Behaving Like An Owner: Plugging Investment Chain Leakages

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The theme of investing for the long term through engaged ownership is gaining profile. This article explores the implications of "behaving like an owner" and estimates its financial benefits. We follow the journey of $100 over 20 years under four different "leakage" scenarios. ***Downstream*** *leakages are active management fees, manager transition costs, and excessive trading;* ***upstream*** *leakages are unwarranted M&A activity and misaligned incentive structures. We find that fixing these leakages can increase the size of savings pots by as much as 25% over a 20-year accumulation period. We also address the behavioral question, "If this is so self-evident, then why do presumably rational investors keep doing these irrational things?" We close with some thoughts on the behavioral changes needed to get institutional investors behaving as owners.*

Keywords: Institutional Investors, Investment Costs, Investment Process, Long-Term Investing, Pension Funds, Short-Termism

Leakages and Behavioral Impediments to Long-Term Investing

There is a growing debate on the negative economic consequences of short-termism in institutional investing and the need for a longer-term approach to investments.[1,2] An example is the recent workshop organized by Rotman International Centre for Pension Management and the Generation Foundation and attended by senior representatives of 40 major pension organizations ($4T in assets) from 12 countries. One of the key outcomes was a resolution to "Design and implement concentrated, long-horizon investment mandates and ensure that we have the necessary resources to implement them successfully" (Ambachtsheer and Bauer 2013).

That resolution fits nicely with our intent in this article, which is to show how institutional asset owners such as pension funds can generate and retain more wealth for their clients/beneficiaries. We do this by estimating the excessive friction costs along the current investment chain – in effect, leakages from investments that could be plugged.[3] To illustrate the impact of these leakages, we look at what happens to a prospective pensioner's $100, invested in public equities over 20 years, under four different investment "journeys."[4]

These leakages are not generally the result of mistakes or oversights that can just be "corrected" by the rational investor; they serve a purpose in the present configuration of the investment system. So plugging them requires institutional investors to think and behave differently and to change the environment that gives rise to those leakages. Given the systemic nature of these changes, we can expect two things: first, change will not be easy (otherwise it would have happened already); and, second, should change be achieved, it will ripple through the entire investment chain, affecting every participant along the way.

Leakages: Downstream and Upstream

There is evidence to suggest that we may be entering a period of investment returns that are modest by historical standards, what has come to be called a low-return world.[5] So today more than ever should we be interested in minimizing unnecessary investment friction costs or leakages. We can look these costs in several ways, but it is helpful to make a distinction between "downstream" and "upstream" leakage.

- ***Downstream leakage*** occurs in the financial services industry – the investment chain that extends from asset owner (often a pension fund or insurance company)

through to asset managers and associated service providers, such as investment consultants. Downstream costs are tangible, measurable, and under the asset owner's control; they include stock turnover, transition activity, and investment management fees.
- ***Upstream leakage*** occurs at the corporation or enterprise level. Looking upstream allows us to explore how and why companies behave as they do, and how they create or destroy – or fail to maximize – long-term shareowner wealth. We also include market regulation (e.g., rules on share trading, disclosure, and taxation), which can strongly influence how companies behave. Upstream costs are generally beyond the control of the investor (e.g., mergers and acquisitions); they tend to be diffuse and hard to quantify (e.g., complex remuneration design, excessive risk taking). Consequently, there is little direct incentive to fix these problems, partly because they are "free rider" issues (i.e., they are the responsibility of "everyone and no one").

Upstream and downstream friction costs are intimately related. However, the distinction is helpful in understanding the characteristics of these costs. It is also useful in structuring our different scenarios for the performance of a saver's $100 and in thinking about how these costs are best reduced.

Downstream Friction Costs

Turnover

Friction costs are usually double edged. They may arise from activities that are important in generating value, but these same activities may become an unrewarded cost when not monitored and constrained. In this section we explore excessive trading in greater detail and consider what investors may do to limit it.

Stock turnover is a key element of portfolio management. Even with passive management, there will be some turnover as periodic rebalancing takes place to track the index. At the other extreme is high-frequency trading, with stock-holding periods counted in seconds. So a distinction must be made between "necessary turnover" and "excessive turnover." Our concern here is excessive turnover in the context of a strategy's objectives. For the purpose of the study described here, we define excessive turnover as anything above 30% stock turnover per annum.[6]

The issue of excessive turnover has recently received considerable attention in the context of the long-term investment thesis. These discussions have three main themes:
- Excessive turnover is a friction cost (via brokerage and other fees) that must be covered by investment returns.
- Asset managers who trade stocks to gain marginal advantage over the short term forgo an opportunity to create value by investment "stewardship" in the form of constructive engagement with companies to create long-term value.
- Excessive turnover by investors is damaging to the efficiency of markets, as momentum trading (herding) drives volatility.

Reducing turnover involves behavioral change. It requires investors to believe that they are holding the right stocks; it also requires monitoring, engagement, resourcing, and corporate communications to give them confidence to continue to hold those stocks. The framework used to consider and measure risk is also relevant, as the prevailing practice of relative performance leads to a focus on "tracking error" and drives turnover. To promote functional behavior, the Kay Review calls for a strategy shift from "exit" (the characteristic behavior of a market trader) to "voice" (the behavior of a long-term owner; e.g., Kay 2012, ch. 1, cl. 1.31).

To capture the cost of excessive trading, we assume an active manager level of turnover of 70%, and we estimate costs associated with turnover at 0.40% per annum.[7] We also assume that a long-term investment approach would reduce turnover for active managers from 70% to 30%.

Manager Transitions

Another significant friction cost is represented by the hiring and firing of asset managers. This process is most relevant to the outsourced asset management model adopted by most small and medium-sized pension funds. Transition costs arise in at least three ways:
- Administration costs arise from transferring to a new manager and the liquidation or transition of stock. The new manager will not generally want the stock that the old manager had acquired, or not in the same proportions. Often, a professional transition manager will be appointed.
- Asset owners can make poor choices when they decide to replace asset managers. A period of underperformance may merely reflect cyclicality related to the manager's investment style, rather than a permanent turn for the worse. It is very often the case that the removal of a manager precedes an uptick in performance (see, e.g., Mercer 2011).
- Consultant fees to undertake a new search will also contribute to the cost of changing managers.

Reducing the frequency of unnecessary manager transitions requires greater confidence in the managers selected by the asset owner, monitoring managers more effectively, and communicating concerns in more productive ways. These behavioral shifts would reduce reliance on disposable agents in an environment where trust is in limited supply. It would be replaced by productive collaboration, with higher degrees of trust validated by effective monitoring.

To capture the cost of unnecessary manager transitions, we assume that transitions currently occur at five-year intervals, and we assume a cost of 0.4% on active returns each time a transition occurs. We further assume that asset owners who adopt a long-term investment framework will reduce transitions from once every five years to once every seven years.

Manager Tenure and Fees

The Kay Review identifies time frames as fundamentally important to performance contract design:

> *The interests of beneficiaries are largely interests in long-term absolute performance. The concern of asset managers – and the basis on which they are monitored by many asset holders and by advisers to asset holders and retail investors – is short-term relative performance. This misalignment of incentives creates a number of problems. (Kay 2012, 41)*

We would add that:

- extending tenure increases the business stability of asset-management organizations, which should reduce operating costs such as expenses related to business development, and this should be reflected in reduced fees;[8] and
- "partnership-like relationships" between asset owners and asset managers should reduce the number of overall managers used, which should increase manager scale and have a beneficial impact on fees.

Greater business stability should reduce the cost of doing business for asset managers, and these savings can then be passed to asset owners. In our calculations, we assume that a more productive relationship with asset managers will reduce active management fees from 0.65% to 0.45%.

Upstream Friction Costs: Investment Returns

Assessing how investment returns might improve through the adoption of a long-horizon investment framework is perhaps the most challenging and uncertain part of the study described here. We believe it also has the biggest potential payoff for asset owners. Woolley (2010, 122, 136) estimates that corporate earnings could be raised by 1% per annum after inflation and that investment returns could increase in the range of 1–1.5 percentage points per annum, lowering volatility at the same time. So in this section we are interested in the corporations in which asset owners invest and in why the senior managements and boards of these organizations behave as they do.

We begin by looking at how investment managers interact with companies. In a long-horizon investment framework, active asset managers will have lower turnover and more concentrated holdings, while passive managers will place greater weight on engaging with their investee companies. This exchange has economic value.[9] It manifests itself in matters such as governance (board nominations), alignment (executive remuneration), and strategy (mergers and acquisitions) – all key areas that can drive or destroy economic value. On the corporate side, however, boards and managements align their behavior with their perception of what investors want;[10] if they see a trading mentality, that is what they will respond to. Many have the view that the "owners" have been largely absent (see AICD 2011).[11]

Other actors in the investment chain also reinforce and amplify short-termism. For example, merger and acquisition activity often destroys value rather than creating it.[12] This outcome is driven by a convergence of interests between external advisors, who derive fees from transaction activities, and executives within companies, who rationally seek to maximize the outcomes of misaligned remuneration structures. Asset owners could question such practices, but those questions are far less likely to be asked when the owners are effectively market traders and have absented themselves from such discussions.[13]

All these practices foster short-termism, exemplified by the tyranny of quarterly earnings – so-called quarterly capitalism – whereby companies focus on meeting short-term market expectations, very often at the expense of long-term value creation.[14] Government activity also plays a role here. A strong assumption of market efficiency has led to a strong emphasis on information and market disclosure, and less emphasis on market failures and how to correct those failures. This is now changing: the introduction of Stewardship Codes in the United Kingdom, the European Union, and elsewhere; the taxation of financial transactions to slow down churn (Tobin taxes); and measures to reinforce good governance, transparency, and integrated reporting are all good examples.[15]

The central point of all this is that if asset owners acted more like real owners; if regulation focused on mitigating market failures and encouraging long-term ownership and capital allocation behaviors; if companies were empowered to resist the short-termism of quarterly earnings, material improvements in long-term value creation and preservation become real possibilities. We noted above that Woolley (2010) estimates improved company performance would flow through to an improvement in investment returns of 1–1.5 percentage points per annum. Our more modest working assumption is that if companies and owners, with regulators as facilitators, act as long-term investors, there will be an increase in global equity returns of 0.5–0.75 percentage points per annum.

Table 1: Assumptions for Each of the Four Journeys

Assumptions	Journey 1: Passive	Journey 2: Active	Journey 3: Downstream	Journey 4: Upstream / Downstream
Start value, $	100	100	100	100
Annual contribution, $	0	0	0	0
Passive proportion of assets, %	100.00	0.00	60.00	60.00
Active proportion of assets, %	0.00	100.00	40.00	40.00
Passive global equity returns, %	5.00	5.00	5.00	5.75
Active outperformance, %	n/a	1	1.25	1.25
Passive turnover, %	10.00	n/a	10.00	10.00
Active turnover, %	n/a	70.00	30.00	30.00
Turnover cost, %	0.40	0.40	0.40	0.40
Transition rate, interval	n/a	5 years	7 years	7 years
Transition cost, %	0	0.40	0.40	0.40
Passive management fees, %	0.10	n/a	0.10	0.10
Active management fees, %	n/a	0.65	0.45	0.45

What Happens to $100 Over 20 Years?

With our operating assumptions in place, the next step is to look at what happens to a saver's $100 over a 20-year period in four different journeys. Table 1 summarizes all of the assumptions for each.

For all four journeys, the $100 is invested at the beginning of the period and we assume no further contributions. We believe the "impact" assumptions developed above and summarized in Table 1 are realistic over a 20-year investment horizon. The four journeys are as follows:

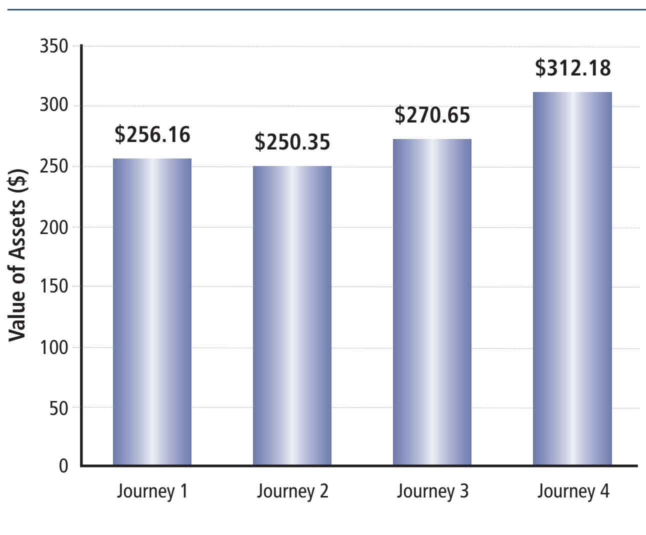
- ***Journey 1 – Passive Investment:*** This is the simplest journey, based on 100% passive investment. In practice, investors will want to think closely about approaches to passive investing, including alternatives to market cap indices such as fundamental weighted, equal weighting, and ESG options, as there are several fundamental items to consider.
- ***Journey 2 – Active Investment:*** We assume 100% active management using a simplistic, single-manager approach. We have claimed a modest amount of alpha (1%), but the cost of pursuing that alpha, in the form of turnover, transition costs, and management fees, extinguishes this excess return versus a passive alternative.
- ***Journey 3 – Addressing Downstream Leakages:*** We assume serious attempt to address the downstream leakages in the financial services sector. We acknowledge the inherent challenges of active management and have shifted to a core/satellite approach, with 60% of the portfolio allocated to passive management and 40% to more enlightened approach to active management via a concentrated and diversified structure. This helps enhance the active management expectations (to 1.25%). Active management fees are lowered from 0.65% to 0.45%:
  - On the passive side, while we may see some scope for fee reduction by aggregation creating larger pools of assets (economies of scale), we also prefer alternative forms of indexation that may cost more.
  - For active management, turnover is reduced to 30%.
  - For both active and passive, it is expected that economic benefit will also be derived from longer-term, more stable relationships between asset owners and asset managers, leading to both reduced business costs for the asset manager and reduced transition (and related) costs for the asset owner.

- ***Journey 4 – Addressing Upstream and Downstream Leakages:*** Here we add a significant change in investment focus upstream in the investment chain, leading to an uplift in aggregate company earnings because of a web of actions related to long-term ownership (e.g., extended dialogue between asset owners and companies; a shift away from damaging short-termism and an increased capacity to pursue long-term value creation; more concentrated and long-term holdings by owners; and some regulatory changes to reduce churn in the system). An additional 0.75% of broad equity market returns results. Active returns remain at 1.25%, although one could argue for a positive impact here also.

In Journeys 3 and 4, asset managers are expected to increase their level of engagement. This will come at a cost, but the cost savings from aggregation of assets, increased smart beta in the active space, improved relationship stability, and fewer transitions are sufficient to absorb this additional expense. The expectation for increased engagement also justifies our reluctance to push passive management fees below 10bps.

Figure 1 indicates the return enhancement potential of a long-term investment approach that addresses both upstream and downstream leakages. Note, for example, that Journey 4 produces 25% more wealth than Journey 2.

Figure 1: Impact of Leakages: Four Journeys of $100 over 20 Years



Downstream Implications for Behavioral Changes in Investment Practice

Much of the literature on long-term investing assumes that the benefits of a longer-term approach to investing are self-evident, that such an approach has no or little downside, and that there is, in fact, a decrease in risk. There is a growing body of evidence supporting this view.[16] However, the actual implementation of a long-horizon investment program is far from straightforward; profound changes in investment practices and behaviors are required.

With respect to downstream implications, we made four assumptions about the relationship between the asset owner and asset managers:

1. More patience in asset management relationships, with manager transitions or turnover from every five years to every seven years. For example, the average turnover for products rated A in Mercer's Global Equity, Core universe is 15% per annum.
2. A reduction in active management fees through the use of enlightened active management, more effective use of active managers, longer tenure, and greater aggregation of assets.
3. Reduction of stock turnover in active management.
4. Increased expectations with regard to stewardship activity.

Achieving such relationships requires different thinking, different tools, and modifications to the principal/agent relationship. It must become more porous, and take on some of the characteristics of partnership.

Three practical implications are:

1. Investment management agreements (IMAs) need to change to provide greater alignment between asset owners and asset managers. Performance must be measured and payment made over a longer period, such as a five-year rolling measurement period.[17]
2. Transparency on the part of the asset manager is needed to reinforce trust. This is part of the tradeoff for longer-term mandates.
3. The asset owner needs to develop a new way of understanding and evaluating manager performance capacity as well as performance (e.g., emphasize qualitative over quantitative factors, expand the quantitative factors monitored [e.g., corporate ROEs, investment income vs. relative stock price performance]).

See Box 1 for the views of 250 experienced investment professionals on actually implementing the changes.

Box 1: What Does the Investment Industry Think?

In a 2013 Mercer client conference, the challenge of "changing the game" to a long-term investment horizon was intensively discussed. The audience consisted of 250 experienced investment professionals – generally at CIO level. We offered four measures and asked them to vote on which would have the most impact and what would be the most beneficial change in fostering a long-term perspective (due to rounding, vote percentages do not add to 100%):

- Asset owners measuring performance of asset managers annually rather than quarterly or monthly (27% of the audience thought this would have the greatest impact)
- Asset owners providing a long-term signal to managers via a longer-term mandate (17%)
- Asset managers modifying their investment approach to account for a longer-term horizon – increase holding period (23%)
- Asset managers modifying their investment approach to account for a longer-term horizon – increase engagement (33%)

We asked not only about which change would have the most impact – the results above – but also about which would be easiest to implement and also, even if the change was high impact and beneficial, how many thought it "will never happen." This is where our audience picked up on the behavioral and systemic barriers to change that we have commented on above.

Take for example the movement from quarterly / monthly earnings to an annual cycle: as noted above, 27% of the audience thought this would have a high impact, and 60% thought it would be relatively easy to implement – but 41% predicted that this will never happen (Mercer 2013a).

The other results were equally interesting. The full paper may be found at:
http://www.mercer.com/referencecontent.htm?idContent=1210745.

Upstream Implications for Behavioral Changes in Investment Practice

We now turn to the relationship between institutional investors and the companies they invest in. Recall that we assumed above that a long-term increase in average global equity returns from 5.0% to 5.75% is plausible. What are the behaviors that would enable this to happen? In short: stop doing counterproductive things and start doing beneficial things.

Counterproductive things include excessive reliance on quarterly capitalism. Resisting this requires a multifaceted approach that draws on all participants in the system. Asset owners must review asset managers' performance over the longer term and commit to addressing such crucial matters as reform of executive remuneration models. Companies must build more stable ownership bases and shift their communication emphasis from the sell side to the buy side.[18] Regulators must support measures that enable these shifts.

Beneficial things include quality interactions between asset owners and corporations. For such interactions to occur, asset owners must understand corporate value creation and the company must know that they do. Where funds are invested passively, we must shift to a paradigm where the ownership is active.

Again, we see three practical implications in this paradigm shift:

1. A structured means of engaging investee corporations to understand company strategies aimed at creating long-term value
2. The requisite resources in asset owners and asset managers to interact with companies and evaluate information in this framework
3. Clearer understandings between companies and owners (e.g., clarity on what is and what is not acceptable in terms of the levels and designs of executive remuneration schemes)

Do we have the tools necessary to achieve this paradigm shift? In our view, the answer is mostly yes, but we have some way to go.

The Free-Rider Problem

This article presents a case for longer-term investment strategies as a means to achieve higher and more stable long-term returns for pension funds and their beneficiaries.

However, despite the beneficial impacts described here, there are also costs associated with implementing these long-horizon strategies (e.g., time spent engaging with companies, time spent with regulators, and time spent with asset managers). Also, someone must pay for the special expertise necessary to understand what corporate information is required and to understand the strategic direction (good or bad) that investee companies may be heading in.

While there may be a net benefit to the asset owners that ultimately bear these costs, it will not be as great as that obtained by their peers who do little or nothing. This is the classic free-rider problem. We believe, however, that it is clearly in the interests of pension funds (and therefore consistent with fiduciary duty) to improve the system for all participants for the longer term. In this context we also note that an evolving understanding of fiduciary duty, an evolution in thinking that more explicitly incorporates a longer-term and intergenerational perspective, offers the opportunity for this approach to become more widely acknowledged as best practice (see Hawley, Johnson, and Waitzer 2011).

We believe that investment consultants also have a key role to play in this transformation process. For example, they could:

- integrate stewardship considerations more fully into how passive managers are assessed;
- pilot new ways to measure the performance of asset managers;
- assess the detailed portfolio characteristics of long-horizon investment mandates and associated portfolio construction opportunities;
- analyze the reasons for turnover when assessing a strategy; and
- conduct global projects to understand how best to promote constructive dialogue and long-term relationships between investors and companies (see Mercer 2013b).

Seven Key Questions for Pension Funds to Consider

If asset owners conclude that long-term investing is of value, they must provide the spark to make it happen. To that end, we pose seven key questions they should ask themselves. These questions are equally relevant to asset owners with internal investment functions and those that outsource this function.

Downstream Questions

1. ***What are the levels of active and passive turnover in our portfolio?*** What is the rationale for the level of turnover? What is the average concentration of stocks held by active managers?
2. ***What is the level of manager terminations in the last decade for our fund?*** How frequently do we review asset managers? What is the average tenure of our managers? How are these managers performing post-termination?
3. ***What is the process for review, including qualitative and quantitative factors?***
4. ***What is the process for engaging with asset managers?*** How well do we know them, and what are their capabilities? How do we retain and use knowledge gained from manager interviews? To what extent is this our own view, and to what extent is it the view of a consultant?

Upstream Questions

5. ***How do we (or our asset managers) engage with companies?*** Is there a clear plan and understanding of what is effective engagement, in terms of the investment thesis? What results have been reported?
6. ***Would we be prepared to support companies that do not provide quarterly earnings guidance?***
7. ***Is our fund willing to expend resources to improve the long-term efficiency of markets overall?*** If so, what is the best approach to achieving this? Do opportunities for collaboration exist?

Serving the Interests of Savers

Our focus on investment system leakages in this article does not imply that we should cease to work on creating better investment strategies and investment processes across a whole range of areas to improve pension returns. Nor do we advocate reducing friction costs at the expense of moving to market-cap passive, selecting managers based purely on turnover statistics and fees, or retaining managers when there are good reasons to terminate them.

We do, however, believe that a focus on leakages serves the best interests of ordinary people saving for their retirement years. That is, many savers and their agents, the asset owners, may not be accumulating pension pots at the rate they could be. We have shown above that asset shortfalls as high as 25% are plausible over a 20-year investment period, largely due to behaviors and processes that are suboptimal but are rational in terms of the current configuration of the system.

In summary, we make two main points:

1. A more productive economy (with higher better gross returns for all), requires investment processes that incentivize longer-term thinking and reduce short-termism. Part of the solution is greater, more effective engagement of asset owners with companies.
2. Better investment outcomes for individual savers require smarter investment strategies and a reduction in friction costs. We have concentrated on the latter in this article, but the former warrants significant focus as well.

Asset owners are in the best position to be catalysts for the kinds of changes we propose. Asset owners can send powerful signals for change rippling through the investment supply chain. What sort of asset owners? Pension funds come foremost to mind, but other large investors such as endowment funds, insurers, and mutual funds can play important roles too. These actors are of critical importance in serving the interests of savers and of the broader economies in which they live.

Endnotes

1. We are grateful to David Zanutto, Director of Consulting for Mercer Investments – Canada, for his thoughtful and challenging comments on an earlier version of this paper. The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed. Past performance does not guarantee future results. Mercer's ratings do not constitute individualized investment advice. Information contained herein has been obtained from a range of third-party sources. While the information is believed to be reliable, Mercer has not sought to verify it independently, and therefore makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability for any error, omission, or inaccuracy in the data supplied by any third party.

2. The issue of short-termism in the investment process has long been a preoccupation of economists and thinkers about finance. Haldane and Davies (2011) include a wonderful comment from William Stanley Jevons's preface to *The Theory of Political Economy* published in 1871, making the point that the complaint is hardly new. However, it is fair to say that this matter has received a lot of recent attention. See, for example, the work of the Marathon Club (2007) and, even more recently, the significant contribution of the Kay Review (Kay 2012), as well as such industry publications as the white paper "Sustainable Capitalism" (Generation IM 2012) and Mercer's briefing paper "Loyalty Shares and Incentivizing Long-Term Shareholders" (Mercer 2013b). On short-termism we may also borrow a pithy definition from the CFA Institute (2012, 2.): "Short-termism refers to the excessive focus of some corporate leaders, investors, and analysts on short-term, quarterly earnings and a lack of attention to the strategy, fundamentals, and conventional approaches to long-term value creation."

3. The term "friction costs" here relates to the cost of doing business and is not necessarily pejorative. These costs may be mandated by regulation (e.g., audit costs or the costs related to disclosure), or they may be discretionary (e.g., the services of investment banks for companies, or the services of fund managers and asset consultants for pension funds).

4. A brief word on terminology: a "saver" is an individual who places retirement funds with an institution; an "investor" is an entity that invests in equities – it may be the pension fund, or it may be asset manager acting as an agent for a pension fund (however, as we will argue, pension funds in relative terms have a critical role in the system); "pension fund" is used interchangeably with "superannuation fund"; "asset owner" is a term increasingly used for institutions acting as fiduciaries in relation to savers (such as pension funds), although these organizations are not actually the beneficial owners. "Asset managers" (or "investment managers") are engaged to implement a specific mandate on behalf of asset owners. For the purposes of our illustration, the investment managers are assumed to be external, but some asset owners have internal investment management, particularly in larger schemes.

5. On a low-return world see Woolley (2010, 121) but also see, more generally, Dimson et al (2013).

6. Woolley (2010, 123) also points to >30% turnover as indicating "excessive" turnover; subsequently, in a recent speech (Woolley 2013), he has called for pension funds and foundations that exceed this level of turnover to lose their tax-free status.

7. See, e.g., IRRC and Mercer (2010, 7), which puts average asset manager turnover at just over 70% but records around "20% of strategies falling into the ≥100% turnover end of the spectrum."

8. All these points are reflected in the Kay Review in one form or another. Woolley (2010, 138) adds an interesting one: "Do not pay performance fees. Trying to assess whether a manager's performance is due to skill, market moves or luck is near impossible. Also performance fees encourage gambling and, therefore, moral hazard. If funds cannot resist paying them, performance should be measured over periods of several years."

9. See Dimson et al. (2012), who puts the engagement impact of ESG engagement at 4.4% one-year abnormal returns for successful engagement, 1.8% for all engagements, and zero (no negative impact) for unsuccessful engagements. See also Junkin and Toth (2010), who identify a positive impact for engagement (2.4% above benchmark on an annualized basis) and notes that the engagement approach has been instrumental in halting the "rapid erosion of performance results" at the company level.

10. Stephen Covey (1989) famously made this point in *The 7 Habits of Highly Effective People*.

11. An interesting finding of this report, completed by Mercer for the Australian Institute of Company Directors, was that companies almost invariably thought of the "shareholder" as an asset manager, while the pension fund rarely rated a mention (AICD 2011, 5). See also Monks (2013).

12. There is a considerable body of evidence on this point: see Christofferson et al. (2004) and, more recently, Christensen et al. (2011), citing earlier studies that place the failure rate of mergers and acquisitions between 70% and 90%.

13. "Say on pay" developments across markets in recent years have created the opportunity for owners to more fully address this issue and have facilitated increased engagement; however, owners have rarely used this tool to voice dissent.

14. See, e.g., Haldane and Davies (2011, 14) on excessive discounting of future cash flows: "This is a market failure. It would tend to result in investment being too low and in long-duration projects suffering disproportionately. This might include projects with high build or sunk costs, including infrastructure and high-tech investments. These projects are often felt to yield the highest long-term (private and social) returns and hence offer the biggest boost to future growth. That makes short-termism a public policy issue." Further, in a survey conducted by Graham, Harvey, and Rajgopal (2005), approximately 80% of managers indicated that they would sacrifice net-present-value-positive projects and cut expenditure directed at supporting long-term value creation to avoid missing quarterly targets.

15. This ground is well covered in Generation IM (2012) and Haldane and Davies (2011). In this context see also the UK Stewardship Code (Financial Reporting Council 2012); the EU "Action Plan" (European Commission 2012); the work of the International Integrated Reporting Council (IIRC 2013); and the work of the Sustainability Accounting Standards Board (SASB).

16. See DB Climate Change Advisors (2012), which covers similar ground and comes to much the same conclusions.

17. Various attempts to redraft IMAs have met with limited degrees of success – see, e.g., the International Corporate Governance Network's Model Mandate Initiative (ICGN 2012).

18. In this context we also note the considerable potential of the Integrated Reporting (<IR>) initiative, which seeks to address the limitations of current accounting-based reporting and, in particular, value in relation to company strategy and intangible factors (e.g., people, natural resources, intellectual capital, market, and regulatory context) – or, to quote the International Integrated Reporting Council, "An integrated report is a concise communication about how an organization's strategy, governance, performance, and prospects lead to the creation of value over the short, medium and long term" (IIRC 2013, 8).

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