with Bernadette Barber

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Long-term focus

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It seems inevitable that reviews of corporate governance and stewardship arrangements follow corporate failures. Indeed, the scale of the recent crisis seems to have spawned an unprecedented number of reviews.

The latest such review will address a long-standing problem, whose solution is frustratingly elusive, namely how to align the timescales on which fund managers operate with those against which company performance is measured. Professor John Kay is the man chosen to discover the remedy.

The primary catalyst behind the Kay Review, which will look at the 'mechanisms of corporate control and accountability provided by UK equity markets', is concern over the impact on UK competitiveness of investor short-termism. It follows the Government's call for evidence, A Long-Term Focus for Corporate Britain, and recent claims by the Bank of England that equity 'market myopia' is real and increasing. With fund managers investing and divesting at the touch of a button, there is an incongruity between the immediacy of their trading decisions and the longer-term performance timescales of individual companies.

The responsibility of investors to perform a stewardship role is now universally recognised, and reflected by the UK Stewardship Code, alongside other guidelines. The inadequate stewardship performed before the banking crisis, especially the failure to effectively challenge bank practices that led to their collapse, has been well-documented. The assumption that the market is perfect no longer holds water. On the contrary, the market is not always efficient or rational; in fact it can be downright daft.

The potential power wielded by short-term investors is actually quite terrifying. Simply by holding shares when a shareholder vote takes place, investors are entitled to exert significant influence over major corporate decisions. Long after those short-term investors have sold their shares, their decisions can have far-reaching, life-changing implications for those whose livelihoods depend on that vote's outcome. The Cadbury takeover is a perfect example.

While doing their best to promote the long-term success of their company, FTSE directors have to keep an eye on keeping the market happy in the short-term. Such considerations can cloud judgments and ideally should have no place in boardroom strategy deliberations.

Part of the answer lies in more effective shareholder engagement. It is heartening that so many investment managers and asset owners have publicly committed to the UK Stewardship Code. A recent report published by the Investment Management Association notes encouraging levels of active engagement amongst the 50 respondents. Yet such results have not been sufficient to allay Government fears over short-termism.

Investment managers are primarily charged with maximising investment returns for their clients. This is explicitly recognised in the Stewardship Code, which states that compliance with the Code does not 'preclude a decision to sell a holding where this is considered in the best interest of end-investors.' Fund managers are constantly taking a view about the outlook for the investments within their portfolio. In order to maximise returns they will inevitably try to adjust their holdings in order to avoid those securities which they feel are likely to perform less well. Decisions based on such short-term considerations will only cease if fund managers are convinced that the benefits of taking a longer-term view outweigh the gains of short-term trading.

In his speech to announce the Kay Review Vince Cable made reference to problems which have been considered before, such as lack of transparency in the investment chain and the means by which fund managers are incentivised. The possible solutions put forward: enhanced rights for long-term shareholders, measurement of executive performance to a greater extent by reference to long-term performance, tax penalties for short-term trading, have also been mooted previously. We will have to wait for the conclusion of the Kay Review in 2012 to discover what recommendations, whether innovative or re-hashes of previous ideas, are made. But one way or another, achieving fundamental changes in market behaviour is not going to be an easy job.

» About the author

Bernadette Barber is the author of ICSA's Corporate Governance Handbook, published by ICSA Publishing. Order your copy at www.icsabookshop.co.uk.