COPING, SHIFTING, CHANGING 2.0

Corporate and investor strategies for managing market short-termism

UN GLOBAL COMPACT

PRI Principles for Responsible Investment

CONTENTS

INTRODUCTION

Companies that operate with a long-term outlook have consistently outperformed their industry peers since 2001 across almost every financial measure including revenue, earnings and job creation.[1] Similarly, strong corporate performance on environmental, social and governance (ESG) factors correlates positively with improved cost of capital and financial performance.[2] However, research shows that companies will forego efforts to create long-term value because of pressure to meet short-term objectives.[3]

Short-term pressure is an obstacle to creating a global financial system that supports long-term value creation and benefits the environment and society.[4] In 2015, 193 world leaders agreed upon 17 Sustainable Development Goals (SDGs), covering issues ranging from climate change to gender equality. The SDGs provide an opportunity for business leaders, investors and companies alike to re-think their approach to value creation,[5] serving as a blueprint for action in both capital and investment markets. However, excessive short-term pressure will hamper progress unless action is taken by both companies and investors.

The perceived investor emphasis on short-term financial performance creates pressure on companies to focus on short-term financial performance and pay less attention to fundamentals.[6] It can result in foregoing opportunities with a positive long-term net present value, including those that provide wider sustainability-related benefits. It can also affect how ESG factors are considered in strategy, capital expenditures and daily operations.[7] Consequently, companies may miss opportunities to: drive sustainability-related innovation; develop their human capital; expand to new markets; grow their customer base; create operational efficiencies; and effectively manage social and environmental business risks.

Investors themselves are also under considerable short-term performance pressures, with the benchmarking and evaluation of investment managers often based on one- and three-month timeframes.[8] Even those organisations with long-term investment time horizons often focus on quarterly or even monthly portfolio performance. Regulatory developments further influence short-term behaviours. Following the global financial crisis, for example, regulatory bodies began to place greater emphasis on short-term performance management and reporting, particularly in situations where pension funds have shortfalls against their liabilities.[9]

While it is important to recognise that there are diverse external and internal pressures on companies that reinforce this emphasis on short-term performance, the relationship between companies and their investors is of fundamental importance. Encouragingly, both have become more vocal about the importance of combating the negative impacts of short-termism in recent times, such as through the Commonsense Principles of Corporate Governance, released by a group of CEOs in 2016.[10] To create a truly sustainable financial system, which will play a role in achieving the SDGs, both investors and companies must join forces to drive meaningful change.

ABOUT THE REPORT

The Principles for Responsible Investment (PRI) and United Nations Global Compact released the first version of *Coping, Shifting, Changing* in 2014. The central premise of the report was that companies could be long-term even in a short-term world, offering practical recommendations on how to achieve this.

This edition responds to feedback that investors could, and should, do more to support companies on those recommendations. It builds on important work done by other organisations[11] also working to tackle this problem. It presents three main strategies, each including recommendations focused on measures that companies can adopt to address the problems caused by market short-termism, and actions that investors can take to support companies in those efforts.

The PRI and UN Global Compact will jointly engage their investor and corporate participants to encourage uptake of the report recommendations. Given the essential role of investor relations in advancing this area of work, both organisations are eager to engage these professionals and their trade associations, along with other key stakeholders.

OVERVIEW OF RECOMMENDATIONS

Below is an overview of the recommendations, which are not comprehensive solutions, but aim to mitigate some of the most serious consequences of short-termism through changes in strategy and practice. They are framed around the belief that companies, with support from investors, can advance strategies that support long-term business growth and improve their impact on society and the environment.

CORPORATE STRATEGIES	INVESTOR STRATEGIES
Cope with short-termism in the existing investor base	Help companies **cope** with market short-termism
Companies need to understand the diverse needs and interests of their current investor base and target investors. Companies should analyse how investor short-termism has affected their business strategy, capital investments and financing of the business. Companies need to define the outcomes they wish to achieve from their efforts to alleviate the effects of investor short-termism on their business. They should use these outcomes to develop measures of success and monitor the effectiveness of their efforts. Companies should communicate any short-term benefits of their sustainability-related strategies and clearly articulate how this positively affects their net present value.	Investors should craft and publish their investment strategy. Investors should publish an explanation of how drivers of long-term performance, including ESG factors, are taken into account in their investment processes. Investors should encourage companies to articulate how their business strategies and capital expenditure plans will create long-term value.

CORPORATE STRATEGIES	INVESTOR STRATEGIES
Shift to a more long-term investor base	**Shift** to support long-term decision-making
Companies should confidently demonstrate how their business strategy, including their approach to sustainability, will create long-term value for their investors. Senior management remuneration should depend on the long-term performance of the business across a range of metrics that include relevant ESG indicators. Companies should consider ending the practice of issuing quarterly earnings guidance, and instead focus on communicating issues and metrics that are relevant to the long-term success of the business. Boards of directors should produce formal statements that outline their duties as stewards of the company and commit to long-term decision-making. They should explain how they define long term, and how this relates to their business and investment cycles. Companies should meet with current and potential investors to discuss their approach to creating and protecting value. These meetings should cover issues such as sustainability, long-term strategy, performance, governance, culture, risk and reputation, and should occur outside of results season.	Investors should ensure that their investment strategy and commitments to long-term responsible investment are covered and effectively implemented in their investment policies. Investors should encourage companies to align remuneration with long-term value creation, end quarterly earnings guidance and publish a board-level commitment to long-term decision-making. Investors should meet with companies to discuss their approach to creating and protecting value.

CORPORATE STRATEGIES	INVESTOR STRATEGIES
Support wider systemic **change** in capital markets	Support wider systemic market **change** in capital markets
Companies should publicise evidence of how market short-termism has affected their business strategy, capital investment decisions, approach to sustainability and ability to create long-term business value. Companies should encourage policy makers to address the negative consequences of short-termism, and to adopt measures that enable companies to take a long-term approach to sustainability-related activities and investments. Companies should take a long-term approach in their own investment practices and in the investment practices of their pension funds.	Investors should support efforts to create evidence that demonstrates how a focus on long-term value creation delivers financial benefits. Investors should support public policy efforts that incentivise and reward companies that take proactive actions to build long-term, successful and sustainable businesses.

I. CORPORATE STRATEGIES

Companies can play a critical role in creating markets that support long-term value creation through action focused on three main areas:

- **coping** better with short-termism in the existing investor base;
- **shifting** to a more long-term investor base;
- supporting wider systemic **change** in the capital markets.

The corporate strategies should empower companies to:

- increase expenditure on research and development;
- seek out and invest in activities that provide positive long-term net present value, even if these incur costs over the short- to medium-term;
- create sustainable products, which could open new markets, increase their customer base and address the UN SDGs;
- develop their human capital.

COPING STRATEGIES: ADDRESS SHORT-TERMISM IN THE EXISTING INVESTOR BASE

UNDERSTAND INVESTORS' NEEDS AND INTERESTS

Recommendation 1: Companies need to understand the diverse needs and interests of their current investor base and target investors.

The immediate priority for companies is to take a long-term perspective in their strategic planning and capital investment decisions, and to ensure that these decisions include sustainability-related considerations. They must reassure their ever-changing investor base that integrating sustainability fully into strategies does not negatively affect enterprise value and, if possible, does not come at the cost of short-term financial performance. It also entails companies explaining how their investments in sustainability, and other measures to enhance the long-term profitability of the organisation, improve net present value.

An important starting point is to understand the diverse needs and interests of current and potential investors. This will enable a company to understand investors' investment objectives and time horizons, the extent to which they care about and are willing to reward the company's long-term strategy, and the extent to which they are prepared to support sustainability-related investments.[12]

BOX 1: A TYPOLOGY OF INVESTORS

A useful typology of institutional investors is provided by Palter *et. al.* (2008), who divide investors into three broad categories: (i) intrinsic investors, (ii) mechanical investors, and (iii) traders.

Intrinsic investors make significant effort to understand the companies they invest in, and are interested in the company's intrinsic ability to create long-term value. In contrast, mechanical investors such as computer-run index funds and investors who use computer models to drive their trades make decisions based on strict criteria or rules. These investors tend to pay limited attention to management quality or strategy in their investment decisions. Lastly, traders seek short-term financial gain by betting on news items, such as the possibility that a company's quarterly earnings per share will be above or below the consensus view. Traders tend to move in and out of stocks over short periods (often days or hours).

Palter *et. al.* suggest that executive management should pay most attention to intrinsic investors because of these investors' interest in the company's strategy, current performance and potential to create long-term value. They also argue that these investors are more likely than other investors to support management through periods of short-term volatility.

In this process, it is important that companies:

- engage with ultimate asset owners in addition to investment managers, such as pension funds, on whose behalf investment managers are acting;
- connect with potential investors, particularly those that the company would like to see represented on its shareholder register;
- recognise that investors are not homogeneous (see Box 1) and that, even within an individual investment organisation, individuals are likely to have quite different time horizons and views on the relevance of sustainability-related issues to their investment decisions. Additionally, many of those investors that are supportive of and interested in long-term strategy may still behave in a short-term manner in relation to their actual investment decisions, and that the average holding period of these investors may not exceed one or two years;[13]
- seek current and potential investors' views on both their investment processes (e.g. the timeframes that inform their investment decisions and the weight they assign to sustainability-related issues[14]) and on their wider expectations of companies (e.g. the importance they assign to long-term strategy and their expectations of companies' approach to sustainability-related investments).

Having a better understanding of their investor base should give companies the confidence to more effectively respond to the demands of extremely short-term investors. Direct engagement, such as through an investor survey, enables companies to make informed decisions on how much attention they should give short-term issues in their strategies and communication with investors.

UNDERSTAND HOW SHORT-TERMISM AFFECTS BUSINESS STRATEGY

Recommendation 2: Companies should analyse how investor short-termism has affected their business strategy, capital investment and financing.

Short-termism in companies can manifest in a variety of ways, including:

- reducing expenditure on research and development;
- foregoing investment opportunities with a positive long-term net present value, including physical assets or intangibles such as product or employee development;
- accounting adjustments that maximise short-term earnings and stock prices, rather than the long-term value of the corporation;
- a bias towards high dividend payouts and share buybacks at the expense of investment or increased use of leverage to fund investments;
- remuneration structures that reward short-term, rather than long-term, performance and incentivise management to focus on short-term boosts to share price;
- a lack of attention to long-term risks in the company's products, services or business strategy;
- an excessive focus on restructuring, financial re-engineering or mergers and acquisitions, rather than on organic growth or developing the operational capabilities of the business.

While these broad implications of investor short-termism on business decision-making may be reasonably well understood, companies would do well to make more granular assessments. This could, for example, be done by assessing how certain decisions, driven by short-term pressure, have affected the business compared with alternative strategies that might have been adopted.

While much of the literature on short-termism emphasises negative impacts, it is important to recognise that investors have an important role in ensuring that companies are run efficiently and deploy capital effectively. These are all important contributions that need to be built into an assessment of the effects of investor short-termism on the business.

This will help companies determine whether investor short-termism is an immediate problem and, in turn, what coping strategies are needed. It will also help them decide how much effort to put into attracting investors that are supportive of long-term strategies. Finally, it will provide them with evidence that they can use in their engagement with investors, policy makers and other stakeholders.

DEFINE THE OUTCOMES REQUIRED

Recommendation 3: Companies need to define the outcomes they wish to achieve from their efforts to alleviate the effects of investor short-termism on their business. They should use these outcomes to develop measures of success and monitor the effectiveness of their efforts.

As companies implement measures to address short-termism, they should monitor and review the impacts of these actions on their engagement with investors, as well as the make-up of their investor base and on the investment system as a whole.

For example, companies could measure the success of efforts to cope with investor short-termism in terms of the:

- level of understanding that their investors have of the company's short- and long-term business objectives, and of the role that sustainability-related activities play in the delivery of these objectives;
- level of support from investors for their sustainability-related strategies;
- assessments that other investment industry actors (e.g. investment banks) make of the company's sustainability strategy;
- behaviour of their investors (e.g. if, in response to

negative news, they divest rather than engage).

Similarly, companies could measure the success of their preliminary efforts to evolve their investor base in terms of the:

- proportion of investors on their share register that is supportive of and interested in long-term strategy;
- proportion of investors on their share register with explicit commitments to responsible investment (e.g. signatories to the PRI or equivalent frameworks);
- share price volatility relative to the market or industry peers. In both cases, lower volatility suggests a more stable investor base.

It is important that this information is collated to facilitate the sharing of practices across the business community. This would help to develop evidence on how actions have been implemented, the challenges and barriers that have needed to be addressed, and the outcomes that have been achieved.

DEFINE THE BENEFITS

Recommendation 4: Companies should communicate any short-term benefits of their sustainability-related strategies and clearly articulate how this positively affects their net present value.

Too often, sustainability-related activities and investments are presented by companies as providing benefits that are difficult to measure in hard financial terms or as solely providing long-term benefits. However, investors will often have less interest in arguments that are not expressed in financial terms.

This is not to say that companies should neglect sustainability strategies that may be harder to calculate, such as improved brand and reputation or strengthened customer loyalty. It is also not to say that companies should prioritise short-term over long-term financial gains. Rather, the point is that companies should, to the extent possible, explore means for communicating any short-term financial benefits of sustainability-related strategies and investments *as well.* As a starting point, the UN Global Compact and the PRI's Value Driver Model toolkit provides guidance on how companies can monitor and gather robust information on the costs and the benefits of their sustainability-related investments.

Companies need to communicate the value of sustainability to their businesses in terms that are also of interest and relevance to their short-term investors. They should be prepared to talk about the implications of these in the context of conventional financial metrics such as net present value and earnings per share. Discussing sustainability-related activities and investments in this way should help reassure investors that management is focused on business outcomes, and that a long-term focus does not jeopardise the company's financial performance; indeed, it might strengthen it.

SHIFTING STRATEGIES: ATTRACT INVESTORS THAT SUPPORT LONG-TERM DECISIONS

COMMUNICATE THE FINANCIAL BENEFITS OF ACTION

Recommendation 5: Companies should confidently demonstrate how their business strategy, including their approach to sustainability, will create long-term value for their investors.

One of the wider arguments for companies to proactively communicate with investors on their long-term strategy is that they can attract investors with similar time horizons and lower stock price volatility.[16] However, research shows that few CEOs are proactively communicating materially relevant, long-term information to investors. [17]

Companies that are most likely to attract investors that support long-term strategies are those that: have a clear focus on long-term performance as an integral part of their overall business strategy; can clearly explain how the business strategy will deliver financial value (profitability and growth) over the short- and long-term; can explain how the company's performance across a range of financial and ESG parameters will develop over time; and can explain how the company will benefit from changes in wider political, economic, social, technological, environmental and regulatory factors.

Investors should see then that the company is: committed to its strategy; understands the risks and opportunities associated with the strategy; appreciates the trade-offs and compromises that have been made; and comprehends how the decisions that have been made may affect financial performance over the short- and long-term. It is also important that companies can explain how they will respond to pressures from short-term investors, such as the threat that these investors will sell their holdings.

Sustainability-related issues should form part of this discussion, although the weight given to such factors will depend on the company, its sector, and the importance placed on these factors as drivers of business value. When deciding on what and when they communicate, companies need to consider:

- Is the issue financially material (i.e. are the amounts involved significant in the context of the business overall and are the timeframes relevant to the analyst)?
- Is the issue relevant to the company's strategy?
- Is the issue relevant to the questions that investors are likely to ask? For example, does it demonstrate that key business risks are being effectively managed, or does it relate to what investors are likely to see as fundamental value drivers or key business risks?
- Can the benefits be quantified in financial terms? Research suggests that companies are increasingly able to quantify the business value of their sustainability initiatives, as reported by 59% of CEOs in 2016 versus 38% in 2013.[18]

LINK REMUNERATION TO LONG-TERM VALUE CREATION

Recommendation 6: Senior management remuneration should depend on the long-term performance of the business across a range of metrics that include relevant ESG indicators.

An integral part of demonstrating how a company's business strategy will create long-term value is by developing metrics that allow both internal management and investors to assess the effectiveness of the company's strategy as well as the long-term performance of the company. To do this, companies must move beyond reporting only standard financial metrics.[19] It is not enough to set and report on these metrics, however; senior management remuneration must be interlinked with performance against long-term metrics. Options for ensuring alignment include: [20]

- three-year performance periods for cash bonuses;
- linking the vesting of share-based pay to underlying performance metrics such as return on invested capital and growth of the business;
- connecting pay to relevant sustainability performance; [21]
- vesting periods for share-based remuneration should reflect genuinely long-term performance – i.e. more than three years;
- requiring management to make a material long-term investment in the shares of the company, with shares held for at least 10 years even when the executive is no longer in post.

REVIEW THE VALUE OF QUARTERLY EARNINGS GUIDANCE

Recommendation 7: Companies should consider ending the practice of issuing quarterly earnings guidance, and instead focus on communicating issues and metrics that are relevant to the long-term success of the business.

The argument for stopping the production of quarterly earnings guidance is that it will reduce the pressure on managers to meet financial performance expectations on a quarterly basis, and allow them to focus instead on building a successful, sustainable business over the long term. Highlighting the problem, a survey of CFOs found a shared willingness to sacrifice long-term economic value, such as delaying a valuable project, to deliver on the earnings expectations of analysts and investors. [22]

Adopting a long-term approach to communication, such as by covering ESG issues during analyst calls or by ending the practice of releasing earnings guidance, does not mean less information is provided to the investment community; rather, it can help investors focus on what is truly material to the company's long-term value creation. While research has found that the costs of issuing quarterly earnings guidance outweigh the benefits, [23] a survey of NIRI members found that nearly a third (29%) continue to provide quarterly estimates. Moreover, only 20% provide long-term (greater than one year) estimates. [24]

There is also enormous symbolic value in publicly committing to ending quarterly guidance; it sends a clear message to investors about the importance of long-term value creation to the business, and about the company's willingness to resist short-term pressures from investment markets.

The US Chamber of Commerce also reported that pressure for businesses to hit their targets can be overwhelming and creates incentives to forego investments in long-term projects. The Commission argued that by ending the practice of issuing quarterly earnings guidance, companies, investors and the broader economy would benefit from increased emphasis on long-term value creation and innovation linked to long-term thinking. [25]

REVISIT THE ROLE AND RESPONSIBILITIES OF THE BOARD

Recommendation 8: Boards of directors should produce formal statements that outline their duties as stewards of the company and commit to long-term decision-making. They should explain how they define long term, and how this relates to their business and investment cycles.

Boards have an important role to play in ensuring that investors understand the company's strategy and how it will create value.

In 2016, BlackRock's CEO asked investee companies to communicate to shareholders their annual strategic framework for long-term value creation and explicitly affirm that their boards had reviewed those plans. In 2017, he reported that many companies responded by publicly disclosing detailed plans, including robust processes for board involvement. [26]

Furthermore, SSGA's CEO argued that for boards to successfully oversee long-term strategy they must focus on improving their independence, diversity and fully incorporate sustainability into corporate governance.[27]

A board could begin addressing these appeals by producing formal statements that outline their duties as stewards of the company and that commit them to long-term decision-making. [28]

The idea is that these statements would provide a framework for company-investor dialogue, as well as commit the company to making decisions and acting in ways that promote its long-term interests. These formal statements could include commitments to:

- promoting the long-term success of the company;
- providing information that enhances shareholders' understanding of company strategy and long-term value creation;
- not allowing expectations of market reaction to short-term performance metrics to significantly influence company strategy;
- disengaging from the process of managing short-term earnings expectations and announcements.

It has also been argued that boards should produce an annual Statement of Significant Audiences and Materiality.[29] The Statement would help create the appropriate context for management to identify risks and drivers of growth, and in turn create long-term value.

One of the important contributions of these statements would be defining what is meant by long term, and how this relates to a company's business and investment cycles. Over half (52%) of directors surveyed by PwC in 2016 said their company's strategic time horizon is between one and five years or greater, compared to 48% in 2011.[30] While the time horizon is lengthening, it is still relatively short. For example, if long term was defined in relation to the business cycle, it may be between seven and 10 years, depending on the sector, whereas it may be 20 or more years for the company's strategic objectives.

It is critical that the board reflects on the company's role in society and contribution to sustainable development. It indicates that risks and opportunities are adequately dealt with at the highest level, and thus is a proxy for good governance overall. By taking a more proactive stance, directors can position themselves to ensure that long-term views are incorporated into business strategy, organisational culture and operational practices in a way that supports the long-term profitability and viability of the company.[31]

COMMUNICATE PROACTIVELY WITH INVESTORS

Recommendation 9: Companies should meet with current and potential investors to discuss the company's approach to creating and protecting value. These meetings should cover issues such as sustainability, long-term strategy, performance, governance, culture, risk and reputation, and should occur outside of results season.

A proactive approach to engagement at the board and executive management levels is central to building long-term, trust-based relationships between companies and their investors. Constructive dialogue can help investors better understand the business and pre-empt problems. To be effective, however, it should not be a one-off activity.

Discussions should cover sustainability, long-term strategy, performance, governance, culture, risk and reputation, with issues such as remuneration discussed in those contexts. These should take place in addition to the formal schedule of meetings and presentations associated with the results calendar.

Companies could also use these meetings to better understand their investors by, for example, asking participants whether they have formal investment principles on long-term investment and sustainability, and, if so, what these principles state (see Box 2 below). They could also ask investors about how they address sustainability and long-term value creation in their investment research and decision-making processes.

Other opportunities to engage with investors on long-term strategic issues include the PRI's Collaboration Platform, which enables investors to engage with companies on a range of ESG issues. Similarly, the UK Investor Forum[32] and the US Shareholder Director Exchange[33] enable companies and investors to discuss corporate governance and long-term strategy issues. Another valuable resource is the PRI and UN Global Compact's Value Driver Model Toolkit and ESG Investor Briefing project, which offers a toolkit, including a series of case studies, for companies looking to incorporate ESG information into their investor communications.[34] Stock exchanges and other organisations have taken forward their own versions of this work, including the Johannesburg Stock Exchange's annual ESG Investor Briefing, Borsa Italiana's Sustainability Day, and CECP's CEO Investor Forum.[35]

Companies should be aware that it may take time for the benefits of improved dialogue with investors, or changes in the investor base, to materialise, but seeking and responding constructively to investor feedback is essential. Inevitably, even investors with an interest in long-term strategy will want to understand how a strategy will create financial value over the short- *and* long-term. Some investors may be sceptical about the benefits of taking a long-term approach or fail to see the link between ESG-focused efforts and financial performance. Companies must prepare a) for these reactions and b) to demonstrate how the strategy is providing real benefits to the business.

CHANGE STRATEGIES: SUPPORT WIDER SYSTEMIC CHANGE IN CAPITAL MARKETS

PUBLICISE THE BUSINESS EFFECTS OF SHORT-TERMISM

Recommendation 10: Companies should publicise evidence of how market short-termism has affected their business strategy, capital investment decisions, approach to sustainability and ability to create long-term business value.

In recommendation two, it was suggested that companies analyse how investor short-termism has affected the decisions they have made in areas such as research and development, capital investment and product development, and how these decisions have affected the long-term health and sustainability of the business. Relevant aspects of this information should be shared to help drive large-scale change.

It is important that investors understand how the pressures they exert and the signals they send affect the long-term success and sustainability of the companies they are invested in. This may encourage them to reassess the dialogue they have with companies and consider whether they should pay greater attention to, and be more supportive of, strategies and investments that support the long-term success of the business. It is also important that other stakeholders – the media, policy makers, civil society and employees – have a fuller understanding of the influence that capital markets have on corporate strategy and investment decisions, as well as the consequences for the business and society.

ENGAGE WITH POLICY MAKERS

Recommendation 11: Companies should encourage policy makers to address the consequences of short-termism, and to adopt measures that enable companies to take a long-term approach to sustainability-related activities and investments.

Public policy has a critical role in regulating and framing the relationships between companies and investors, with many countries examining how long-term investment can be encouraged. Issues discussed have included: disclosures by companies to investors and society; shareholder rights (e.g. in relation to takeovers); investors' fiduciary duties;[36] incentivising longer shareholding periods; promoting long-term investment; and mobilising asset owner beneficiaries to voice their concerns on long-term issues.

Companies are recognised as key stakeholders in these discussions. Input is sought on the implications of investor short-termism on their businesses as well as the policies that could be adopted to help alleviate some of these pressures or, more positively, to help companies adopt a long-term approach to their strategy and capital investment decisions.

Regarding engagement[37] with policy makers, there are three broad factors for companies to consider, the first being that much corporate lobbying is conducted through industry groups. Companies should therefore ensure that the positions adopted by these groups align with those of the company. The second factor to consider is that companies should, where feasible, work with investors and investor groups such as the PRI, which has established mechanisms for its signatories to engage with policy makers.[38] The third factor is that companies should be transparent about their engagement with policy makers, including engagement conducted on their behalf by industry groups and other actors. This should include details of the proposals they have made to policy makers, as well as who has made these proposals (e.g. the company itself or organisations acting on behalf of the company), and the resulting outcomes.

LEADING THE CHANGE

Recommendation 12: Companies should take a long-term approach in their own investment practices and in the investment practices of their pension funds.

As discussed previously, one of the key drivers of investor short-termism is the demands that are placed on investment managers by their asset owner clients. By adopting appropriate responsible investment policies and strategies for their pension funds and other pools of capital that they control or influence, companies demonstrate leadership and can directly influence other investors. This may enable them to alleviate some of the short-term pressures that they and their peers face. It may also allow them to demonstrate the benefits of taking a long-term approach to investment, thereby providing best practice leadership for the industry at large.[39]

Corporate plans remain under-represented among investor groups that explicitly incorporate ESG issues in investment decision-making — particularly when compared with public pension plans and endowments. For example, while nearly 50% of the world's largest corporates are UN Global Compact signatories, only 10% of their plans are PRI signatories.[40]

While corporate plans are legally distinct from their sponsors, plans and their beneficiaries can benefit from responsible investment in several ways, including: improving investment performance; fulfilling fiduciary duty and managing regulatory risk; aligning external managers and third-party advisers; supporting deficit management; and boosting corporate sponsor credibility and employee retention.

Adopting responsible investment strategies in their investment practices and in the investment practices of their pension funds is starting to be seen as a standard expectation of companies that have made strong commitments to corporate responsibility.

II. INVESTOR STRATEGIES

In broad terms, investors send three signals through the financial system, which are reflected in the strategies framed around how investors should:

- help companies **COPE** with market short-termism;
- **SHIFT** strategies to support long-term decision-making;
- support wider systemic **CHANGE** in capital markets.

The complementary investor strategies support alignment with the PRI's Sustainable Financial System (SFS) programme, finance the SDGs and deliver benefits including:

- creating evidence on the business and investment value of accounting for long-term value drivers, including sustainability-related issues, in business strategy and capital expenditure decisions;
- educating the market on how investor short-termism can erode investment value;
- building the supply of sustainable companies by increasing the number of companies and the proportion of activities, products and services that provide long-term benefits to society and the environment;
- aligning the interests of long-term investors and companies through better business decision-making and structured remuneration;
- increasing management and board commitment to stewardship and long-term decision-making;
- improving the quality of relationships between investors and companies.

COPING STRATEGIES: HELP COMPANIES COPE WITH MARKET SHORT-TERMISM

PUBLISH AN INVESTMENT STRATEGY

Recommendation 1: Investors should craft and publish their investment strategy.

Investors should formulate an investment strategy that considers all the long-term trends affecting their portfolios and how to operate as efficiently as possible. This will involve examining their vision of the future, their organisational mission, investment principles and investment strategy formulation.

The investment principles should be a set of clear, impactful statements that are accepted across the organisation. They will help to define the investment strategy and, later, influence investment decisions in line with that strategy. The PRI has published a report for investors looking for greater guidance on crafting such a strategy.

Long-term organisations with a strong focus on sustainability are likely to hold investment principles that reflect one or more of the statements in Box 2.

BOX 2: POTENTIAL STATEMENTS ON LONG-TERM INVESTMENT AND SUSTAINABILITY

- Long-termism in financial markets is conducive to long-term value creation in the economy.
- Taking a long-term investment approach encourages investee companies to behave long term.
- Market risk premium in general can only be generated over at least a full market cycle.
- Active returns related to long-term ESG trends can only be realised over long holding periods.

- Certain ESG issues represent long-term systemic risks.
- Companies with a long-term approach outperform companies with a short-term approach, on both financial and sustainability KPIs.
- The long-term is more than just the sum of incremental short-term horizons.
-
- Long-term investment outcomes are driven by company fundamentals, as opposed to a series of short-term fluctuations, driven by sentiment and irrationality.
- Stock prices revert to their fundamental value over the long term.
- As a long-term investor, we can hold stocks for a long period and do not have to make short-sighted decisions in response to market fluctuations.
- Committed stewardship adds value to investments and is an investor's responsibility.
- Investors can protect their long-term returns by engaging with policy makers on market-wide risk issues.
- Long-term, responsible and sustainable investment is consistent with fiduciary duty.
- As an organisation, we have the capabilities and resources required to take a long-term approach, with a strong focus on sustainability.

The strategy helps define how investment value can be created in the context of future uncertainty, risks and opportunities, as well as make practical decisions on: investment style; selection, appointment and monitoring of investment managers; asset allocation; performance objectives; and approach to active ownership.

Well-considered and articulated strategies from the board and policies from the management of an asset owner are cornerstones of good governance and long-term investment. This is also in line with regulation trends, such as recent EU policy that encourages institutional investors to disclose how they take long-term interests into account in their investment strategies.[44]

DESCRIBE INVESTMENT PROCESSES

Recommendation 2: Investors should publish an explanation of how drivers of long-term performance, including ESG factors, are taken into account in their investment processes.

While investors continue to demand improved reporting of ESG information, recent PwC research suggests that it is unclear to many corporates if and how investors use this information to make investment decisions. Companies may in turn conclude that ESG information is not a critical factor in overall investment decision-making.

Investors should therefore publicly explain how they take account of long-term performance drivers, including ESG issues, in their investment research and decision-making processes, to signal that these issues are important and need to be managed effectively. Investors should also describe how their company engagement (often referred to as active ownership or stewardship) relates to their investment processes, and how the results of this engagement influence their investment views on individual companies.

There are barriers to this, however, including that investors are often reluctant to disclose such information. The PRI has sought to address this issue by publishing practical guidance and examples of how investors take account of ESG issues in their investment research and decision-making, including in listed equities and fixed income.

Another challenge relates to the uncertainty associated with long-term issues. Incorporating the potential effects of long-term issues into the investment processes requires organisations to consider how risks and opportunities may evolve, as well as potential business implications under different conditions. One way to assess such implications is through the use of scenario analysis. As an example, the Task Force on Climate-related Financial Disclosures has published a technical guide for climate-related issues.

ENCOURAGE COMPANIES TO EXPLAIN THEIR VALUE CREATION STRATEGIES

Recommendation 3: Investors should encourage companies to articulate how their business strategies and capital expenditure plans will create long-term value.

Research suggests that one of the reasons that investors do not take full account of ESG issues and long-term value creation in their decision-making processes is because of weaknesses and gaps in the data and information provided by companies.[48]

This has caused investor scepticism about the credibility of corporate commitments to long-term value creation and whether a focus on ESG factors will create long-term value, in turn curtailing ESG integration in the investment process. It has also impacted the ability of researchers to analyse the relationship between ESG issues and long-term financial and investment performance. Companies may therefore conclude that investors are not interested in such data, creating a cyclical problem.

In the corporate recommendations, it is suggested that companies communicate the short- and long-term financial benefits of their sustainability-related strategies and activities, and demonstrate how their business strategy will create long-term value for their investors. As companies may be reluctant to implement these recommendations on their own, investors should encourage them to articulate how their business strategies and capital expenditure plans will create value over the long-term.

SHIFTING STRATEGIES: SUPPORT LONG-TERM DECISION-MAKING

IMPLEMENTATION

Recommendation 4: Investors should ensure that their investment strategy and commitments to long-term responsible investment are covered and effectively implemented in their investment policies.

Although many investment organisations have committed to long-term responsible investment (e.g. in their investment principles and policies), levels of implementation remains mixed. For example, the PRI has found: inconsistencies in investment practices across asset classes; a lack of high-level statements on sustainability in investment principles; and a gap in formalising ESG objectives into contracts, with less than 50% of the asset owners that report to the PRI saying that they define ESG objectives in their mandates.[49 50] Furthermore, when it comes to mandates, contracts between asset owners and managers often require investment managers to report on a quarterly basis or on investment performance, again reinforcing the perception that short-term investment performance is of primary importance.

There are several factors at play, including principal-agent issues, which can mean that the views of asset owners are not properly communicated to companies or to other investment actors. These issues can exacerbate short-term pressures that are at odds with the goals of a sustainable financial system, as each link in the investment chain typically has a shorter time horizon than the one above it.[51]

This creates a multiplier effect throughout the investment system. Weak implementation of commitments to long-term responsible investment by individual institutions signals that responsible investment is not a priority for investors. In turn, this limits companies' willingness to focus on long-term value drivers in their business strategies and capital expenditure plans.

Therefore, institutions that have adopted investment principles based on long-term investment and sustainability should ensure that these are effectively implemented. Depending on the organisation, this will likely require them to:

- assign responsibilities to ensure that the investment principles are implemented throughout the organisation;
- integrate long-term value creation and sustainability-related considerations into their investment research and corporate engagement process;
- integrate long-term value creation and sustainability-related considerations into their selection, appointment, monitoring and reappointment processes for service providers;
- report, publicly and to clients, on how they have implemented their investment principles including analysis of how these have affected investment performance and the social, environmental and economic performance of the entities in which they have invested.

SUPPORT CONCRETE ACTION

Recommendation 5: Investors should encourage companies to align remuneration with long-term value creation, end quarterly guidance and publish a board-level commitment to long-term decision-making.

It is not enough for investors to simply call on companies to prepare and publish an analysis of ESG issues and long-term value drivers. Investors also need to send signals to companies that support the substance of these disclosures and empower management to make strategic and operating decisions that build long-term value.[52] In doing this, investors can fulfil their responsibilities to be engaged owners of both active and passive long-term holdings. Long-term investors are particularly well placed to develop close, lasting relationships with companies that enable confident management of long-term value creation factors, including those relating to sustainability.

Previously, three recommendations were made to companies on remuneration, quarterly reporting and board statements as areas where they could tangibly demonstrate their commitment to long-term value creation. Many companies are reluctant to take such actions because of concerns about potential backlash from investors. Therefore, investors should encourage:

- companies to ensure that senior management remuneration depends on the long-term performance of the business, across a range of financial and non-financial metrics;
- companies to stop producing quarterly earnings guidance, and instead report on issues and metrics that are of relevance to the long-term success of the business;
- boards of directors to produce formal statements that outline their duties as stewards of the company and commit them to long-term decision-making.

COMMUNICATE AND ENGAGE

Recommendation 6: Investors should meet with companies to discuss their approach to creating and protecting value.

One of the key recommendations made to companies is that they regularly engage their investors. This covers the company's own reporting, its willingness to respond to queries from investors and its meetings with investors.

The corollary to this recommendation is that investors must also spend time developing these relationships. Investors need to explicitly discuss issues such as corporate strategy, long-term performance indicators, and activities that will enhance the intrinsic value of the business. They can do this in company meetings as well as on earnings calls and investor days. They could also do this through collaborative engagements, such as those organised through the PRI's Collaboration Platform.

However, investors must also:

- provide feedback on long-term strategy and performance;
- monitor the implementation of the strategy to encourage companies to adopt short- and long-term performance measures that facilitate monitoring;
- ask about the progress of the strategy and review progress against the performance measures that have been chosen.

By investing in these processes, investors signal the importance that they assign to strategy and their support for companies that take a long-term approach. This is also in line with the growing trend around stewardship codes. While the first Code was not established until 2010, 17 of the largest 50 countries by GDP have or are developing guidelines on investor stewardship. These codes focus on the interactions between investors and investee companies, with a view to promote long-term value creation strategies.

Furthermore, recent research has found that stewardship codes are associated with better company ESG risk management in both emerging and developed countries.[53] For a code to be truly effective, the quality of reporting against it should become a tool for competitive differentiation between asset managers as well as a source of information for asset owners during manager selection.[54]

CHANGE STRATEGIES: SUPPORT WIDER SYSTEMIC MARKET CHANGE

DEVELOP EVIDENCE THAT SUPPORTS LONG-TERM VALUE CREATION

Recommendation 7: Investors should support efforts to create evidence that demonstrates how a focus on long-term value creation delivers financial benefits.

The recommendation that investors should support efforts to build evidence (such as case and correlation studies) that demonstrates how a focus on long-term value creation delivers investment benefits, has three elements:

The first, mirroring recommendation 10 to companies, is that investors should encourage companies to publicise evidence of how short-termism has affected their business strategy, their capital investment decisions, their approach to sustainability and their ability to create long-term business value. Investors should also provide evidence of how short-term business practices have harmed investment returns and, conversely, how long-term business practices have enhanced long-term investment returns.

The second is that investors should support high-quality academic research on the relationship between ESG issues and investment performance. This may require investors to give researchers access to their own data on company performance, investment decision-making and engagement.

The third element is that investors should support wider efforts to develop market capacity and expertise through the development of case studies, collaboration on engagement and through sharing success stories and lessons learned. Of particular importance is building investors' ability to integrate ESG data into their investment process, and their ability to engage effectively with the companies in which they are invested.

These efforts could also help encourage corporate pension funds and other pools of capital that companies control or influence to take a long-term approach to investing, in line with recommendation 12. Investors can support these efforts by encouraging companies to ensure that their pension funds have adopted responsible investment policies and strategies, as well as through emphasising the importance of ensuring that the strategies adopted are aligned with the commitments to long-term value creation and responsible practices made by the parent company.

PUBLIC POLICY

Recommendation 8: Investors should support public policy efforts that incentivise and reward companies that take proactive actions to build long-term, successful and sustainable businesses.

Many of the barriers to long-term investment exist outside of the direct investor-company relationship. Some relate to the regulatory and policy frameworks that influence the investment system itself, and others relate to how the social and environmental impacts of business and investment are regulated.

The number of responsible investment policies is growing globally. Among the 50 largest economies, the PRI has identified almost 300 policy instruments that encourage investors to consider long-term value drivers, including ESG factors. Over half of these were created between 2013 and 2016.[55]

However, policy effectiveness is often hampered by weak implementation and signals. Investors can be sceptical of the effectiveness of public policy due to weaknesses in design and monitoring, as well as inconsistencies between government departments and regulators. Combined, these send a signal to investors that sustainability is separate from the core purpose of financial markets, in turn making them more reluctant to consider ESG issues when investing.

Indeed, PRI research consistently finds two gaps in the approaches taken by policy makers on this topic. The first is that financial ministries (e.g. treasuries and market regulators) often have a limited understanding of, or concern for, ESG issues, or of the specific role that investors play in social or environmental outcomes. The PRI recommends that policy makers articulate the role of capital market actors in contributing to a sustainable financial system, with measurable objectives.

The second is that policy makers outside of the financial ministries tend to have a limited understanding of how financial markets work or how to incentivise investors to support the development and implementation of policy on ESG issues. The PRI recommends that policy makers strengthen policy design, communicate impact and build capacity for monitoring implementation.

The recommendation for investors is, therefore, that policy engagement must have its place in responsible investment strategies. The PRI has provided a framework for investors to support effective regulation using the five Cs:

- committing resources to public policy engagement;
- constructing a strategic process for policy engagement;
- clarifying public policy positions;
- collaborating on public policy engagement; and
- communicating to stakeholders regarding public policy engagement.

On the issue at hand in this paper, investors should support public policy efforts that incentivise and reward companies that take proactive actions to build long-term, successful and sustainable businesses.[56]

This report was prepared by Danielle Chesebrough (PRI, UNGC) and Dr Rory Sullivan (consultant).

Designed by: Alessandro Boaretto
Edited by: Eliane Chavagnon

ABOUT THE UNITED NATIONS GLOBAL COMPACT

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 9,500 companies and 3,000 non-business signatories based in over 160 countries, and more than 70 Local Networks. www.unglobalcompact.org

ABOUT THE PRINCIPLES FOR RESPONSIBLE INVESTMENT

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole. The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system. More information: www.unpri.org

ENDNOTES

1. McKinsey Global Institute (2017): Measuring the Economic Impact of Short-Termism.

2. Deutsche Asset Management and the University of Hamburg (2015): ESG and Corporate Financial Performance: mapping the global landscape.

3. Examples include: Graham, J., Harvey, C. and Rajgopal, S. (2005): The Economic Implications of Corporate Financial Reporting, Journal of Accounting and Economics, Vol. 40, Issue 1. Graham, J., Harvey, C. and Rajgopal, S. (2006): Value Destruction and Financial Reporting Decisions, Financial Analysts Journal, Vol. 62. FCLT Global (2016): Rising to the challenge of short-termism.

4. PRI (2016): Sustainable financial system: nine priority conditions to address.

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7. Aviva Investors (2014): A Roadmap for Sustainable Capital Markets.

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9. For example, solvency requirements, MIFID and Dodd Frank. Only in recent years (five years after the crisis) has there been growth in regulation looking at ESG integration and system purpose.

10. (2016): Commonsense Principles of Corporate Governance.

11. Examples of organisations, in addition to the PRI and UN Global Compact, that are active in this area include:
    - FCLT
    - OECD
    - The Long-Term Investors Club
    - Tomorrow's Company
    - CFA Institute
    - Brookings Institution

12. There is an increasing amount of information on how investors take account of sustainability-related issues in their investment processes. A number of investor managers, asset owners and insurance companies now produce Transparency Reports on their approach to responsible investment. Also see PRI (2016): A practical guide to ESG integration for equity investing and Eccles, R., Krzus, M. and Serafeim, G. (2011): Market Interest in Nonfinancial Information.

13. See, for example, the analysis by Cremers et. al. (2013) that showed the median holding period for US mutual funds and pension funds had remained relatively unchanged at around 1.5 years in the period from 1985 to 2010. See also Chakrabarty et. al. (2013) who found that even pension funds tend to trade in and out of shares in less than a year for some 65% of their portfolio. See also MSF Investments (2016): Lengthening the Investment Time Horizon, which found the average holding period for an NYSE-listed company fell from eight years between 1950-1960 to just 8.3 months in 2015.

14. It is important to stress that the fact that investors do not explicitly ask about long-term strategy or about sustainability-related issues does not mean that they are not taking these factors into consideration in their investment decision-making process. Most investors now have access to company information through data providers such as Bloomberg, and through specialist ESG research organisations such as Sustainalytics and MSCI. This means that investors can benchmark and

evaluate company performance without needing to ask the company for data. For insights on the data that investors look at, see endnote 12.

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28. See, for example, the proposals in Kay (2012) and Department for Business, Innovation and Skills.
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30. PwC (2016): Annual Corporate Directors Survey.
31. UN Global Compact (2014): Board Programme: Unlocking the Value of Corporate Sustainability.
32. The Investor Forum.
33. The Shareholder-Director Exchange.
34. See endnote 18 and the PRI and UN Global Compact's ESG Investor Briefing Project.
35. For more information, see: JSE: Issuer and Investor Engagement; Borsa Italiana. Sustainability Day; CECP, CEO Investor Forum.
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