FAIR CAPITALISM: A MANIFESTO FOR CHANGE

MAY 2013
The growing call for capitalism to be ‘fairer’ or ‘more sustainable’ is not going away. In fact realistic prospects of a low return environment has increased visibility on the issues and provided greater impetus for action.

The importance of stewardship in protecting and enhancing value has been strengthened by initiatives such as: the 2012 Kay Review of UK Equity Markets and Long-Term Decision Making\(^1\), which argued that “business and finance work together to create high performing companies and earn returns for savers on a sustainable basis”; Elroy Dimson’s recent study on the efficacy of engagement\(^2\); and Andy Haldane’s work on ‘patient and engaged capital’, which should lead to the optimal allocation of resources across the economy\(^3\).

Mercer has begun actively reviewing how we can help investors implement beneficial changes to directly contribute to creating and preserving a ‘fairer’ long term value for their invested capital. ‘Fair Capitalism: A Manifesto for Change’, was a well received plenary session at Mercer’s Melbourne Global Investment Forum in March. Divyesh Hindocha, Global Director of Consulting, and Jane Ambachtsheer, Global Head of Responsible Investment, built on last year’s presentation on value lost through leakages, by focusing on possible behavioural and market changes to create and retain value for long term investors.

As Divyesh highlighted, this is a human challenge for reasons of biology and the way our brains make short term versus long term decisions; our attention spans appear to be getting shorter and our willingness to commit in many aspects of our personal lives diminishing. In investments there is a role for short and long term participants but short term participants may be having a bigger impact. Patient investors need to find a way of restoring some balance resulting in a beneficial cycle of patient investing for long term value creation.

The speakers proposed ten areas of change for asset owners, asset managers, the system and companies. The audience of about 300 attendees were also asked to vote on which changes were expected to:

- have the ‘most impact’,
- be ‘easiest to implement’
- ‘never happen’.

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Improving timeframe and incentive alignment throughout the investment value chain is expected to increase the probability that the end investor will ultimately receive a greater share of the wealth created for putting their capital at risk.

The panel session which followed gave the opportunity for an asset owner, Andrew Gray of AustralianSuper, an asset manager, Dr Simon Marais of Allan Gray, and an industry representative, Paul Smith of the CFA Institute, to provide their views on the change proposals and where our industry should direct our focus.

This short paper summarises the proposals, the voting results, the key panelist views, and offers a short list of actions to maintain momentum for a positive change.

The risk and return relevance

Improving timeframe and incentive alignment throughout the investment value chain is expected to increase the probability that the end investor will ultimately receive a greater share of the wealth created for putting their capital at risk. Misalignment can undermine long term value creation by allowing rent extraction and other leakages that are not in the best interests of investors.

Mercer believes these issues are always important, but when everyone is doing well the return impact is less visible. A low return environment leads investors to focus on leakages, or an unnecessary loss of value, and it becomes more visible.

Leakages through the investment supply chain can have a material impact, as quantified in recent Mercer research, which references the work of Paul Woolley4 and others, to trace the journey of 100 dollars invested by a super fund member for their retirement under multiple scenarios. The journey which was most successful in addressing leakages delivered additional returns in the magnitude of up to 16% over a 20 year period. This strategy aimed to reduce aspects such as high turnover in portfolios, high turnover in managers, and ‘upstream’ loss associated with excessive executive remuneration and questionable merger and acquisitions activity5.

Ignoring the long term may not just lead to a loss of value – it may also materially increase risk. Climate change is a powerful example. Recent research by Baker & McKenzie concludes that superannuation fund trustees are exposed to legal risks in the event of financial losses caused by the impacts of climate change. Under the Superannuation Industry (Supervision) Act 1993 and the Superannuation Industry (Supervision) Regulations 1994, trustees are required to ensure that all risks are “adequately and prudently considered”. Given climate change poses significant risks to investments, Baker & McKenzie concluded that climate change should be considered and managed as part of super trustees’ legal obligations and duties. It also concluded that “the gap between understanding and action represents a clear legal risk to trustees”6.

Change proposals

There are three fundamental ways to affect this manifesto for change – legislation, litigation and voluntary codes (which in a common law framework often find their way into law). Legislation is a blunt instrument, and can bring unintended consequences; litigation driven by stakeholders is not inconceivable to imagine in future on topics like managing climate risk; and the third option is to change industry practice.

The Mercer session on a manifesto for change focused primarily on industry practice, with benefits and challenges presented for each. The suggestions are intended to generate discussion and debate and should not be interpreted as Mercer policy.

Divyesh first presented on the relationships between asset owners and asset managers and concluded with four change items. The key point is that all participants in the value chain have a role to play.

Jane then presented on changes for the system and companies, concluding with three proposals for each.

For asset owners, the changes for consideration were:

- Increasing the measurement period of financial performance of asset managers to say annually, as compared to current practice of monthly or quarterly. In between this annual cycle assets owners should instead, monitor aspects such as voting and engagement with invested companies. In other words investors should judge financial outcomes with less frequency but spent more time on the ‘how’ in between the period of financial evaluation.
- Signalling longer term mandates with fund managers to align objectives and reduce their business development costs and therefore, it is expected, their fees.

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4. Paul Woolley Centre for Dysfunctional Capital Markets at London School of Economics http://www2.lse.ac.uk/fmg/researchprogrammes/paulwoolleycentre/home.aspx
5. Mercer paper by Dr Richard Fuller and Divyesh Hindocha to be released Q2 2013.
For asset managers, the changes for consideration were:
- Adopting a longer term time horizon and extending holding periods to reduce turnover costs in favour of a higher concentration, higher conviction approach.
- Adopting a ‘farming, nurturing, influencing’ approach and increasing engagement and voting processes with companies.

The system changes for consideration were:
- Financial transaction taxes as a disincentive for excessive short term, high frequency trading.
- Stewardship Codes could be introduced, as has been done elsewhere around the world, to raise the bar in relation to fiduciary duty and engaged ownership.
- Price externalities to overcome the ‘tragedy of the commons’ and protect long term capital markets.

For companies, the changes for consideration were:
- Redesigning executive compensation to pay for ‘real performance’ i.e. long term value creation not just stock performance.
- Integrated reporting on real performance, which includes financial, strategy and sustainability factors.
- Rewarding patient capital through a ‘loyalty shares’ concept where additional voting rights or dividends could be provided for longer term investors. A project is currently underway to review the viability of this sort of approach for companies.

It is worth noting, that while it is more difficult for the investment industry to directly influence the system changes, investors are key stakeholders in capital markets and it is important for fiduciaries to have well considered views and take active responsibility to benefit their ultimate investors. System changes could improve the conditions for the most immediately relevant changes within the investment value chain.

The audience vote
Three questions were posed to the audience to then vote on in relation to the proposed changes: which were expected to:
- have the ‘most impact’,
- be ‘easiest to implement’
- ‘never happen’?

Approximately 250 results were received from audience members, which included primarily Australian superannuation funds, insurers, foundations, wealth management platforms, fund managers and Mercer staff. While we don’t claim that the results from these quick polls during the session represent the views of the finance industry, the outcomes are, nevertheless, the views of an expert and thoughtful subset of that industry.

Changes for asset owners and asset managers:
Asset owners measuring performance annually rather than quarterly was a clear favourite for easiest to implement, with 59.7% of the vote. However, 41.3% also believed that this would never happen. 26.8% expected this change to have the most impact.

In terms of most impact, the clear front runners were asset managers increasing their level of engagement with companies (33%), and asset managers increasing their holding periods (23.4%). Increased engagement only received 13.0% of the vote, however, for easiest to implement, and it was lower again for implementing increased holding periods, and each option had roughly 17% of the votes for would never happen.

Signalling longer term mandates for managers was not considered particularly difficult to implement but was also expected to have the lowest impact, with only 18.0% of the vote.

Changes for companies and the system:
Changing executive remuneration structures was a clear winner in the impact stakes with 38.6% of the vote, with loyalty shares and taxing short term trading the next favourites with just under 20% of the vote each. Stewardship codes and integrated reporting were expected to have the least impact.
A threshold issue is for companies to have strong relationships with their beneficial owners, e.g. the super fund behind the agency chain of managers and brokers, so that the long term interest of fund members can be clearly communicated to companies.

ANDREW GRAY, AUSTRALIANSUPER

Taxing short term trading was deemed easiest to implement by 29%, followed by just under 20% each going to integrated reporting, changing executive remuneration and including stewardship codes. Loyalty shares weren’t too far behind but pricing externalities barely registered a reading for easiest to implement.

Changing executive remuneration and pricing externalities were deemed equally likely to ‘never happen’ with 26% of the vote each.

Voting differences between asset owners and asset managers:

There was, on the whole, consistency between the asset owners and the fund managers in the room, leaving the Mercer vote to one side, but there were some areas where the differences were revealing.

• Asset owners thought it would be much easier to change manager performance monitoring to annually than managers thought it would be.

• Asset owners were generally more positive about the implementation ease and the impact level for the three proposed company changes than asset managers were.

• Asset owners were also more convinced that taxing short term trading would never happen but asset managers were more likely to think it would have a bigger impact.

• Asset owners were much more positive than asset managers about the impact of increased engagement; however, it was the asset owners that were also three times as likely as the asset managers to say that it would never happen.

• Asset managers thought it would be easier for asset owners to provide longer term mandates than asset owners did.

The panel discussion:

The panel session which followed gave the opportunity for an asset owner, Andrew Gray of AustralianSuper, an asset manager, Dr Simon Marais of Allan Gray, and an industry representative, Paul Smith of the CFA Institute, to discuss their views. There was general consensus on the need for a longer term focus, that value was being undermined etc., but there were, not surprisingly, different focuses for each. This summary will not do each of these participants justice, but it is worth raising a few key focus areas.

Andrew Gray pointed out the significance of principal / agency issues, and that at the end of the investment chain was a saver that needed retirement income. He pointed to biases in the system against long-term behaviours: the need for fund members to recognise the long term nature of superannuation despite the short term focus in media and news reporting on superannuation, the influence of one year league tables, and the challenge of engaging members in communicating a long term investment approach.

Dr Simon Marais recognised there are a broad array of issues, but said we should look at measuring what is important and then act strongly (and courageously) on those things that will really trigger behaviour change, such as voting against excessive executive remuneration and lengthening executive incentive alignment to a ten year time frame.

Paul Smith of the CFA Institute made connections to the Institute’s new Future of Finance project, aimed at promoting greater professionalism and ethics in our industry. He proposed that getting back to putting clients’ interests first is important to encouraging more active ownership and pushing for the governance changes that have never eventuated after 2008.

Conclusions / Actions

Different experiences and exposures along the value chain, not surprisingly, produce different perspectives on the proposed changes and the likely impact of implementation. Trying to find the changes that combine greatest impact and implementation ease throughout the system is not easy, but it is possible.

Mercer doesn’t believe we need to pick just one change in just one part of the value chain to make a material difference. A single behaviour change is, however, a good start. Putting the ultimate investors’ interests first, becoming more active and engaged owners, and making changes to the relationship between asset owners and asset managers will be made by shifting incentives and measurement approaches.

So out of the ten proposals, even if you focus on just one behaviour change that will start to make a difference. Maybe it is reviewing the way manager performance is monitored? Maybe it is reviewing your voting and engagement practices, particularly in relation to executive remuneration? And Mercer commits to doing the same in reviewing how we invest and how we advise our clients.
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- **59.72%** Asset owners measuring annual performance monitoring rather than quarterly or monthly
- **19.42%** Asset owners provide a signal to managers via a longer term mandate
- **7.91%** Asset managers modify their investment approach to account for a longer term horizon increase holding period
- **12.95%** Asset managers modify their investment approach to account for a longer term horizon increase engagement
- **26.76%** Asset owners measuring annual performance monitoring rather than quarterly or monthly
- **16.89%** Asset owners provide a single to manager via a longer term mandate
- **23.39%** Asset managers modify their investment approach to account for a longer term horizon increase holding period
- **32.96%** Asset managers modify their investment approach to account for a longer term horizon increase engagement
- **41.34%** Asset owners measuring annual performance monitoring rather than quarterly or monthly
- **18.44%** Asset owners provide a signal to managers via a longer term mandate
- **20.67%** Asset managers modify their investment approach to account for a longer term horizon increase holding period
- **19.55%** Asset managers modify their investment approach to account for a longer term horizon increase engagement
- **18.42%** Companies to change executive remuneration structures to pay for real performance
- **19.08%** Companies to disclose integrated reporting (financials, sustainability, strategy) to report on real performance
- **14.47%** Companies to reward patient capital - e.g. loyalty shares
- **28.95%** System to tax short term trading
- **17.60%** System to include stewardship codes for investors
- **1.48%** System to price externalities
### Most impact?

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<td>38.64%</td>
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### Will never happen?

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JILLIAN REID  
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Jillian is a Principal within Mercer’s Responsible Investment team. The RI team assists investors to consider environmental, social and governance (ESG) factors within investment decision-making.

Jillian holds a Bachelor of Arts and a Diploma of Education from University of Newcastle and a Graduate Diploma in Applied Finance and Investment from FINSIA. She is currently completing a Master of Development Studies, at University of NSW.

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