-term shareholding is also important for ensuring the efficient pricing of companies. Examples of mechanisms that could be explored further include:
Financial or other incentives that reward longer-term shareholding. For example, Barton (2011) mentions the rule in some French companies that gives two votes to shares held longer than a year.
Taxation measures that increase transaction costs, and hence incentivise longer shareholding.</td></tr>
<tr><td>Important</td><td>Senior managers</td><td>Encouraging a focus on longevity of client relationships, as evidence shows (see Mercer 2010: 5) that managers feel more able to stay true to their processes in these situations.</td></tr>
<tr><td>Important</td><td>Professional bodies</td><td>There is a need for whistle-blowing mechanisms that are overseen by professional bodies who give them adequate protection.</td></tr>
</table>

Important	Pension funds	Requiring pension funds to provide information on the age composition of their membership and requiring pension fund trustees to explain how they are discharging their fiduciary duties with respect to different age groups. For example, younger pension fund members may have different attitudes and needs from pension fund members who are retiring in two years' time.

CASE STUDY

In its report *Climate Change Scenarios: Implications for strategic asset allocation*, published in February 2011, the investment consultant Mercer reported that climate change poses 10 per cent downside investment risk in portfolios and also brings significant investment opportunities from low carbon technologies – a potential $5 trillion global market by 2030.

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

This recommendation is about enabling the success of company executives and boards to be judged in new ways.

Behaviour aim

The aim of this behaviour is that company CEOs, boards and managers should be incentivised through performance criteria and 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.

Barriers to this behaviour

There are currently a number of barriers to this for the key groups involved:

For CEOs and boards:

- Company performance is almost invariably measured by reference to short-term indicators, particularly quarterly returns. This means that boards of quoted companies feel pressure from the market to announce increasing short-term profits.
- These short-term indicators are often used to measure individual performance and reputation, and executive remuneration. Remuneration practices can give a perverse incentive for risk-taking or short-term behaviour.
- Managing quarterly earnings reduces the time and attention available for other things.

- Boards are often composed of like-minded individuals whose views are not challenged and who may feel pressure from their peers to behave in certain ways. Where the norm is to think short-term, this tends to continue.
- Evidence shows that CEO tenure has become shorter. Board members may not perceive their role as long term, and they may not have a sound historical perspective about the business.
- Short-term gains are seen as confirmation that the company is being well managed and give investors confidence.
- There is often a lack of evidence that longer-term thinking generates greater value for the company than a focus on the short term.

For all managers throughout the business:

- If senior management and board pay are dictated by short-term considerations, then junior managers may be encouraged (financially or culturally) to follow short-term approaches in order to progress:
  - Their objectives and remuneration will be aligned to corporate strategy, so these will probably include more short-term than long-term measures of success.
  - Within the culture there may be unspoken rules that discourage managers from proposing ideas that deliver over the longer term.
  - During periods when short-term measures are under-performing, managers may feel pressure to stop or cut initiatives that do not meet immediate goals.
- Performance reviews may be relatively frequent, meaning that managers need to account for their actions on a regular basis.
- When roles change frequently, career success and status may depend on making a relatively quick impact, rather than on investments in long-term value that may be harder to measure and to attribute to any one person.
- Perceived risks for managers of moving to new approaches because of the 'herd' effect and the lack of measures/an evidence base relating to longer-term factors.
- The challenges involved (cost, time, skills) in understanding longer-term risks.
- There is often a lack of evidence that longer-term thinking generates greater value for the company.

For shareholders and other stakeholders of the business:

- They may not see any benefits arising from longer-term thinking.
- They may not currently look for information on remuneration or think it is significant.
- There is little transparency about executive remuneration, so investors may not know if business incentives are indirectly encouraging approaches that are not aligned to their interests. When remuneration is made public, this tends to be the amount rather than the structuring of pay.

Key recommendation: A nudge or catalyst for change

There needs to be real transparency about how executive remuneration is structured. This would not necessarily include the amount of remuneration, but would be more about the criteria used to judge success and the type of payments involved. Actions would include:

- Providing greater transparency about the structure of remuneration, for example the proportion linked to short-term or long-term criteria, rather than the amount.
- More transparency on how compensation is linked to fundamental drivers of long-term value, such as innovation and efficiency, rather than share price.
- Further research on the way that the structure of remuneration influences executive decisions, with the aim of drawing together an evidence base.
- Understanding and highlighting the processes adopted by remuneration consultants.
- Development of a 'best practice' version of a remuneration package linked to sustainability and aligned to the long-term interests of shareholders.
- Exploration of how the concept of 'malus' might work in practice. A 'malus' is the opposite of a bonus – an option to claw back money if performance lags. In practice it means that a bank will be able to pledge a particular cash sum to an employee for their annual bonus, but to stagger the payment over a period of time.[17]
- Development of best practice on how to evaluate the performance of remuneration committees in aligning remuneration with shareholder value.

What is a successful outcome of this recommendation?

Through successful action in this area, we would see a range of businesses piloting approaches that involve being more transparent about the structure of their executive remuneration and incentives throughout the business. These could include:

- Transparency about long-term incentive plans and bonus deferrals.
- How they are linking sustainability with executive performance, demonstrating to customers and investors that sustainability is being taken seriously at a strategic level.
- How they are integrating long-term measures within objectives and performance criteria throughout the business.

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17 www.telegraph.co.uk/finance/newsbysector/banksandfinance/4560844/The-future-face-of-the-City-bonuses.html (accessed 27 April 2011)

CASE STUDY

While our recommendation is mainly focused on remuneration within businesses, a good example of new approaches comes from the Swiss bank UBS. In 2008, it introduced a 'bonus-malus' compensation model for senior managers. This means that a cash portion of a bonus award is held back at the end of a financial year and reduced if targets are not met in subsequent years.[18]

With such pilots in place we would see increased demand from asset managers for this type of information, and an enhanced evidence base on executive remuneration and incentivisation. Another indicator of success would be that businesses are increasingly seen to shift the incentives for managers throughout their organisations, moving towards longer-term measures of success.

Why is this a key area of focus, and how will it catalyse change?

This intervention helps to reduce many of the cultural or financial barriers to long-term thinking within businesses, both at board level and throughout the business. Sharing these with other businesses and investors will catalyse a cross-sector shift in business incentives, and a cultural shift towards longer-term value creation.

CASE STUDY

National Grid has had greenhouse gas emissions targets in place since 2005/6 and has a target of 80 per cent reduction in emissions by 2050 against a 1990 baseline. During 2009/10, each line of business in National Grid developed five-year plans for greenhouse gas reduction. Executive compensation is linked to performance against the plans.

18 www.economist.com/node/13604627 (accessed 26 April 2011)

What other actions are helping or might help to support and reinforce this behaviour?

Priority of action	Who does this action involve?	Supporting action
Critical	Managers throughout the business	Companies can pilot and apply new approaches that incentivise executives and managers at all levels of the business to focus on creating long-term value. This includes business objectives and the criteria used for remuneration decisions. It also involves linking performance criteria and executive pay to longer-term and more qualitative targets. As well as benefiting sustainability, these approaches provide many business benefits, unlocking new long-term innovation.
Critical	Asset managers	Asset managers can engage companies on the composition of remuneration packages for CEOs and boards, and the criteria by which this is judged.
Important	Business leaders	Transparency on bonus payments and payments on departure: ■ Further disclosure relating to the nature of departure and how this equates to the payments made on departure would certainly help. ■ There is an urgent need for significant improvement in the level of retrospective disclosure of the performance that led to awards being granted under bonus schemes. Many companies still provide no information to justify large annual bonus awards.
Important	Government and regulators	Actions could involve: ■ Mandatory disclosure of differentials between the remuneration of the CEO and median remuneration in the company, or that of the lowest paid. ■ Government requirements around disclosure on remuneration.

Chapter 6
Conclusions

Key actions now and in the future

Our research showed that companies, asset owners and asset managers are faced with a daunting range of actions to take to enable greater sustainability and long-term success.

Based on our analysis and supporting the *areas of focus*, here are the actions they should prioritise now and in the future.

Companies

Now:

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.

And going forward:

1 Explore in more detail 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

Now:

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).

And going forward:

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

Now:
1 Commit more resource 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.

And going forward:
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

Now:
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 long-term risks to the financial system as a whole.

And going forward:
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.

Future plans

This report was designed to build on existing work and thinking and to encourage action. Forum for the Future now aims to work with a range of organisations to pilot these change approaches, and to build a base of evidence and case studies on the benefits of long-term thinking. We will then communicate this widely, to create momentum around how significant change might happen.

We welcome interest from individuals or organisations who are keen to work with us on longer-term projects. You can contact us through our website, which also shows more information on the project. This will continue to detail our ongoing work to support the implementation of these recommendations.

Contact us at: http://www.forumforthefuture.org/projects/overcoming_barriers_long-term_thinking

Appendix I
Experts who provided input to this research

Experts who participated in interviews or discussions

The following experts participated in interviews on the barriers to long-term thinking, or provided insights on the recommendations we proposed.

Participant	***Organisation***
Analyst	F&C Investments
Richard Burrett	Earth Capital Partners
Diane Coyle	Friends Provident Foundation
Tom Crompton	WWF
Mike Hampton	Friends Provident Foundation
Stephen Hine	EIRIS (Experts in Responsible Investment Solutions)
Virginia Jennings	EIRIS
Keith L. Johnson	Reinhart Boerner Van Deuren s.c. (US)
Sean Kidney	Climate Bonds Initiative
Dean Krehmeyer	Business Ethics Council (US)
Matt Orsagh	CFA Institute (US)
Will Oulton	Mercer
Jonathon Porritt	Forum for the Future
Penny Shepherd	UKSIF
Ashley Taylor	Friends Provident Foundation
Raj Thamotheram	AXA Investments
Danielle Walker Palmour	Friends Provident Foundation
Steve Waygood	Aviva Investors
Allen White	Global Reporting Initiative, Tellus Institute (US)
Simon Wong	Governance for Owners

Many experts also gave us very valuable feedback on the recommendations as they developed, particularly Stephen Hine from EIRIS who provided comments and suggestions at several stages in the project.

Through our Better Decisions, Real Value project we have also discussed these issues (particularly relating to area of focus 1) with:

Roger Seabrook	Unilever
Catherine Nash	BT
Jessica Fries	Accounting for Sustainability

Experts who participated in our round-table meeting in January 2011

As well as testing the research findings and recommendations through these discussions, we also organised a round-table meeting in collaboration with UKSIF and the Aldersgate Group. This involved 20 representatives from business and the investment community. Appendix II shows the key themes from this meeting.

Participant	*Organisation*
Richard Burrett	Earth Capital Partners
Alice Chapple	Forum for the Future
Peter Cooper	Hammerson
Ruth Curran	Forum for the Future
Frank Curtiss	rpmi-RailPen Investment
Victoria Fleming-Williams	Aldersgate Group
Phineas Glover	The Co-operative Asset Management
Tim Goodman	Hermes EOS
Matthew Hale	Bank of America Merrill Lynch
David Harris	FTSE Group
Emma Howard-Boyd	Jupiter Asset Management
Alexis Krajeski	F&C Investments
Caroline McCarthy-Stout	Kingfisher
Jonathon Porritt	Forum for the Future
Andrew Raingold	Aldersgate Group
Penny Shepherd	UKSIF
Andrew Slight	PepsiCo
Ivar Smits	AkzoNobel
Nicholas Tott	Herbert Smith
Ariane Van de Ven	O2
Sarah Wilson	Manifest
Peter Young	Aldersgate Group

Appendix II
Summary of themes from expert round-table meeting

This appendix captures the key themes emerging from our round-table meeting for the BIS consultation on 'A long-term focus for corporate Britain'. It also suggests a number of interventions that the UK Government could make.

On 12 January 2011 Forum for the Future, UKSIF and the Aldersgate Group convened a round-table meeting with senior-level representatives from investment institutions and large (mainly FTSE 100) businesses to debate issues covered by the BIS consultation.

The points expressed in this appendix reflect the individual views of the participants and are not necessarily shared by any of the organisations attending or hosting.

1 Strengthen tax incentives for long-term holding

- There seems to have been a move away from incentives for longer-term holding through differing rates of capital gains tax in the recent past, and we should understand why.
- Where the investment is through a fund, we need to distinguish properly between incentivising an individual investor to invest for the long term, and incentivising the fund manager to make longer-term investments in the underlying assets. Incentivising the individual investor won't change the investment strategy.
- Loyalty dividends would be interesting but have created legal problems when some companies have tried to introduce them.
- We are not necessarily trying to make people hold for longer. We are trying to redirect the economy to invest in key areas. This could be incentivised in other ways.
- You need a crude financial incentive so that the short-term disbenefit of not playing the market on a day-to-day basis is rewarded in the longer term.
- It may be difficult in practice for a company to track exactly who its shareholders are.
- Equity finance is disadvantaged in tax, and this has prompted a move towards other assets.

2 Take care on interventions to slow down the number or frequency of transactions

- Given that UK institutional investors only represent a minority of the investors in the UK, a significant transaction tax could risk sending capital elsewhere.
- You need to include externalities in trades so that the incentives to trade are different. Trading is not a bad thing if you've taken into account all the relevant factors.
- In some emerging markets, policies to introduce transactions taxes have resulted in a flow of capital out of the market.
- Incentives for long-term holding may be a better route.

3 Undertake a wholesale review of the structure of mandates and the operation of performance appraisal within them

- It is difficult for asset managers to make investments in long-term propositions that show lower short-term returns than the alternatives, because they are reporting to clients on a quarterly basis.
- We need longer-term mandates with strong get-out clauses, benchmarked against growth in GDP and fundamentals rather than an index.
- The way pension funds have been regulated has contributed to short-termism in the market. The minimum funding requirement for pension schemes introduced in the 1995 Pensions Act was well intentioned but had a completely perverse effect.
- There is too much emphasis on the form that mandates take and not enough on the substance. For example, pension funds ask fund managers for detailed disclosure on how they are approaching sustainability and claim to support that approach, but behave very differently in their practical decisions about mandates.
- Asset managers are not incentivised to control transaction costs because they don't bear them, so these costs nibble away at performance. Pension funds need to be much more robust about their questions on transaction costs.

4 Require greater disclosure by pension funds on how they are engaged in long-term thinking

- Support the development of ratings/metrics to assess the performance of pension funds in this area.

- The way the investment chain works, and the relationship and reporting between asset owner and asset manager, create a focus on returns instead of on strategy. The amendment to the Pension Act in 2000 [to require disclosure on management of social and environmental issues] was a positive move towards addressing this problem, but more is needed.

- It would help to have better information on the age profile of pension funds. Working with future beneficiaries on long-term issues will be more effective in pension funds with younger members than for those already in pay-out mode.

5 Create policy certainty

- The regulatory framework favours the laggards rather than the leaders. In all areas – in carbon accounting, for example, and planning requirements – investors need credible long-term policy frameworks.

- There has to be a much clearer policy direction so that companies and asset managers have confidence to invest in key areas. We have an enormous separation between sustainability risk and financial risk, and this has been compounded by a host of poor decisions by government that make regulatory risk huge.

- Corporate Britain has to work in a highly political environment and the political horizon is very short, so politics is always changing the ground rules. There is a paradox in asking businesses to take a longer term view when the fundamental ground rules change so rapidly.

- Coal India recently floated quite successfully and this caused a hubbub, whereas there was less appetite for Enel's Green Power flotation. But this is not surprising given the regulatory signals. Markets take into account the factors that are there.

- Further policies on pricing externalities are needed. The UK Government started the process on carbon, and the floor price for carbon will help. But it's really only just started. If you look at other resources we've only just scratched the surface, so more research is needed.

- The UK Government will need to encourage an international approach to addressing these issues.

6 Walk the talk on procurement and public sector pensions

- Government has to procure sustainably so that this drives more investment in sustainable companies.

- Government could send some clear signals about how pension funds can be managed for the long term, through the way in which it requires its own pension funds to be managed.

7 Require more strategic and longer-term thinking in company reporting

- The primary focus for company reporting should be on strategy, not on returns.
- At the moment there is very little focus on how a company is investing for long-term sustainability, and investors tend to give very little credit for this kind of investment.
- There should be greater disclosure on how five-year plans fit into a sustainable future.
- The current culture is such that even in the context of a discussion on long-term trends, the focus reverts to the present.
- There is work going on in the House of Lords about the role of audit, and this could be an important area of focus.
- Companies need to have more resources for long-term thinking or have a platform to enable them to share future insights across markets, so that there is more momentum around longer-term thinking.
- There is still a disconnection between sustainable investment and mainstream investment. Some companies are beginning to present their sustainability information in a way that interests mainstream investors, and more work is needed in that area.
- It would be valuable to assess how investors would rethink their fiduciary duty if companies were being held in perpetuity. This long-term strategic view from investors could then be reflected in their approach to returns and company engagement.
- Long-term, sustainability-related KPIs need to be included in the remuneration of directors.

8 Consider institutional decision-making structures in government

- The UK Government could review and learn from the structure of ministerial responsibilities in other governments that have successfully adopted a more long-term approach. For example, in Australia the links between pensions and business are closer as pensions, company law and Treasury all sit within one government department.
- There is a need to make sure that responses on the many government consultations (e.g. environmental taxation, disclosure) are tied together and coherent, both in submissions and in the Government's response.
- Past and future policies need to be reviewed to assess their impact on long-termism. Several drivers of the current short-termism are the unintended consequences of

otherwise desirable past policies – on pensions, for example. Policies like these should be reviewed to identify where this has occurred and what could be done to address this.

9 Contribute to a better narrative/cultural shift

- Tell a better story about the relevance of longer-termism to our wealth and well-being.
- Tell a better story about the relative importance of liquidity and stability, and the trade-offs between them.
- We have a psychological problem in that investors feel they are expected to make deals and behave as 'gamblers', and there is a cultural bias against longer-term strategies.

10 Provide support for collaboration on measuring and managing long-term risks

- It's becoming harder and harder for people to think in the long term because they know that unexpected events (or 'black swans') can happen anywhere, at any time. They focus on the short term because it is easier to predict and control.
- One powerful way to incentivise people for longer-term holding is to demonstrate that this does generate more robust and stable returns for investors. This can only be done by focusing more on fundamental long-term systemic risks. Government could help with research.
- There are unforeseen risks associated with the management of issues such as climate change and with the depletion of water, biodiversity and other resources. More research is needed in this area.
- Better assessment of long-term risks, and research into different ways of valuing them, would help in the integration of financial and sustainability agendas. For this reason such assessment and research merits government support.

Appendix III
Summary of recommendations from other reports

The following table summarises some of the key recommendations made within the reports referred to in Chapter 4.

Table 8
Recommendations made by other organisations on long-term thinking

Organisation	*Recommendations*	*Aimed at which group*
CFA Institute Centre for Financial Market Integrity/ Business Roundtable Institute for Corporate Ethics	Corporate leaders, asset managers, investors, and analysts should: 1 **Reform earnings guidance practices:** all groups should reconsider the benefits and consequences of providing and relying upon focused, quarterly earnings guidance and each group's involvement in the 'earnings guidance game'. 2 **Develop long-term incentives** across the board: compensation for corporate executives and asset managers should be structured to achieve long-term strategic and value-creation goals. 3 **Demonstrate leadership** in shifting the focus to long-term value creation. 4 **Improve communications and transparency:** more meaningful, and potentially more frequent, communications about company strategy and long-term value drivers can lessen the financial community's dependence on earnings guidance. 5 **Promote broad education of all market participants** about the benefits of long-term thinking and the costs of short-term thinking.	Corporate leaders, asset managers, investors and analysts (from a United States perspective)

Organisation	*Recommendations*	*Aimed at which group*
Aspen Institute (from its 2009 report, *Overcoming Short-Termism*)	**1 Market incentives: Encourage more patient capital** By enlisting natural market forces and establishing incentives for market players to modify their respective behaviours, the following recommendations encourage patient capital, discourage investor 'churning', and generally reinforce society's long-term goals: ■ Revise capital gains tax provisions or implement an excise tax in ways that are designed to discourage excessive share trading and encourage longer-term share ownership. Capital gains tax rates might be set on a descending scale, based on the number of years a security is held. An excise tax could be imposed that would also allow for the inclusion of tax-exempt and other investment entities. ■ Remove limitations on capital loss deductibility for very long-term holdings, currently capped at $3,000 per year for losses related to holdings of any duration. ■ In exchange for enhancing shareholder participation rights, consider adopting minimum holding periods or time-based vesting, along the lines of the one-year holding period required under the SEC proxy access proposal currently under review.	Policy-makers
	2 Fiduciary duty: Better align the interests of financial intermediaries and their investors It will be a considerable challenge to address the misalignment between the interests of the ultimate investors/beneficiaries and society in the long run and the incentives and perceived and the incentives and perceived duties of the institutional investor community and	Policy-makers, regulators and investors

Organisation	*Recommendations*	*Aimed at which group*
	other financial intermediaries. Improved alignment might be accomplished through the clarification of existing federal laws and regulations, or the creation of new ones. This might include the following: ■ Apply a higher degree of accountability and enhanced fiduciary duties to financial intermediaries, by requiring increased disclosures on compensation, incentives, trading, policies on proxy voting and other matters that help quantify compatibility (or lack thereof) with the fund's stated objectives, and with the goals of the ultimate beneficiaries. ■ Modify ERISA allowable investment practices through rule changes to promote long-term investing by those investors holding equity in tax-advantaged accounts. ■ Ensure (through clearer and more rigorously enforced fiduciary duties) that investment advisers of all types take into account, and clearly inform investors of, tax and other implications of changes made to encourage long-term holding as recommended herein. ■ Pursue regulation or policy to base the compensation of long-term oriented fund managers on the fund's long-term performance. ■ Extend to such funds the compensation disclosure requirements that are currently applicable to operating companies.	
	3 Transparency: Strengthen investor disclosures The final leverage point, greater transparency in investor disclosures, can also play an important role in helping corporations maintain a long-term orientation. The advent of increasingly complex non-traditional structured and derivative	Policy-makers, regulators and investors

Organisation	Recommendations	Aimed at which group
	arrangements has enabled some investors to influence corporate decision-making without being subject to duties to disclose the existence or nature of their positions or their plans. This lack of transparency undermines the efficacy of the disclosure regime and creates opportunities for investors to use their influence to achieve short-term gains at the expense of long-term value creation. Updated disclosure rules that take into account these complex but increasingly common arrangements can play a significant role in helping corporations maintain a long-term orientation by encouraging investment behaviour consistent with longer-term value creation and providing corporate decision-makers with a better understanding of the corporation's shareholders and their motivations.	
FairPensions (*Protecting Our Best Interests*, 2011)	Recommendations for Government: ■ Conduct a fundamental cross-departmental review of investors' fiduciary obligations, both to ensure that this valuable concept remains relevant in the twenty-first century, and to step back and reconsider whether the law is fulfilling its purpose of protecting beneficiaries. The goal should be to achieve enlightened fiduciary standards of care over all private pension savings and other long-term savings. ■ Establish a cross-departmental group to carry forward the outcomes of this review and to act as a focal point for institutional investment issues within government. ■ In particular, the review should consider: □ whether the existing legal framework is equipped to deal with the problem of systemic risk; □ whether new law or guidance might be needed to ensure that trustees feel	Government The report also makes further recommendations for the UK's Department for Work and Pensions (DWP) the Department for Business, Innovation and Skills (BIS) and regulatory bodies

Organisation	*Recommendations*	*Aimed at which group*
	free to take account of systemic issues with implications for their members; □ the legal obligations that apply to contract-based pension providers, with the aim of ensuring that standards of care and accountability mechanisms are consistent across the market.	
	Recommendations for all pension providers: ■ Offer an ethical option based on an assessment of members' ethical preferences. ■ Consult with members and encourage and welcome member engagement, including by providing full and open disclosures on their investment policies and practices.	Pension providers
	■ Consider how to embed appropriate incentives in contracts with asset managers – for instance, by incorporating longer-term performance measures on a wider range of factors than benchmark relative financial performance.	Pension providers
	Recommendations for trustees: ■ Seek to avoid and manage conflicts of interest not just within the trustee board itself, but also among their service providers. In particular, funds should request information regarding the policies their asset managers and consultants have in place to ensure that specific relevant conflicts are properly managed. ■ When asked by members to consider an ethical issue, perform an analysis of its effect on their portfolio, in line with the 'ethical tie break' principle. Currently many funds wrongly invoke fiduciary duty to justify a refusal even to consider a non-financial issue.	Pension fund trustees

Organisation	*Recommendations*	*Aimed at which group*
Simon Wong (from the paper 'Why stewardship is proving elusive for institutional investors', 2010)	This paper details a number of potential remedies that could help to provide a more conducive setting for stewardship: **1 Eliminate unnecessary intermediation and strengthen internal capabilities** Asset owners should strive to eliminate unnecessary links in the ownership chain and boost in-house expertise. Where possible, pension funds and other long-term asset owners should also strengthen internal capabilities. **2 Revamp performance metrics and other arrangements** Where outside fund managers are retained, asset owners should put in place arrangements – pertaining to such matters as performance evaluation, fee structure and portfolio turnover – that encourage long-term thinking and active ownership by investment managers. **3 Rationalise portfolio holdings** To improve monitoring capabilities and alleviate free-rider issues, asset owners and asset managers should consider reducing the number of portfolio holdings. Concentration of holdings increases the incentive to monitor investee companies because a greater proportion of gains would accrue to the instigating investor. With fewer holdings in their portfolios, fund managers would be more able to undertake intensive engagements with investee companies, critical in such areas as evaluating board effectiveness where meaningful insights are gleaned through face-to-face meetings rather than scanning annual reports. **4 Re-orient the passive investing model** Asset owners and asset managers should work together to change the business model and governance approach of passive funds, so that stewardship is featured more prominently. How passive funds approach stewardship is highly significant given their present size and expected growth.	A range of groups including asset owners, asset managers and policy-makers

Organisation	*Recommendations*	*Aimed at which group*
	5 Clarify fiduciary duty Policymakers should clarify to asset owners and asset managers that discharging fiduciary obligations requires thorough examination of both short-term and long-term considerations. It is also important to stress that – when making investment and other important decisions – qualitative assessments could be as vital as quantitative data, especially when precise calculations cannot be made easily, such as regarding the value of a vote.	
Eurosif report *Remuneration*, 2010	Shareholders should engage with companies by: ■ voting against unacceptable remuneration packages and calling for and taking part in shareholder dialogue in determining remuneration policy; ■ requesting the detailed rationale behind actual remuneration packages and asking for the integration of ESG issues into short-term and long-term variable pay; ■ working with regulators to encourage a 'say on pay' vote. Regulators should promote active dialogue between companies and shareholders and wider stakeholders by: ■ legislating for a binding (or if not possible, an advisory) 'say on pay' vote; ■ setting appropriate guidelines to promote good remuneration practices and disclosure; ■ engaging with companies to promote detailed disclosure of remuneration policies and systems; ■ monitoring the remuneration practices of institutions where there is a significant government shareholding.	Shareholders and regulators

Organisation	*Recommendations*	*Aimed at which group*
Dominic Barton, from the paper 'Capitalism for the long term', 2011	In order to 'shift from quarterly capitalism to what might be referred to as long-term capitalism' this paper recommends three essential elements: ■ Business and finance must jettison their short-term orientation and revamp incentives and structures in order to focus their organisations in the long term. ■ Executives must infuse their organisations with the perspective that serving the interests of all major stakeholders – employees, suppliers, customers, creditors, communities, the environment – is not at odds with the goal of maximising corporate value. On the contrary, it is essential to achieving that goal. ■ Public companies must cure the ills stemming from dispersed and disengaged ownership by bolstering boards' ability to govern like owners.	Leaders within business and finance

Appendix IV

Recommendations for pension funds

Priority of action	Who does this action involve?	Supporting action
Critical	Leading businesses	Businesses leading on sustainability could integrate long-term thinking into their mandates so that their investment portfolios are aligned with the transition to a sustainable economy. This would increase the demand for pension fund trustees and managers to integrate sustainability into their investment decisions, and through the investment chain.
Critical	Pension fund trustees and managers	Practical initiatives to help pension fund trustees to integrate sustainability considerations into their practical decisions about mandates and ask better questions on long-term approaches. Pilot projects can explore ways to help pension fund trustees and managers to integrate sustainability into their decision-making. This could be done through a 'nudge' approach, requiring pension funds to include long-term considerations in standard items, or could involve training and engagement. It could also involve less frequent reviews of performance. Examples of potentially useful actions include: ■ encouraging conversations between companies and pension fund managers; ■ guidance on how to integrate long-term thinking into decisions. This could involve larger pension funds sharing skills with smaller funds that may not have the necessary resources; ■ training for pension fund trustees and managers on how to integrate sustainability into their decisions.

		For example: ☐ training each year on areas such as megatrends; ☐ dialogue between trustees and sustainability experts within organisations. Initiatives such as these would establish precedents and best practice through trials in many organisations, which could then be shared more widely.
Critical	Government	Government could send some clear signals about how pension funds should be managed for the long term, through the way it requires its own pension funds to be managed.
Critical	Pension funds	Pension funds could ask for less frequent performance reviews. For example, one US public pension fund, having committed itself to a three-year investment, refused to meet the asset manager during the first year to discuss results, believing that a full review of performance should occur only after the second year.[19]
Critical	Pension fund community	More independent measures for assessment would support this. These could be independent assessments of how businesses perform, for example based on scenarios or tests of resilience. Also approaches such as the Asset Owners Disclosure project that provide the level of information needed on material risks.[20]
Important	Pension fund community	Research could give greater understanding of pension fund needs and attitudes. This recommendation may require research on the short-term or long-term liabilities within pension funds, for example the balance of people who may retire in two years' or in 40 years' time. It would also help to explore the attitudes of younger and older members.

19 corporatefinance.mckinsey.com/_downloads/knowledge/mckinsey_on_finance/MoF_Issue_37.pdf (accessed 18 February 2011)

20 www.responsible-investor.com/home/article/aodp/ (accessed 18 February 2011)

Important	Pension funds and regulators	Transparency from pension funds, for example: ■ Requiring greater disclosure by pension funds about how they are engaged in long-term thinking. Thoughts from the round-table meeting included the need for ratings or metrics to assess the performance of pension funds in this area. ■ More legal regulation for disclosure by pension funds (e.g. the amendment to the Pension Act in 2000).
Important	Pension fund community	Developing initiatives to bring together pensions system experts and practitioners within the finance sector. These discussions are important to share learning and approaches. For example, Long Finance events on pension issues.

Appendix V
Setting a framework of policy, regulation and taxation that supports longer-term investment

Through our research, we found that businesses can face a number of systemic barriers in taking these actions. A comment during the round-table event was that 'the regulatory framework favours the laggards rather than the leaders'. It has been difficult for individual businesses to take the lead without peer action or demand from investors. Reducing these barriers to long-term thinking may therefore require government support, through actions such as:

Government focus	Specific actions from government
Developing policies designed to support, encourage or mandate boards to communicate better with investors on their long-term strategy and how this addresses social and environmental sustainability. Policies are also needed to help ensure that there is less emphasis on short-term measures of performance.	Introducing mandatory carbon reporting would be a good example of this, helping to provide investors with clear and comparable information on corporate emissions. Policies could incorporate clearer guidelines for consistent communication and reporting on sustainability risks, and they could also include accounting approaches such as confidence accounting (as mentioned above). These aspects should be considered in the context of developing the requirements for corporate reporting and of rethinking the Operating and Financial Review.
This would be supported by clear long-term policy commitments that environmental and social externalities will be increasingly factored into costs.	Our project research showed that it is important to create market certainty around the benefits for sustainable businesses. One comment from the round-table meeting summarised this neatly: 'There's a paradox in asking businesses to take a longer term view when the fundamental ground rules change so rapidly.' The policy commitments needed will require a joined-up approach within government, and action to encourage an international response to sustainability issues.

Supporting companies in efforts to identify and value their dependencies and impacts on people and the environment. Ensuring that more effort is allocated to developing robust data, to benchmark company performance against peers and against scientific information.	This includes supporting research to understand, assess and assign a more realistic value to the natural capital that their operations depend on (water, fertile soil, stable climate, etc.), human capital (the skills and experience of employees) and social capital (customer loyalty and trust, support of various suppliers and local communities). Making this happen may require support for cross-sector initiatives to develop new measures of success for companies and to support financial analysts in the construction of new models.
In addition to policy action, government communication could also influence the debate within the business and investor community. There is a need to create expectations that successful companies and boards must focus on long-term issues.	This could include a clearer narrative on the relevance of long-term thinking to our wealth and well-being, and clear messages to emphasise that liquidity must not come at the expense of long-term stability. Government needs to help keep long-term risks (such as climate change) at the forefront of the debate, and encourage the development and application of research on future business risks and opportunities. Support is also needed with education and training that helps businesses to develop the skills needed to tackle these issues.
Government can also provide leadership, promote collaboration and encourage sharing of success.	Encouraging collaboration between businesses, investors and the insurance sector, to enhance understanding of long-term sustainability risks and opportunities. Raising awareness of existing best practice within the business and investor community on long-term thinking, and encouraging communication between businesses and investors on the mutual benefits of long-term value creation.

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