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TERMISM: THE LONG AND SHORT OF IT

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Supported by CFA UK's Market Integrity and Professionalism Committee

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INTRODUCTION

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"Making sweeping statements about the virtues of long-termism and the vices of short-termism is a satisfying pastime...but it is a poor way of analysing the dynamics of wealth creation—and it is an even worse way of designing corporate policies."

(The Economist[1])

Termism is a philosophy that calls for long-term investment horizons – possibly incentivised by tax or regulatory measures – while criticising short-term investment horizons. There is considerable support for 'long-termism' – an increasing number of important, influential and informed individuals write or speak in its favour. CFA UK shares many of the broad concerns and views held by the group that call for a more 'long-term' approach, but suggests that it would be more constructive to frame the discussion around value generation rather than around time periods.

THE PURPOSE OF THIS PAPER

This paper suggests that the outcomes that 'long-termists' seek could be more effectively achieved by measures other than the imposition of specific holding period requirements. The key issue is value generation and how that can best be achieved – (and how the investment profession can contribute towards that) – rather than the time period over which that value is generated.

CFA UK advocates that there is no single optimal time horizon from an investment perspective. The time horizon(s) chosen by an asset owner and applied by an investment manager should appropriately reflect the stakeholder's preferences and requirements. The time horizon(s) is an outcome of a robust process rather than a driver of the process. CFA UK understands that we do not live in a world where market prices always reflect fundamental value. Company management can manipulate earnings, capital can be misallocated and risk can be mispriced . However, addressing these issues requires an approach that looks at the structural causes of these faults rather than focussing on the length of an investment's time horizon.

By improving the ability of company managers, asset owners and investment managers to generate value, the system should encourage efficient capital allocation.

[1]The Economist – Schumpeter: 'The tyranny of the long term. Let's not get carried away in bashing short-termism';Nov 22nd 2014 (print edition) http://www.economist.com/news/business/21633805-lets-not-get-carried-away-bashing-short-termism-tyranny-long-term

VALUE GENERATION

CFA UK understands the attraction of long-termism and sympathizes with the frustration expressed when companies increase dividends or announce buybacks apparently at the cost of opportunities to generate greater economic value through investment. Similarly, we share the disappointment felt when investment managers fail to take advantage of clients' ability to invest over long time horizons or direct their activities primarily to avoid generating performance too far from the benchmark.

However, we are concerned that 'long-termists' focus on 'term' rather than on 'value creation' misses the point and may also encourage sub-optimal policy decisions. We also believe that it is inappropriate to focus on public equity alone (as is typically the case), rather on the full range of asset classes through which capital can be invested.

Corporate management, asset owners and investment managers have a common goal to allocate capital efficiently. Each should have appropriate and effective governance mechanisms to ensure that they are aligned with this aim. In addition, there also needs to be an effective regulatory environment with the same aim.

By requiring long-term investment approaches, it is proposed that we can reduce the costs and mitigate the risks related to the types of unwelcome behaviour non-exhaustively listed below:

» Buying high, selling low - chasing returns or allocating capital to last year's 'winners'.

» Asset owners and investment managers deviating from their investment strategy without good cause.

» Company management using techniques to mask the poor economic health of their organisation.

» Wealth and portfolio managers window dressing portfolios by purchasing recent risers and selling recent losers.

While the frequency of these behaviours might be diminished by requiring or encouraging longer holding periods, the root causes themselves will not be addressed.

The inverse is also true. The powerful benefits ascribed to long-termism (see list below) are also available through a focus on structural issues that would enhance value generation across all time periods.

1) Focuses on the quality of the business and on developments likely to affect it.

2) Controls portfolio turnover and costs.

3) Enhances stewardship.

4) Generates sustainable returns for investors.

5) Improves the systemic governance of the financial and economic system

CORPORATE MANAGEMENT

Companies generate value when they generate returns on capital (equity and non-equity) that equal or exceed the cost of capital. Metrics that are commonly associated with company success such as profit growth, earnings per share, return on equity etc. have been shown to have a weak relationship with value generation[2]. The longevity of a company will depend on its ability to at least cover its cost of capital over time. Hence, it is essential that companies focus on economic not accounting profits.

Earnings have a weak link with value generation, yet this metric continues to provide a focal point for market participants and commentators. There is a long and shameful list of companies whose senior management has gone to great trouble to distort their accounts so as to convey a misleading picture, though the companies on this list still represent a small minority of the corporate universe. Schilit[3] has identified multiple forms of "financial shenanigans"; practices that corporate managers use to provide (in most cases) a positive representation of the company's financial performance and position. The desire to manage earnings in this way is not a new phenomenon as Warren Buffet observed recently -

[2] 'Measuring and rewarding performance: theory and evidence in relation to executive compensation', CFA UK, Professional Investor, December 2014.
[3] Schilit, Howard M. "Financial Shenanigans: Detecting Accounting Gimmicks That Destroy Investments," (corrected November 2010) CFA Institute Conference Proceedings Quarterly, (Dec 2010): 67-74

"Wall Street's love affair with this hocus-pocus intensified as the 1960s rolled by. The Street's denizens are always ready to suspend disbelief when dubious maneuvers are used to manufacture rising per-share earnings[4]."

(Warren Buffet 2014 Letter to Shareholders)

Corporate executives often blame the financial market (investors) for pressuring them to make short-term decision in order to meet short-term earnings targets. However, their concerns appear somewhat misplaced. In a recent CFA UK member survey, 55% of respondents indicated that they have an investment time horizon of three years or more, while 31% opted for a year and just 14% reported an investment horizon of less than one year. Setting and meeting short-term earnings targets is an important way that corporate management can build and hold the trust of its investors, but investors understand that companies should seek to maximise value over an appropriate term, not necessarily the short-term.

it is important to bear in mind that earnings-related metrics play a key role in the remuneration of senior corporate executives. So, is corporate management's fixation on earnings driven by the market or by the remuneration of the executive? While not all the blame can be placed at the hands of the market, the 'market' has to bear some responsibility. After all, financial history is littered with instances when the markets get it wrong, though it is notable that the market is much more prone to over-price securities (thus inflating bubbles that are then burst) than it is to excessively under-pricing them. Railroad stocks in the late 19th century; airlines in the 1960s; telecoms, media and technology (TMT) stocks in the late 1990s are all good examples where the market has, arguably, taken too long-term or optimistic a view of a sector's prospects; as are the 1990s junk bond bubble in the US or the widespread real estate bubbles that preceded the 2008 global financial crisis.

According to a senior investment practitioner Michael Mauboussin[5], free cash flows to the firm (FCFF) should be the basis for any valuation. Mauboussin prefers FCFF to earnings because as Mauboussin states, 'in reality, EPS (earnings per share) tells very little about value because EPS does not explicitly take into account capital intensity'. Reported earnings (composed of cash and accruals) uses information only from the income statement. In other words, two businesses can have the same EPS growth rates but different returns on capital; therefore, they will have, quite understandably, different valuations. (Mauboussin).

The distinction between earnings and FCFF is a crucial one to understand. It indicates that a company can grow earnings as much and as fast as it likes, but if it does not cover the cost of capital, it is destroying value just as fast as it grows earnings. This is further demonstrated by Mauboussin in Table 1, which demonstrates how to understand the direction of the relationship between the return on invested capital (ROIC) and earnings. The information is based on an all equity financed company to make the analysis more accessible.

[4] *Berkshire Hathaway Inc Letter to Shareholders 2014 http://www.berkshirehathaway.com/letters/2014ltr.pdf*
[5] *Mauboussin ,Michael J. "Expectations Investing: Reading Stock Prices for Better Returns," CFA Institute Conference Proceedings Quarterly, (Sep 2006): 61-70*

TABLE 1 P/E MULTIPLES AND THE RETURN ON INVESTED CAPITAL

Table 1 presents three essential observations about valuation as a multiple of a company's earnings –

Earnings Growth	ROIC			
	4%	8%	16%	24%
4%	6.1x	12.5x	15.7x	16.7x
6	1.3	12.5	18.1	20.0
8	NM	12.5	25.5	29.9
10	NM	12.5	25.5	29.9

NM=not meaningful

Note: Assumes all equity financed; 8 percent WACC; 20-year forcast period.

» The P/E multiple should be maintained as long as the company covers its cost of capital regardless of the growth rate of earnings.

» The P/E multiple should decline if a company does not cover its cost of capital.

» The P/E multiple should increase if the company earns a return greater than its cost of capital.

However, this does not imply that rising P/E multiples necessarily indicate that companies are generating returns in excess of the cost of capital. They may simply reflect falling earnings that are not yet reflected in the price. As equity markets have demonstrated on a regular basis, sentiment can diverge dramatically from fundamentals. Rising P/E multiples should be supported by returns in excess of the cost of capital. Companies that make accounting profits while making economic losses are not delivering value.

When companies destroy value and do not face market discipline there are governance and/or market integrity failures. Similarly, when companies engage in financial shenanigans, we also have corporate governance, market and regulatory failures.

ASSET OWNERS

Asset owners seek to maximise the risk-adjusted returns (net of fees) from their entire portfolio not just the equity allocation. Retail or institutional asset owners can have a variety of time horizons to meet their short, medium and long term goals. These goals can vary between asset owners and are determined by their objectives, preferences, risk appetites and capacity for loss. Based on the asset owner's requirements the portfolio can consist of a variety of investment approaches that can include low turnover strategies with long-term investment holding periods and high turnover short-term strategies. The key is how these investments are combined to align with the asset owner's needs. The asset owner can then determine which combination is most appropriate for the total portfolio to deliver the expected net benefits.

Asset owners are likely to own portfolios that include asset managers with longer-term horizons and low turnover strategies and asset managers that use higher turnover strategies and short-term horizons. For example, large endowment funds invest in hedge funds as well as private equity in addition to publicly traded debt and equity securities.

In a world where asset owners are diverse, have a variety of goals, objectives and preferences, using a one size fits all approach would be against the interests of the ultimate beneficiary. Asset owners may have several investment horizons that take into account different objectives that have to be met in the short, medium and long terms. Similarly, how these time horizons are defined will vary from client to client. CFA UK believes that there should be no single definition of the time horizon and that there is no optimal investment holding period. Asset owner preferences will also have a significant influence on their investment horizons and how the portfolio will be constructed.

Consideration should also be given to goals-based metrics[6], which are adopted by the most forward thinking private sector schemes. The metrics used to measure success are defined for the short, medium and long term goals. Having a goals-based approach can ensure that each scheme has the ultimate beneficiary and stakeholders in mind; all those involved have a set of clear consistent objectives that can be continued regardless of changes in decision-making personnel. This means that the portfolio has to be constructed to take into account these goals and the diversity of time horizons. Furthermore, asset owners can state their preferences regarding the constituents of their portfolios and may decide to include some types of strategies and exclude others. These portfolios may not always be optimal but will align with the beneficiaries' preferences.

As described in CFA Institute's September 2013 paper on long-term financing[7], asset owners may 'find long-term investment opportunities attractive in view of the typically long-term nature of their liabilities. Insurance companies or pension funds with long-lived obligations to pay well in the future need not necessarily insist on investment opportunities that offer immediate liquidity or indeed immediate returns, and may find advantage to closer alignment of their asset-liability structure. In this regard, such investors can be 'patient' and counter-cyclical as needed.

Although institutional investors are likely to have long-term horizons that are consistent with the longer-term nature of their liability structure, it remains common practice to evaluate the performance of the investment managers retained to manage assets on their behalf on much shorter time horizons — sometimes as short as quarterly.

70% of CFA Institute members surveyed in advance of the CFA Institute paper's publication cited 'performance evaluation based on short periods' as a barrier to investment in long-term assets. Both asset owners and investment managers should be encouraged as a matter of best practice to discuss appropriate evaluation periods and relation to liability structures and potential constraints on the selection of assets; the resulting policy should be recorded in an investment policy statement for ready reference by both parties.

[6] *Client Goal–Based Performance Analysis, Stephen Campisi, CFA; CFA Institute Conference Proceedings Quarterly March 2011, Vol. 28, No. 1: 32–41 http://www.cfapubs.org/doi/abs/10.2469/cp.v28.n1.1*

[7] *Long-term financing: investor perspectives in Europe. CFA Institute, September 2013 http://www.cfainstitute.org/ethics/Documents/ltf_issue_brief_final.pdf*

RISK MANAGEMENT AND SHORT-TERMISM

Asset owners care about performance but are more concerned with risk-adjusted performance or maximising the reward to risk ratio. Portfolios are constructed to align with asset owners' risk profile and capacity for loss, so it is essential that there is a robust risk management process in place to ensure that their portfolios are exposed to relevant levels of risk. One way to manage risk is portfolio rebalancing although such turnover can be perceived as short-termism. This is not short-termism or related to time horizons but the consequence of a disciplined approach to risk management. When the markets are volatile, rebalancing may be more frequent because it will be necessary. Not rebalancing the portfolio when required may be detrimental to the asset owner[8].

THE LONG-TERM NEEDS THE SHORT-TERM

"Goldman Sachs is an exceptional institution....It has an unrivalled global franchise, a proven and deep management team and the intellectual and financial capital to continue its track record of outperformance."

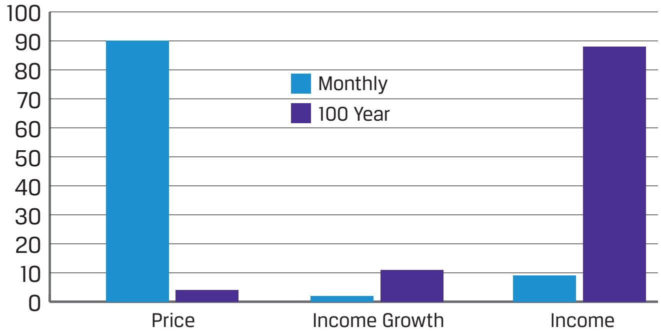
(Warren Buffett, Chairman and CEO of Berkshire Hathaway, Inc, 2008)[9]

Though supporters of long-termism are critical of short-term market movements, these provide valuable opportunities to investors with longer time horizons. A notable example is Warren Buffett's investment in Goldman Sachs during the height of the 2008 financial crisis. In essence, the long-term portfolio manager has to exercise judgement about whether or not to take advantage of a short-term market signal when it aligns with the manager's views on any of the portfolio holdings. In a journal article by Israelov and Katz (2011)[10], the authors state that long-term investors can improve the risk-adjusted returns (Sharpe ratio) net of costs of their portfolios by paying more attention to signals created by short-term activity. As Ben Graham wrote in the Intelligent Investor: 'Price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal.' He went on to add, 'At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies.'

Diversity in financial market participants is welcome as it enhances liquidity and the quality of the market. Some participants base their actions more on short-term movements in prices while others favour a long-term approach based on fundamental value.

Con Keating[11] demonstrated why there are opportunities for both types of participants. Chart 1 (Keating) shows that in the short-term price provides nearly all of the sources of real returns while income provides the source of real returns in the long-term.

THE LONG AND THE SHORT SOURCES OF REAL RETURNS



Source Professional Investor

[8] *CFA Level III Refresher Reading Portfolio Management Rebalancing frontier, rebalancing threshold, target allocation, portfolio drift*
[9] *BERKSHIRE HATHAWAY TO INVEST $5 BILLION IN GOLDMAN SACHS, September 23, 2008 http://www.goldmansachs.com/media-relations/press-releases/archived/2008/berkshire-hathaway-invest.html*
[10] *To Trade or Not to Trade? Informed Trading with Short-Term Signals for Long-Term Investors, Roni Israelov and Michael Katz, Financial Analysts Journal Volume 67 Number 5*
[11] *"Long-term investment, motherhood and apple pie", Con Keating, Professional Investor, Spring 2013*

Each type of participant is driven by a different set of objectives. The short-term participants are concerned with their position relative to others and may not want prices to reflect fundamental value. Instead they "may prefer distortions of this relation" (Keating). Long-term investors are likely to be less concerned about short-term movements in market prices and focused more on fundamental value. However, as Israelov and Katz's research shows, there is value in long-term managers being aware of and receptive to short-term signals. Their academic research backs up the views expressed privately by a number of long-term investors that they maintain a rigorous interest in short-term market movements as these permit them to take opportunities to express their long-term views.

It is also important to point out that some short-term participants – notably those that might short stocks in expectation of a short-term correction of a mispricing – perform a valuable service in terms of market efficiency. Similarly, long-term investors that hold onto a mispriced stock without seeking to address that mispricing through 'voice' or 'exit' are failing to act as good stewards. Unthinking investment supports mispricing just as momentum trading amplifies the over- and under-shooting of prices.

STEWARDSHIP

Where appropriate to the investment approach selected by the asset owner and agreed with the investment manager, asset owners should encourage the investment manager to engage with the investee company across strategic and governance issues to enhance value creation. Activist investors and others with material shareholdings in companies will have a greater incentive to engage than those with less material holdings

INVESTMENT MANAGERS

The investment manager universe is large and diverse. Investment managers invest in a variety of asset classes (equities, bonds, credit, real estate, commodities etc) using a variety of instruments and approaches that can have short, medium and long time horizons. Whichever asset class or approach is used, the ability to deliver net benefits to their clients should be based on a robust process that can resist the fads and fashions associated with investment trends. Just as there are investment managers that are successful using long-term approaches, there are also investment managers that have delivered net benefits to clients over long periods of time using short-term approaches. The purpose of investment management is to deliver to clients the net risk-adjusted returns that they seek over their appropriate time horizon(s).

Effective investment approaches require a combination of factors only one of which is the investment horizon. The appeal of an investment manager depends on the quality of its people, process and philosophy. A disciplined approach to risk management is also important, so that buy and sell decisions are made in a consistent and objective manner. Effective investment approaches can involve 'long' and 'short' holding periods, although the focus should be on the drivers for these holding periods rather than the holding periods themselves. Disciplined investment approaches may not always be in favour, but they are more likely to stand the test of time.

TABLE 2 - KEY CHARACTERISTICS OF SUCCESSFUL INVESTMENT MANAGERS[12]

Factor	
1	Intelligence
2	Knowledge
3	Focus
4	Long-term thinking
5	Independent thinking
6	Alignment of interests

Source: Manager Selection

Table 2 is a synopsis of views expressed by Warren Buffet, Jack Treynor and David Swensen. Research cited in 'Manager Selection' found that there is a combination of factors that mark out successful managers rather than one specific characteristic.

Essential to an effective investment approach is risk management, which is likely to result in portfolio turnover. All too often portfolio turnover is mischaracterised as evidence of short-termism. Ensuring that the portfolio provides adequate risk exposure is vital to generating returns for investors in a variety of market and economic conditions. Having an objective process that can determine buy and sell decisions is vital if the asset manager is to avoid the behavioural trap of the disposition effect (the tendency to hold onto losing positions while exiting profitable ones too early).

[12] 'Manager Selection', Scott D. Stewart, CFA, Research Foundation Publications, December 2013 Vol. 2013 No. 4 132 pages; Research Foundation of CFA Institute http://www.cfainstitute.org/learning/products/publications/rf/Pages/rf.v2013.n4.1.aspx?WPID=AlsoViewedProducts

DEFINING 'SHORT-TERM' AND 'LONG-TERM'

One of the difficulties of emphasizing the long-term, rather than focusing on value generation across time, lies in defining something that is inherently a subjective. Chart 2 provides an overview of the how the 'long-term' is regarded by different entities. Family offices and sovereign wealth funds have time horizons that are in perpetuity while life insurers have a liability profile of seven to 15 years. Someone starting out in their working life and saving for a pension would probably have a long-term horizon of 40 years; a period which for an endowment could be considered short-term.

THE LONG-TERM INVESTOR MATRIX'

Ability to invest long-term	**Institution**	**Estimated AUM (US$ trillions)**	**Key Stakeholders**	**Liability profile**	**Risk appetite**	**Decision-making structure/ agency concerns**	**Estimated allocation to illiquid investments**
	Family offices	$1.2	Family	In perpetuity	High	Low	35%
	Endowments/ Foundations	$1.3	Non-profit beneficiaries	In perpetuity with yearly payout requirement	High	Low	20%
	Sovereign wealth funds	$3.1	Governments/ Nations	In perpetuity	Moderate	Moderate	10%
	Defined benefit pension funds	$11	Members/ Shareholders	Average duration 12-15 yrs	Low	High	9%
	Life insurers (general account)	$11	Policyholders/ Shareholders	Average duration 7-15 yrs	Low	High	4%

Positive for long-term investing | Moderate for long-term investing | Negative for long-term investing

Source: Celent, NACUBO, The Foundation Center, SWF Institute, OECD, US Federal Reserve Flow of Funds, CEA, Wharton Global Family Alliance, The Monitor Group, Mercer Capital IQ, Corporate annual reports, Oliver Wyman analysis.

Source World Economic Forum, The Wellcome Trust

Finding evidence to attack short-termism is also challenging. As the box below highlights making inferences from equity market turnover to measure holding periods is usually a poor approach.

BOX: ILLUSTRATION FOR CALCULATING HOLDING PERIODS

Holding periods are frequently calculated based on market capitalisation and turnover, with a derived figure of, say, three or four months erroneously used to argue that investment managers are short termist. CFA UK has previously[13] noted that the assertion that the "average holding period" of large capitalisation UK equities is of the order of one year or less, is incorrect.

Consider the following hypothetical example. Assume that there are only two classes of investor, types A and B, in the market. Assume that investors of type A own 20% of the outstanding equity of all companies and hold shares for 20 years on average and that investors of type B own the remaining 80% of equities and hold shares for 3 months on average. Clearly the average holding period will be (0.2 X 20) + (0.8 X ¼) years....4.2 years. Fallacious commentators, however, will observe that every year the total market experiences turnover of 20% of 5% plus 80% of 400% which is 321% from which they will wrongly deduce that the average holding period is less than 4 months as opposed to the correct figure of 4.2 years.

Stakeholder impatience and indiscipline can result in value destroying decisions based on short-term signals. The key to understanding short-term signals is that they provide information; these signals need to be assessed in an objective manner rather than reacted to in value destroying ways. Similarly, investors may ignore short-term signals and find that their failure to incorporate that information could be equally value destroying. Investors unwilling to cut their losses can become ultra-long-term holders of low quality assets that eventually have no value. How many Kodak investors held on for too long? How many Northern Rock investors threw good money after bad? Long-term investors are not infallible as Warren Buffet learned with his investment in Tesco.

Berkshire Hathaway had been invested in Tesco since 2006 and its stake was raised to more than 5% after the company's profit warning in 2012. However, more recently the holding has been sold on the back of concerns about the quality of the company's financial statements. The divestment reflects the reality that sometimes, even for long-term investors, it is preferable to redeploy capital to more productive uses than to remain invested in businesses where the qualities of a 'business with excellent economics and able, honest management' may no longer hold.

In their paper of 2011, the Bank of England's Andy Haldane and Richard Davies took a different approach to trying to identify short-termism. They looked at the rate at which cashflows from investments were discounted and found that these were discounted increasingly highly as the term extended (myopic discounting). They also found that the rate with which cashflows were being overly discounted had increased in recent times.

One of their findings was that myopia differed across sectors. Whereas, investors had not discounted cashflows generated by companies in the financial sector, they had done so across health, materials and IT. Our interpretation of that finding is that investors' have less confidence in their ability to foresee the stability of cashflows from investments in sectors that are experiencing rapid innovation and disruption, than from finance (where the business model changes more slowly). Recent academic research (Farmer and Geanakoplos) suggests that where there is greater uncertainty about future discount rates, myopic discounting is more appropriate and even rational.

[13] CFA UK response to the Kay Review of UK Equity Markets December 2011 https://secure.cfauk.org/assets/2162/CFA_UK_response_to_the_UK_Equity_Market_Review_SENT.pdf

THE OBJECTIVES OF LONG-TERMISM

Those who promote a 'long-term' approach typically appear to be concerned about failures by companies, asset owners and investment managers to generate value.

Companies are thought to fail to invest appropriately – particularly in projects with a longer pay off period – either due to their own desire to generate short-term returns or to meet investors demands for short-term returns.

Asset owners are criticised for failing to use their ability to take a longer-term view (to match their long-term liabilities), for not engaging with the companies in which they invest (either directly or via investment managers that are instructed to do so) and for agreeing investment mandates that might have inappropriate performance evaluation periods and/or compensation structures that are not aligned to the mandate.

Investment managers are reckoned to be too shot-term in their analysis of companies, to be disinclined to agree compensation structures that align to value creation over the long-term as well as the short-term, to be too keen to justify their existence by amending portfolio holdings and for failing to invest in stewardship.

The purpose of this paper is not to consider each of these criticisms (some of which we might challenge; some of which we agree with wholeheartedly), but to consider whether the imposition (or incentivisation) of longer holding periods would address these perceived failures. CFA UK's position is that it would not and that other measures would contribute to improved value generation more effectively.

WHAT SHOULD BE DONE?

There are opportunities to improve value generation across the investment process.

At the corporate level, remuneration committees should consider balancing incentives based on share prices or earnings with incentives based on economic value generation. Companies should also put greater emphasis on measuring and communicating their long-term strategy, goals and value generation alongside the provision of the near-term progress towards those goals. The UK's Companies Act says that directors should 'promote the success of the company for the benefit of its members as a whole, and in doing so have regard to…the likely consequences of any decision in the long term'. It is important to recognise that definitions of long and short-term will be necessarily subjective. As pointed out earlier, the long-term for a company operating in a sector experiencing rapid innovation will be much shorter than that for a company whose operating environment is more stable and predictable.

Asset owners are the key. They determine the time horizon for their investment portfolios and have the ability to allocate and manage assets accordingly. They should identify the degree to which their portfolio can be managed long-term and then award investment mandates for those components that are long-term. They should appoint investment managers based on their track records over the appropriate term (accepting that this will be variable) and should study managers' people, process and philosophies to assess their ability to deliver over the appropriate term. They should engage with companies (and encourage their managers to engage with companies) to encourage value generation across appropriate terms and should ensure that their investment managers (internal and external) are aligned with their investment time horizons.

Investment managers are agents of the asset owners, but also manage significant sums for retail investors. Investment managers should develop their skills in analysing companies' ability to deliver long-term value and in investing over longer time periods – as well as short time periods – and more investment managers should consider developing products that take advantage of some investors' ability to allocate more capital over longer terms. Where they do so, they should select appropriate benchmarks and ensure that compensation structures align with those strategies. Where working directly for an asset owner, the investment manager should be careful to agree appropriate performance measures and performance measurement periods.

CONCLUSION

"The long run is a misleading guide to current affairs. In the long run we are all dead."

(John Maynard Keynes, A Tract on Monetary Reform,1923 Ch. 3)

Termism proposes that to improve value generation stakeholders need to take a long-term approach. While CFA UK sympathizes with the aims of those that support long-termism (and makes common cause against many aspects that are described as 'short-termist'), we believe that it is important to note that many drivers of value generation are not time dependent and should be practised consistently across short, medium and long timeframes.

In addition, it is important to recognise that value generation should not only be a concern with reference to equity capital, but across all forms of capital. It is also important to acknowledge that corporate management, asset owners and asset managers generate value in different ways. We need to understand these differences if we are to enhance these groups' ability to generate value for themselves and others.

Requiring a long-term approach will not alone address the structural challenges to improving value generation. It also risks creating new behaviours that would impede allocative efficiency. Rather than calling for an end to short-termism and the adoption of long-termism, it would be better to campaign for enhanced value generation through:

» A clearer understanding by asset owners about their own time horizons and objectives and the subsequent development of appropriate strategies;

» A clear understanding by investment managers' of clients' objectives and constraints, framed in a carefully worded – and jointly agreed – investment policy statement;

» The use of appropriate time horizons for evaluating investment managers' performance;

» Regulation that supports investment across appropriate time horizons;

» A corporate focus on economic value creation alongside accounting profits;

» A better understanding by all market participants of the importance of analysing cash flow returns on investment;

» Clearer communication between company management, capital providers and their agents about the company's objectives and their progress towards those; and

» The use of compensation structures (across companies, asset owners and investment managers) aligned to appropriate time horizons.

Addressing the issues that impede value generation requires a systemic approach involving all of the key stakeholders, but if we improve the value generated through the investment process, the rewards for each stakeholder group and for society as a whole may be significant.

APPENDIX

CFA UK MEMBERS' RESPONSIBILITIES

When it comes to agreeing investment horizons for clients, our members' responsibilities are clearly set out in the Code of Ethics and Professional Standards of Conduct. The relevant parts of our Code of Ethics are:

» Act with integrity, competence, diligence, respect, and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets.

» Place the integrity of the investment profession and the interests of clients above their own personal interests.

» Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.

» Promote the integrity of and uphold the rules governing capital markets.

STANDARD I PROFESSIONALISM

A. Knowledge of the Law. Members and Candidates must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organization, licensing agency, or professional association governing their professional activities. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.

B. Independence and Objectivity. Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another's independence and objectivity.

C. Misrepresentation. Members and Candidates must not knowingly make any misrepresentations relating to investment analysis, recommendations,, actions, or other professional activities.

STANDARD III DUTIES TO CLIENTS

A. Loyalty, Prudence, and Care. Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests.

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