

Financial stability

Short-termism pressures from financial markets

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Summary

Short-termism in finance refers to the focus placed by market participants on short-run profitability at the expense of long-term investments, a tendency that political initiatives such as the EU's action plan on financing sustainable growth seek to limit. The recent empirical evidence collected by ESMA sheds some light on commonly discussed drivers of short-termism. In particular, our findings suggest that the misalignment of investment horizons in financial markets and the remuneration of fund managers and executives that rewards short-term profit seeking could be potential sources of short-termism. Improvements in the availability and quality of ESG disclosure could serve to promote more long-term investment decisions by investors.

Introduction

In its action plan on financing sustainable growth in March 2018, the European Commission includes fostering transparency and long-termism in financial and economic activity as one of its three main aims (European Commission, 2018). On 4 February 2019 the Commission sent a call for advice to the ESAs, requesting them to collect evidence of undue short-term pressure from capital markets on corporations and consider, if necessary, further steps based on that evidence (European Commission, 2019). Following that call, ESMA collected evidence in a public consultation and issued the advice on 18 December 2019 (ESMA 2019). This article discusses some of the commonly identified drivers of short-termism in financial markets, building on the recent collection of evidence by ESMA.

What is short-termism?

Most definitions of short-termism include a reference to the conflict between long-term goals and market drivers.

Short-termism has been defined recently as:

- the focus on short time horizons by both corporate managers and financial markets, prioritising near-term shareholder interests over long-term growth of the firm (Mason, 2015);
- a tendency to place too much weight on short-run profitability at the expense of the long run (HLEG, 2018);
- the need to meet quarterly earnings at the cost of long-term investment (Tang and Greenwald, 2016).

From an investor's perspective, the short-term focus of the investment manager or of the issuer on near-term earnings may come at the cost of reduced investment in both physical and human resources. Excessive focus on near-term earnings and remunerations may conflict with the longer-term interests of a firm's stakeholders, including the investors.

Short-termist goals are reflected in short-term actions. It is on this basis that short-termism can be measured and monitored. For example, the investment-holding period and the turnover of stocks by institutional investors are, *inter alia*, useful indicators to monitor short-termism in financial markets. Based on these indicators, recent evidence suggests that short-termism has

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been increasing, with stocks being held for record short periods of time (Roberge et al., 2014; OECD, 2011).

Another indicator is the turnover rate, which conveys the time spent by managers and corporate post-holders in a given job. Recent evidence here also suggests growing short-termism. For example, the mean duration of departing chief executives from the world's largest 2 500 companies declined from around 10 years in 1995 to around 6 years in 2009 (Haldane, 2010).

The investment horizon is another good indicator for monitoring short-termism. Available evidence here indicates that allocations to long-term and less liquid assets, such as infrastructure and venture capital, have been declining and are being overtaken in importance by allocations to hedge funds and to other high-frequency traders (OECD, 2011).

According to market intelligence, there is an excessive focus of equity research on near-term corporate earnings rather than on sustainable earnings growth over the medium term. This also signals short-termism.

Drivers of short-termism

Possible drivers

The misalignment of investment horizons between investors, asset managers and asset owners is one of the main indicators of short-termism in financial markets. While asset managers typically have a short-term horizon (1 year or less) in their asset evaluations and incentives, investors and asset owners may have much longer-term horizons.

A short-termism 'vicious circle' has also been highlighted whereby the setting of short-term goals and metrics by companies in response to investor demand contributes to shorten investors' horizons further. A frequently cited reason for this vicious circle is stock market forecasts of firm value based on companies' quarterly reported earnings, thus introducing a short-term or myopic incentive in company behaviour (Stein, 1989).

Sustainability is also linked to long-term horizons, because investments needed to generate public good externalities – in economic, social and environmental terms – tend to require action with a long-term orientation. Investment in education, housing, infrastructure, renewable energy and climate change mitigation all require a long-term

horizon, often over several years if not decades (Carney, 2015).

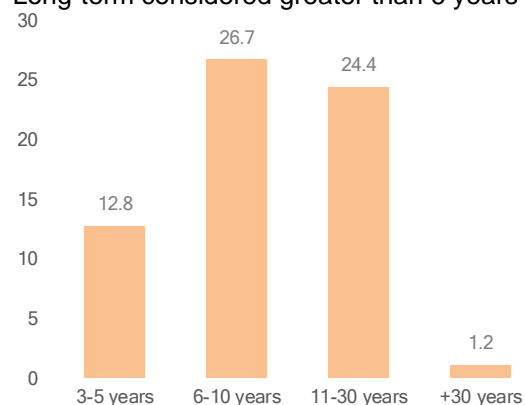
Sustainability cannot develop in a context where investment is dominated by short-term considerations. This is because delivering a sustainable development in economic, social and environmental dimensions requires large-scale investments in physical and intangible assets that are amortised not over a few months but over several years (HLEG, 2018).

Evidence from the ESMA survey

The recent ESMA survey sheds some light on the features and focus of financial market participants investment strategies and horizons. It shows, for example, that over 51% of respondents defined an investment horizon as long-term when it is longer than 6 years (RA.18).

RA.18

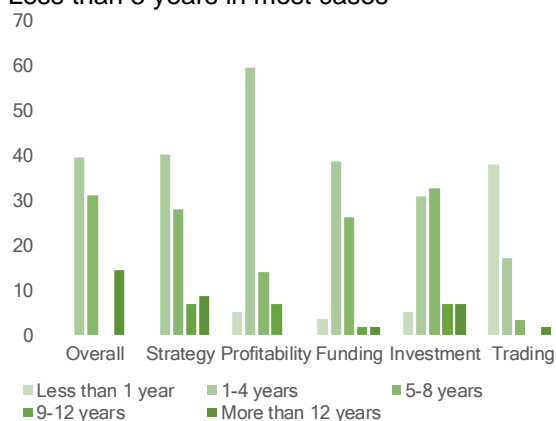
Time frame considered for long-term investment
Long-term considered greater than 6 years



Note: Time frame considered when defining long-term investment (Q7),%.
34.1% of respondents chose the option 'other', not shown in the chart.
Source: ESMA public consultation.

The time horizon applied overall to general business activities is less than 5 years for 40% of respondents. Almost 60% of respondents also chose this range in relation to profitability activities. Some 31% of respondents indicated that the time horizon they apply in their overall business activities is between 5 and 8 years (RA.19). The divergent horizons between different respondents and activities highlight the potential for misalignment of horizons.

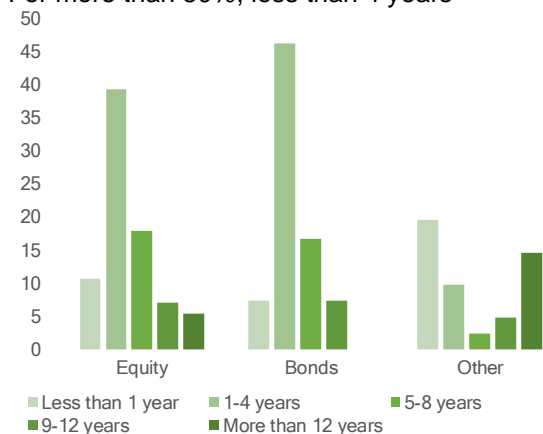
RA.19
Time horizon applicable to business activities
Less than 5 years in most cases



Note: Time horizon applicable to business activities (Q8), %
Source: ESMA public consultation.

The evidence on the actual investment-holding periods (RA.20) shows that the equities are commonly held in portfolios for less than 5 years (50% of respondents). Only a small minority of respondents (13%) apply a holding period that exceeds 9 years. Similarly, the holding period for bonds is less than 5 years for 54% of respondents, while only 7% hold them for a period of longer than 9 years.

RA.20
Holding period
For more than 50%, less than 4 years



Note: Actual holding period prevailing in the investment strategy (Q11), %
Source: ESMA public consultation.

Respondents were asked about the extent to which nodes in the investment value chain contribute to short-termism. Here 45% of respondents consider that sell-side analysts contribute to short-term investment behaviour to a large extent. Smaller proportions of the respondents consider that other financial market participants contribute to a large extent to short-

termism, including top managers of listed issuers (28%), retail investors (20%), asset owners (17%) and asset managers (15%) (RA.21).

RA.21
Drivers of short-termism
Sell-side analysts contribute to short-termism



Note: Nodes in the investment value chain contributing to the tendency towards short-termism (Q9), %
Source: ESMA public consultation.

Market participants tend to indicate several concurring factors without selecting the main cause of short-termism. Potential drivers cited include client demand (35%), market pressures (31%) and competitive pressure (30%). On the other hand, 44% of respondents consider that executive management remuneration does not result in short-termism by their institution, while 21% of respondents think that executive remuneration is only a limited driver of short-termism. Macroeconomic environment contributes to short-termism according to 42% of respondents, while it is not considered relevant at all by 22%.

Finally, 80% of the respondents to the survey do not expect any major change in relation to the investment horizon characterising their business in the coming years.

Can environmental, social and governance disclosure help?

The public debate on short-termism frequently cites disclosures of sustainability and environment, social and governance (ESG) factors as a way to relieve pressure on corporates and financial institutions to deliver short-term financial results, thus enabling investors to take a longer-term approach.

The disclosure of appropriate non-financial measures constitutes an important element to complement traditional financial measures (Barton, 2017). The recent increase in stakeholder scrutiny of ESG matters, including by

large institutional investors, and companies' growing awareness of the risks and opportunities associated with ESG issues confirm the importance of disclosure on these aspects.

As of 2018, 1 950 organisations, with almost USD 90tn in assets under management, had signed the Principles for Responsible Investment. This indicates a growing commitment by investors to incorporating sustainability issues into their analysis and decision-making. ESG factors also increasingly appear to influence the allocation and monitoring of assets at major institutions (Deutsches Aktieninstitut and Rothschild & Co. Deutschland, 2018).

However, the existing literature also identifies a number of challenges to effective mandatory ESG disclosure, most notably the difficulty of creating standards that ensure disclosure of comparable, reliable and relevant ESG information, the (lack of) materiality of ESG information disclosed, the use of boilerplate language as an avoidance tool, and the absence of an enforcement and assurance regime for ESG reporting (Christensen et al., 2019). Another challenge identified relates to the risk of bias in the reported information (Boiral, 2013).

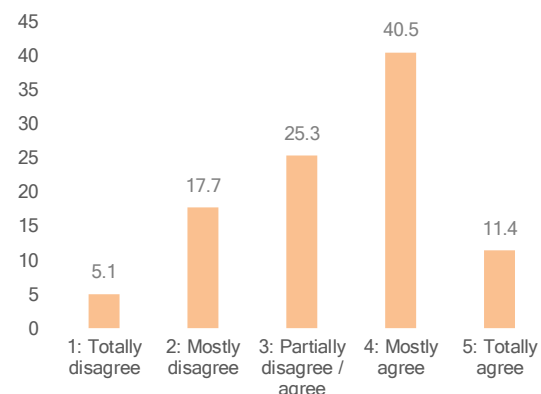
These challenges and the increasing demand from investors for ESG disclosure highlight the importance of the quality of the information provided by issuers.

The importance of ESG disclosure by listed companies for enabling investors to take long-term investment decisions is also supported by some of the ESMA survey findings: 77% of the respondents acknowledge, to varying degrees, that ESG disclosure provides insights into a listed company's long-term risk profile, that it complements the information provided by listed companies in their financial statements and that it provides insights into a company's future financial performance (RA.22).

RA.22

ESG disclosure by listed companies

Improved ESG disclosure for longer investments



Note: Extent of agreement with the statement: disclosure of ESG information by listed companies enables investors to take long-term investment decisions (Q15), %.

Source: ESMA public consultation.

However, several factors discouraging investors from using ESG disclosure to apply a long-term investment horizon have also been mentioned, including:

- a lack of sufficiently forward-looking disclosure on ESG risks and opportunities;
- a lack of comparability between different companies' disclosure, due to the Non-Financial Reporting Directive requirements not being sufficiently detailed and allowing use of various frameworks;
- a lack of a clear link between ESG matters and the company's current and future performance;
- a lack of consistency between companies' disclosed ESG policies and evidence of their actions.

Finally, ESG data quality also remains an issue: data are self-reported, leading to low reliability and consistency; disclosure methodologies vary between data providers; and data are often not quantifiable.

Fair value accounting: a short-termism driver?

Another potential factor affecting investment horizons is the use of fair-value measurement, especially since the implementation of IFRS 13 Fair Value Measurement (effective since 2013) and of IFRS 9 Financial Instruments (effective since 2018). Some stakeholders have voiced concerns that the increased volatility in profit and loss brought by IFRS 9 might lead those entities that are subject to the new standard, namely listed companies, to reduce their exposure to

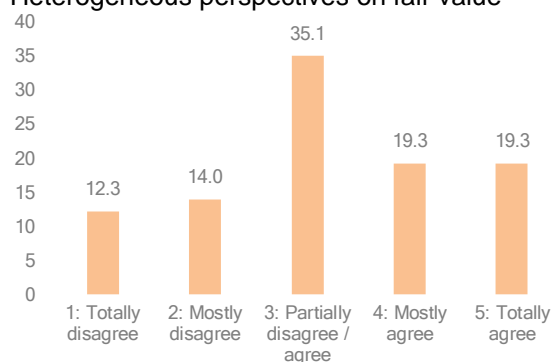
equity-type instruments, which would be detrimental to long-term investment.

While recognising the limitations of fair value accounting, the economic literature overall recognises that there are no credible alternatives (Véron, 2008; CFA Institute, 2013; Magnan et al., 2015).

The ESMA survey findings also shed light on fair value accounting: 39% of respondents generally agreed that fair value provides relevant information for a company's management regarding the short- and long-term consequences of the investments held, 35% held mixed views (i.e. partly agreeing and partly disagreeing) and 26% disagreed (RA.23). More decisively, for a majority of respondents IFRS 9 is not a decisive factor when deciding whether or not to undertake a new long-term investment (58%) or when triggering divestment (66%).

RA.23

Perspectives on fair value accounting measures
Heterogeneous perspectives on fair value



Note: Fair value accounting, replies to the question: for the purpose of enabling an external analyst or investor to assess the performance of long-term investments held in equity instruments by a company, fair value provides relevant information in order to better understand the short-term and the long-term consequences of the investments (Q23), %
Source: ESMA public consultation.

Therefore, according to both the survey and the recent literature, the fair value measurement does not appear to lead to distortions of the investment process that trigger undue short-termist pressures in financial markets.

Investor engagement

Shareholder engagement is often mentioned as a way to counter short-termism and to ensure the sustainable development of companies. Traditionally, researchers considered monitoring to be the key tool to reduce the information

asymmetries between shareholders and managers (Berle and Means, 1933). Corporate finance literature has also investigated this (Rock, 2015), and concluded that investors lack proper incentives to monitor.⁷⁵

Recent literature also presents a variety of engagement possibilities available to minimise this principal-agent problem between shareholders and management (Ertimur et al., 2010) and investigated their ability to steer firms' strategies more towards long-term value.

These engagement strategies can be classified in three broad categories: (i) engaging in private conversations with management and the board, (ii) exercising voting rights at companies' shareholder meetings and (iii) proposing resolutions at companies' shareholder meetings (shareholders' proposals).

The typical areas for shareholder engagement are governance and strategy. As shown in a survey presented by McCahery et al. (2015), 88% of the respondents consider inadequate corporate governance and excessive compensation somewhat or very important triggers for engagement. Another important trigger is disagreement with a firm's strategy, e.g. a proposed merger or acquisition (82%). These results indicate that investors engage not only over short-term issues (e.g. on dividend policy) but also, and even more, on long-run strategic issues.

Overall, considering the whole spectrum of engagement measures, there is some evidence of the beneficial role of engagement in terms of increasing shareholder value (Cuñat et al., 2012; Iliev and Lowry, 2015).

Based on the evidence collected through ESMA's public survey, fund managers perceive themselves as following a predominantly active investment strategy (82%) and tending to invest with a long-term horizon (71%) (RA.24).

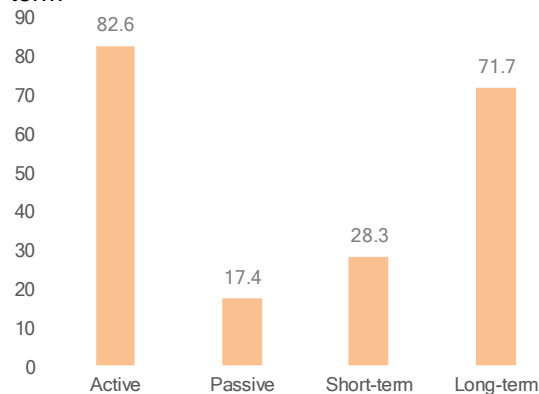
⁷⁵ They suffer from 'rational apathy' because rational shareholders exert the effort to make an informed decision only if the expected benefits of doing so outweigh

its costs. As a result, free-riding issues operate as key obstacles to effective monitoring.

RA.24

Fund managers' strategies

Managers define themselves as active and long-term



Note: Distribution of replies to Q27 (i): 'is your investment strategy predominantly active or passive?' and to Q27 (ii): 'are you predominantly long-term or short-term?', %.
Sources ESMA public consultation.

Among those respondents who indicate that they have a long-term active investment strategy, several explained that their approach is characterised by low portfolio turnover and focuses on sustainable value creation. On that basis, they conduct thorough scrutiny of the companies they invest in, assessing, inter alia, the quality of corporate governance of investee companies.

Respondents who identified themselves as long-term passive investors generally explained that their portfolio allocation follows a certain index/benchmark and is not decided by a portfolio manager. In most cases this implies being the quasi-permanent owner of certain securities and therefore a long-term focus is an inherent part of their business strategy, in line with their clients' interest.

Short-term investors often argue that their investment strategy is dictated by liquidity needs, the nature of their clients and/or the type of products they market.

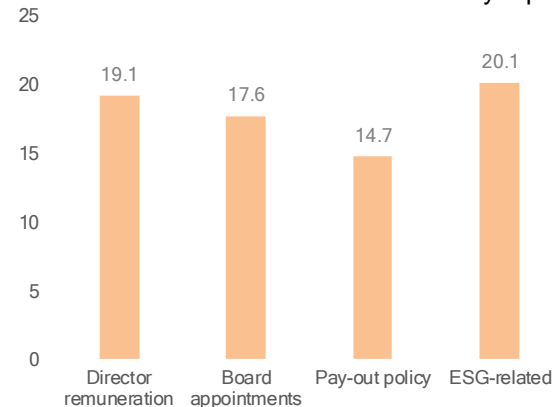
In addition, it is interesting to note that, while leading asset managers consider themselves predominantly active and long-term, they acknowledge that their equity holdings are nonetheless managed with a short-term horizon.

Moreover, the results of the call for evidence also indicate that long-term engagement increasingly addresses sustainability-related topics, for example when it comes to AGM votes (RA.25).

RA.25

Active engagement topics

ESG and directors' remuneration are key topics



Note: Distribution of replies to the question: what are the main topics your firm engages on in order to mitigate any potential sources of undue short-termism? (Q32), %.
Source: ESMA public consultation.

Remuneration of fund managers and executives

Short-termism is often related to the pursuit of short-term earnings and behavioural factors.⁷⁶ On earnings, the performance of corporate executives and investment managers is frequently assessed on a short-term time horizon. There is a link between short-term earnings and a company's share price, which in turn is a key determinant of senior executives' compensation. Similarly, investment fund performance is often measured against recent investment returns and portfolio managers are compensated on the basis of that short-term performance.

The recent evidence collected by ESMA is also informative on remuneration. For two of the most common fund types, namely equity funds and fixed income funds, around 27% of respondents indicated that the variable component of remuneration for identified staff was over 50%. Hedge fund and alternative fund respondents were evenly split between the two extreme options of 0-20% and over 50%. Private equity respondents showed a slight majority for over

⁷⁶ As regards behavioural factors, availability bias and myopia are often cited in literature as potential drivers of short-termism. Emphasis on short-term performance is likely to fuel availability bias, the human tendency to focus on the information that is readily available. Myopic loss

aversion is the tendency to focus unduly on short-term losses. Under its influence, corporate executives and investors may overreact to recent losses.

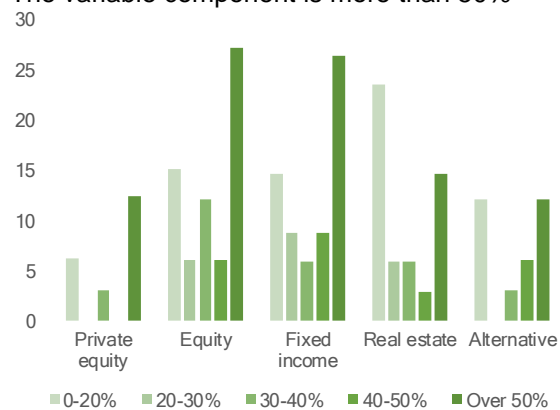
50% while real estate respondents reported a slight majority for 0-20%.

Overall, across all fund types, a slight majority of those who responded indicated that the variable component of identified staff remuneration is over 50%, while the second most popular option is at the other end, namely 0-20% (RA.26).

RA.26

Remuneration of fund managers

The variable component is more than 50%



Note: Distribution of replies to the question: 'in the salaries of identified staff of your firm's funds, what is the average share of the variable component compared to the fixed component?'; (Q40), %
Source: ESMA public consultation.

A significant majority of respondents indicated that the time period considered for the pay-out of the variable remuneration is 4 years or less (1-4 years). The majorities were striking in equity (57%) and fixed income (56%) funds.

The remuneration of executive directors is also a traditional area of research. In particular, because remuneration is often connected to short-term indicators, such as annual and quarterly performance metrics, it is frequently argued that it provides incentives to take riskier decisions to boost short-term revenues (Salazar and Mohamed, 2016).

Evidence from the survey shows that variable remuneration constitutes either less than 30% or more than 50% of fixed remuneration. The reference period for the calculation of variable remuneration is normally between 1 and 4 years (67%) or less than 1 year (30%). Deferral of payment of variable remuneration is either by 3-5 years (63%) or by less than 3 years (37%). Only one third of respondents stated that variable remuneration is linked to ESG-related objectives. Some respondents commented that such objectives are part of the company's strategic targets or KPIs and incorporated as such in their remuneration packages.

In line with the economic literature, more than 40% of respondents considered that there are common practices in the remuneration of corporate executives that contribute to short-termism, for example stock options linked to short-term value of the company's shares or to shareholder return based on an inappropriate peer group. The absence of malus or clawback clauses and the connection of remuneration to short-term KPIs such as sales were also mentioned.

Conclusion

Building on the recent collection of evidence through ESMA's survey on short-termism, this article discusses some of the commonly identified drivers of short-termism. Based on the survey, sell-side investment research and the remuneration of fund managers and executives are identified as potential factors determining excessive focus on short-term results. Improvements to the quality of ESG disclosure and institutional investor engagement would further help investors take more long-term investment decisions.

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