# Investing for the long term

**Dominic Barton, McKinsey's global managing director, and Mark Wiseman, president and CEO of Canada's largest pension fund, explain why big investors are crucial to ending the plague of short-termism.**

**Dominic Barton and Mark Wiseman**

The tension between "quarterly capitalism" and managing for the long term is growing sharper. In 2013, McKinsey and the Canada Pension Plan Investment Board (CPPIB) surveyed more than 1,000 board members and C-suite executives around the world to assess their progress in taking a longer-term approach to running their companies. The results are stark:

- Sixty-three percent of respondents said the pressure to generate strong short-term results had increased over the previous five years.

- Seventy-nine percent felt especially pressured to demonstrate strong financial performance over a period of just two years or less.

- Forty-four percent said they use a time horizon of less than three years in setting strategy—while seventy-three percent said they should use a time horizon of more than three years.

- Eighty-six percent declared that using a longer time horizon to make business decisions would positively affect corporate performance in a number of ways, including strengthening financial returns and increasing innovation.

What explains this persistent gap between knowing the right thing to do and actually doing it? About half of the executives surveyed said that the pressure to deliver strong short-term financial performance stemmed from their boards—but the board members made it clear that they were often just relaying increased short-term pressures from investors, including institutional shareholders.

That's why we have concluded that the single most realistic and effective way to move forward is to seek change in the investment strategies and approaches of the players who form the cornerstone of our capitalist system: the big asset owners, who today own 73 percent of the top 1,000 companies in the United States, versus 47 percent in 1973. In this article, we will briefly review the problems with short-termism and discuss practical approaches that investors are deploying to focus on the long term.

## Practical changes for institutional investors

With few exceptions, big investors are not taking a long-term approach in public markets. They do not routinely engage with corporate leaders to shape the company's long-range course. They use short-term investment strategies designed to track closely with benchmark indexes like the MSCI World Index. And they let their investment consultants pick external asset managers who focus mostly on short-term returns. To put it bluntly, they are not acting like owners.

The result has been that asset managers with a short-term focus are increasingly setting prices in public markets. They take a narrow view of a stock's value that is unlikely to lead to efficient pricing and collectively leads to herd behavior, excess volatility, and bubbles. Work by Andrew G. Haldane and Richard Davies of the Bank of England has shown that stock prices in the United Kingdom and the United States have historically overdiscounted future returns by 5 to 10 percent.

Avoiding the pressure for short-term results is a big reason why private-equity firms take public companies private. With that freedom, they can achieve better performance over time. Research, including an analysis by CPPIB, indicates that over the long term (and after adjustment for leverage and other factors), investing in private equity rather than comparable public securities yields annual aggregate returns that are 1.5 to 2 percent higher, even after substantial fees and carried interest are paid to private-equity firms. Other research pegs the private-equity performance premium even higher.

Short-termism undermines the ability of companies to invest and grow, which ought to concern investors. Those missed investments, in turn, have far-reaching consequences, including slower GDP growth, higher unemployment, and lower return on investment for savers. To reverse this destructive trend, we suggest four practical approaches for institutional investors serious about focusing more capital on the long term.

### Invest the portfolio after defining long-term objectives and risk appetite

Many asset owners will tell you they have a long-term perspective. Yet rarely does this philosophy permeate all the way down to individual investment decisions. To change that, the asset owner's board and CEO should start by defining exactly what they mean by long-term investing and what practical consequences they intend. The definition needs to include a multiyear time horizon for value creation. For example, Berkshire Hathaway uses the rolling five-year performance of the S&P 500 as its benchmark to signal its longer-term perspective.

Just as important as the time horizon is the appetite for risk. Short-term underperformance should be tolerated—indeed, it is expected—along the road to greater long-term value creation. Singapore's sovereign-wealth fund, GIC, maintains a 20-year horizon for value creation. Since the mid-2000s, it has pursued long-term growth by placing up to one-third of its investments in a range of public and private companies in volatile Asian markets. This has meant that during developed-market booms, its equity holdings have underperformed global equity indexes. While the board looks carefully at the reasons for those results, it tolerates such underperformance within an established risk appetite.

Next, management needs to ensure that the portfolio is actually invested in line with its stated time horizon and risk objectives. This will likely require allocating more capital to illiquid or "real" asset classes like infrastructure and real estate. It may also mean giving much more weight to strategies within a given asset class that focus on long-term value creation, such as "intrinsic value–based" public-equity strategies, rather than momentum-based ones. Since its inception in 1990, the Ontario Teachers' Pension Plan (OTPP) has been a leader in allocating capital to illiquid long-term asset classes as well as making direct investments in companies. Real assets, such as water utilities and retail and office buildings, account for 21 percent of OTPP's portfolio. Another believer in this approach is the Yale University endowment fund, which began a self-proclaimed "revolutionary shift" to nontraditional asset classes in the late 1980s. Today the fund has just over 31 percent of its portfolio in private equity and 19 percent in real estate.

Finally, asset owners need to make sure that both their internal investment professionals and their external fund managers are committed to this long-term investment horizon. The conventional "2 and 20" arrangement does little to reward fund managers for long-term investing skill. Annual cash payments still make up three-quarters of fund managers' compensation, according to a recent Ernst & Young survey. Yet, rather than simply reducing fixed management fees, encouraging a long-term outlook should be the focus. CPPIB has been experimenting with a range of novel approaches, including offering to lock up capital with public-equity investors for three years or more, paying low base fees but higher performance fees if careful analysis can tie results to truly superior managerial skill (rather than luck), and deferring a significant portion of performance-based cash payments while a longer-term track record builds.

## Unlock value through engagement and active ownership

The typical response of many asset owners to a failing corporate strategy or poor environmental, social, or governance practices is simply to sell the stock. Thankfully, a small but growing number of leading asset owners and asset managers have begun to act much more like private owners and managers who just happen to be operating in a public market. To create value, they engage with a company's executives—and stay engaged over time.

Such engagement falls along a spectrum, with varying levels of resources and commitment required. Investors with stakes of only 1 or 2 percent cannot go it alone as easily and need to act as necessary alongside other investors. Other investors may seek stakes of 10 percent or more with a deliberate strategy to win a board seat and work with management on long-term strategy. But all asset owners can find ways to engage, either individually or in small coalitions with other like-minded investors.

Some asset owners are large enough to engage on their own by dedicating capital to a relationship-investing strategy. This could involve taking a significant stake (10 to 25 percent) in a small number of public companies, expecting to hold those for a number of years, and working closely with the board of directors and management to optimize the company's direction. For smaller asset owners, independent funds like ValueAct Capital and Cevian Capital provide a way to pool their capital in order to influence the strategies of public companies. The partners in such a coalition can jointly interact with management without the fixed costs of developing an in-house team.

Engaging with companies on their long-term strategy can be highly effective even without acquiring a meaningful stake or adopting a distinct, formal investment strategy. The California Public Employees' Retirement System (Calpers) screens its investments to identify companies that have underperformed with respect to total stock returns and fallen short in some aspect of corporate governance. It puts these companies on its Focus List—originally a published list but now an internal document—and works with management and the board to institute changes in strategy or governance. Several studies have concluded that companies on the Focus List outperform peers. Interestingly, the companies Calpers worked with privately outperformed those named publicly, so from 2011 onward, Calpers has concentrated on private engagement.

Despite the evidence that active ownership is most effective when done behind the scenes, there will inevitably be times when public pressure needs to be applied to companies or public votes have to be taken. In such cases, asset owners with sufficient capacity should go well beyond following guidance from short term–oriented proxy advisory services. Instead, they should develop a network with like-minded peers, agree in advance on the people and principles that will guide their efforts, and thereby position themselves to respond to a potentially contentious issue with a company by quickly forming a microcoalition of willing large investors. That approach worked well recently for a microcoalition of owners alongside a long term–oriented hedge fund with stakes in Canadian Pacific.

## Demand long-term metrics from companies

Making long-term investment decisions is difficult without metrics that calibrate, even in a rough way, the long-term performance and health of companies. Focusing on metrics such as ten-year economic value added, R&D efficiency, patent pipelines, multiyear return on capital investments, and energy intensity of production is likely to give investors more useful information than generally accepted accounting principles in assessing a company's performance over the long haul. The specific measures will vary by industry sector, but they exist for every company.

Some companies already publish such metrics. Natura, a Brazilian cosmetics company, is pursuing a growth strategy that requires it to scale up its decentralized door-to-door sales force without losing quality. To help investors understand its performance on this key indicator, the company publishes data on sales-force turnover, training hours per employee, sales-force satisfaction, and salesperson willingness to recommend the role to a friend. Similarly, Puma, a sports lifestyle company, recognizes that its sector faces significant risks in its supply chain, and so it has published a rigorous analysis of its multiple tiers of suppliers to inform investors about its exposure to health and safety issues through subcontractors.

But at other companies, asset owners need to encourage management to shift time and energy away from issuing quarterly guidance and toward metrics that correspond to long-term value creation. In pursuing this end, they can work with industry coalitions that seek to foster wise investment, such as the Carbon Disclosure Project, the Sustainability Accounting Standards Board, the investor-driven International Integrated Reporting Council, and, most broadly, the Principles for Responsible Investment sponsored by the United Nations.

Asset owners must make it clear that their primary fiduciary duty is to use professional investing skill to deliver strong returns for beneficiaries over the long term, rather than to compete in horse races judged on short-term performance.

With those metrics in hand, investors need to act. After all, for several years, data sources including Bloomberg and MSCI have been offering at least some long-term metrics—employee turnover and greenhouse-gas intensity of earnings, for example—and uptake has been limited. To translate data into action, portfolio managers must insist that their own analysts get a better grasp on long-term metrics and that their asset managers, both internal and external, integrate them into their investment philosophy and their valuation models.

### Structure institutional governance to support a long-term approach

If asset owners are to do a better job of investing for the long term, they need to run their organizations in a way that supports and reinforces this. They must make it clear to themselves and others that their primary fiduciary duty is to use professional investing skill to deliver strong returns for beneficiaries over the long term, rather than to compete in horse races judged on short-term performance.

Executing that duty starts with setting high standards for the asset owner's board. The board must be independent and professional, with relevant governance expertise and a demonstrated commitment to a long-term investment philosophy. Board members need to have the competencies and time to be knowledgeable and engaged. For example, the New Zealand Superannuation Fund is overseen by a board of "guardians" selected for their experience, training, and expertise in the management of financial investments. The board operates at arm's length from the government and is limited to investing on what it calls "a prudent, commercial basis." The board is subject to a regular independent review of its performance. It publishes its progress in responding to the recommendations it receives. Two other exemplary models are the global charitable foundation Wellcome Trust and Yale University's endowment fund; each delegates strategic investment implementation to a committee of experienced professionals.

Professional oversight needs to be complemented by policies and mechanisms that reduce short-term pressures and promote long-term countercyclical performance. These could include automatic rebalancing systems to enforce the selling of equities during unsustainable booms, liquidity requirements to ensure there is cash available to take advantage of times of market distress, and an end to currency hedging to reduce the volatility of short-term performance. Such policies need to be agreed to in advance of market instability, because even the best-governed institutions may feel the heat during such periods.

A case in point is Norges Bank Investment Management (NBIM), which manages more than $800 billion in Norway's global government pension fund. In 2007, the Ministry of Finance and NBIM set a long-term goal to raise the equity content of the fund from 40 to 60 percent. That goal was immediately tested: when the financial crisis hit, NBIM lost over 40 percent of the value of its global equity portfolio, and it faced significant external pressure not to buy back into the falling market. Its strong governance, however, coupled with ample liquidity, allowed it to continue on its long-term path. In 2008, it allocated all $61 billion of its inflows, or 15 percent of the fund's value, to buying equities, and it made an equity return of 34 percent in the following year, outperforming the market. In the market decline of mid-2011, NBIM kept to its countercyclical strategy; by buying during the slide, it turned an equity loss of nearly 9 percent that year into an 18 percent return in 2012.

A final imperative for the boards and leadership of asset owners is to recognize the major benefits of scale. Larger pools of capital—more than $50 billion—create more opportunities to invest for the long term by opening up illiquid asset classes, making it cost effective to invest directly, and making it easier to build in-house engagement and active-ownership capabilities.

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The right place to start moving beyond the short-term mind-sets that still dominate today is with the people who provide the essential fuel for capitalism—the world's major asset owners. It is in their own interest and the interest of savers and society at large. By making change in the way we have described, large asset owners can be a powerful force for instituting the kind of balanced, long-term capitalism that ultimately benefits everyone.

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