



From Short- to Long-Term: Who Cares? Institutional Investors, Beneficiaries and Investees in Dialogue

7th International Sustainability Leadership Symposium
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Preface

Many, if not most, players in stock market investment who pursue long-term strategies are driven by financial goals. The common objective of these players – institutional investors, asset managers as well as the ultimate beneficiaries – is to achieve maximum risk-adjusted returns over an extended period of time. Consequently, one would expect them to favour stable investments and to put a strong emphasis on companies' long-term performance.

Yet it is a fact that short-term earnings figures continue to play a dominant role in the way companies report their performance and investors make their decisions. This has raised a number of important issues. First, from a financial perspective, long-term thinking is futile if there are no reliable criteria to show that it can be translated into successful strategies with a sustained positive effect on profitability. Second, short-term behaviour might be reinforced by the incentive structures in place for those who take the actual investment decisions. This suggests a potential conflict of interests with the ultimate beneficiaries. Third, how companies and investors communicate and interact with each other is strongly influenced by frameworks and regulations, in particular on corporate governance.

The 7th International Sustainability Leadership Symposium, "From Short- to Long-Term: Who Cares? Institutional Investors, Beneficiaries and Investees in Dialogue", took place on 31 August and 1 September 2006 at the Swiss Re Centre for Global Dialogue in Rüslikon, near Zürich. More than 150 participants discussed the respective approaches of long-term oriented institutional investors such as insurers, pension funds and their trustees as well as of asset managers, investment advisors and listed companies to achieve sustainable returns. The main interest was to find out whether these approaches differ from each other, and if so, how they can be aligned. Taking the standpoint of each of the players involved, including the ultimate beneficiaries, the participants tried to identify options for a long-term oriented selection of investment opportunities. Finally, it was assessed whether this process may lead potential investees, i.e. listed companies, to reconsider short-termism in favour of long-term business practices.

This report summarises all the keynotes, panel discussions and workshops of the symposium, and draws some key conclusions. Through its publication, we would also like to express our appreciation to all participants who actively contributed to an open, insightful and constructive dialogue.



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Input Paper¹

An increasingly large proportion of investments in financial markets are made by institutional investors such as pension funds and insurers. Both in the US and the UK, institutional investors account for around 50 per cent of total funds invested in equity markets. In Switzerland, pension funds are expected to own close to a quarter of all company shares traded on the Swiss stock market by 2010. The huge amounts of money managed by these institutions come from the contributions paid in by individuals for their old-age pensions and insurance policies.

These savers and insureds have a strong interest in investments that lay the foundation for secure long-term returns. If companies are consistently encouraged to invest capital into those projects promising the highest investment returns in the long run, this will maximise their growth potential and thus their ability to create economic value over time.

Short-termism must therefore be expected not only to reduce long-term returns in financial markets but to damage our societies' overall well-being. Yet, a short-term investment perspective seems, if anything, to have become ever more dominant in financial markets. Trading volumes have been rising steadily and companies that do not meet analysts' earnings targets often lose billions in market capitalisation overnight. American researchers have found that, as a result, about half of all Chief Financial Officers of listed companies are willing to forego the creation of genuine economic value – that is, capital spending projects with a positive net present value – in order to meet quarterly consensus earnings.²

This contradiction between the needs of the ultimate owners of pension fund and insurance assets and actual investment behaviour defies logic, if one assumes that the best interests of the former are truly and effectively represented in financial markets.

The 7th International Sustainability Leadership Symposium examined and challenged this paradox, identified possible reasons and proposed corrective measures by asking four key questions:

- 1) What are the main reasons for short-term behaviour in financial markets?
- 2) How can the ultimate beneficiaries influence institutional investors to take a more long-term view?
- 3) How can investors influence companies' business strategy with a view to encouraging long-term value creation?
- 4) What information should long-term oriented investors take into consideration when making investment decisions?

¹ Authors: S. Moser, T. Streiff and H. Wiemer, with inputs from the Center for Corporate Responsibility and Sustainability of the University of Zurich (CCRS), A. Barkawi, E. A. Brugger, I. Menzinger and T. Scheiwiller.

² J.R. Graham, C. Harvey and S. Rajgopal: The Economic Implications of Corporate Financial Reporting, NBER Working Paper No. 10550, June 2004.

Thesis 1:
The multiple delegation of decision-making in the institutional investment process creates pronounced principal-agent problems in which the ultimate beneficiaries' interests are heavily diluted.

1 What are the main reasons for short-term behaviour in financial markets?

Between the contributions paid in by the individual insureds and the use of equity capital by the investee companies there are several actors whose decisions are more or less well controlled or influenced by the ultimate beneficiaries. This delegation of decision-making involves two principal-agent relationships: the first between the ultimate beneficiaries and the institutions that manage their money, the second between the institutional shareholders and the investee companies, in particular their management.³

The second principal-agent problem becomes even more significant when financial intermediaries such as brokers, banks and external fund managers are employed in the investment process. With each additional step in the process of delegation between the ultimate beneficiaries and the final investment decision, the risk of misaligned or diverging interests increases and transparency diminishes if governance structures are found wanting.

Given the risk of misaligned interests in the institutional investment process, the actual criteria on which decisions are made play a crucial role. Academic surveys show that pension fund trustees strive to base their investment decisions on established financial market theories and models. While in principle these can be used to underpin long-term investment decisions, in practice they are used for time horizons of 2 to 5 years. Why this? In a typical discounted cash-flow (DCF) model used for a corporate valuation, individual cash flows are only estimated for the next few years, and even for the longer-term growth estimate (e.g. after 5 years), the cash flow estimates of the next few years are taken as the basis.

With very few exceptions, pension fund trustees do not take into consideration additional insights revealing long-term causal relationships, e.g. from growth theory or resource economics.⁴ Their reluctance to go beyond the traditional valuation methods used by most of their peers is rather surprising as they often complain that every traditional valuation aspect has already been researched, that they have no choice but to "shout with the crowd" and to "follow the momentum". But the more any single aspect or method of valuation is being applied, the less additional value it actually creates. Useful research generating relevant insights must therefore strive to be unconventional.

Pension fund trustees' performance is monitored by regulators and auditors on a yearly basis. Though this is a very short time span, average investment horizons are probably even shorter. Asset managers' performance is usually assessed on their ability to beat market benchmarks over short periods as little as three months. In turn, they demand short-term out-performance of the companies they invest in. This leads to an exaggerated focus on yearly, half-yearly, or even quarterly, earnings figures and how these measure up against analysts' forecasts. It is evidently rather easy to simply compare one published figure (by the

³ Principal-agent theory (Jensen/Meckling 1976): a relationship between two economic actors in which one of them commissions the other to act on behalf of him.

⁴ Anita Sigg, Jutta Portmann and Suzanne Ziegler: Corporate Governance von Pensionskassen, Center for Corporate Responsibility and Sustainability at the University of Zurich, and Zurich University of Applied Sciences Winterthur.

company itself!) to another published figure (the consensus earnings estimate): both are quantitative. In contrast, much more knowledge, courage and effort are required to formulate an informed opinion on a company's market position, efficiency or management, and to interpret it adequately.

Thesis 2:

The decisions made along the institutional investment process are mostly based on short-term criteria that reflect the interests of the involved actors, not those of the ultimate beneficiaries.

When company reports from "sell-side" analysts at financial intermediaries (investment banks, brokerages) have been used, this has tended to intensify short-term pressures. Traditionally, these intermediaries have received "bundled commissions", which cover both research and trading in a single, per-share fee. Thus, sell-side research has in essence been paid for by frequent trading. Only very recently have we been able to observe some timid efforts to overcome this obvious conflict of interests, by un-bundling payment for research from the payment for the execution of a trade. However, fixed amounts paid for research increases pressure for size rather than fostering diversification. The resulting concentration process will not necessarily stimulate research creativity.

The preference given to short-term performance criteria has consequences on how institutional investors influence company behaviour. Basically, they can choose between two different approaches: "active" and "passive". The large majority of them only use passive strategies: if they are not satisfied with a company's performance, they simply sell their shares. With a few exceptions they have shied away from engaging with companies by exercising voting rights, arguing that their stake is too small or that "running companies" is simply not their task.

Thesis 3:

Most institutional investors do not exert influence on companies by actively engaging with them ("shareholder activism"), but only indirectly, by buying and selling shares.

This is true even if recently one has been able to read more about controversial discussions at Annual General Meetings (AGMs) or in the run-up to AGMs, e.g. on fights for proxy votes. Though it would appear that shareholder democracy is becoming a less tedious process, these discussions are very often about some very specific and urgent decisions, such as proposed take-overs and possible targets. And in the case of take-overs, attention is usually focused on the question which deal pays the highest premium now and not on the question which strategy would create most value in the longer run.

Thesis 4:

Most individual savers do not have the necessary financial knowledge to make informed assessments of their pension fund's performance. Finance and economics should therefore play a much larger role in general education.

2 How can savers influence institutional investors to take a more long-term view?

The first of the principal-agent problems outlined above is the one between the ultimate beneficiaries and their pension fund trustees. Although much is at stake for pension fund savers, the majority of them do not seem to take a very keen interest in monitoring how well their contributions are managed. There are at least two reasons for this apparent contradiction: Most savers feel they lack understanding of financial matters and do not see how they can easily change this handicap. Given the importance of financial markets for the overall economy, the corporate sector and individuals, there is a strong case, therefore, to improve general education in financial and economic matters.



Thesis 5:

Incentives for savers to monitor the management of their pension funds must be improved, by creating a proper market based on the disclosure of relevant information and the freedom of choosing, and changing, their fund manager.

But even if savers do possess extended financial knowledge and have access to relevant information, they usually have few incentives to monitor how well their pension funds are managed. In the second pillar of the Swiss pension system, e.g., employees cannot choose their pension fund manager. They are forced by law to use their employers' pension fund, which, incidentally, also exposes them to a substantial lump risk in the case of their company going bankrupt: their salary and their pension. The fact that there is no choice and competition in large parts of institutional saving is likely to perpetuate an attitude among savers that perceives institutional saving merely as a burden and not as an opportunity. Thus, a genuine market must be introduced for pension funds, based on freedom of choice and disclosure of relevant information suitable for benchmarking.

3 How can investors influence companies' behaviour?

At present, the majority of institutional investors do not engage directly with the companies they are investing in; frequently they hand over responsibility to intermediaries such as brokers and specialised fund managers, and when they do decide on investments themselves, they prefer to express dissatisfaction over performance by simply selling shares. Yet, the existing empirical evidence suggests that exercising shareholder rights and engaging with company boards improves company performance (e.g. CalPERS). It is clear, however, that in the short run pursuing such an "activist" strategy imposes additional costs on the investor.

Thesis 6:

Active engagement strategies with a longer time horizon are not sufficiently exploited by the majority of institutional investors, partly because of a reluctance to carry additional up-front costs and partly because of conflicts of interests in the financial industry.

An active engagement approach is further undermined by a conflict of interests commonly encountered in the financial industry. Large multi-division banks offer private banking and institutional asset management as well as investment banking. A rights issue or an M&A project is unlikely to be voted against by a bank's asset management division, if this means straining the relationship between the corporate client and the bank's investment banking division. As a result, in most countries the asset management divisions of the big banks help to carry all votes at Annual General Meetings (AGMs) in favour of the investee companies' management – and not necessarily in favour of the investors.

Thesis 7:

Institutional investors should treat short-term performance indicators with caution and instead put a stronger focus on fundamental information indicating future competitiveness and growth prospects.

Short-term earnings figures play a crucial role in investment decisions. Though they do not yield any reliable information on genuine economic value creation, they add transparency and may help to discover and find early remedies for problematic developments. The problem is the apparent unwillingness or missing independent-mindedness of many CEOs, CFOs, investor relations managers, brokers, portfolio managers etc. to take such reports with a pinch of salt, not to over-dramatise, and to draw more comfort from market position, brand, management quality, operating earnings and their long-term trends. Some companies have already drawn their lessons from this: Porsche has decided to stop publishing quarterly earnings figures; Coca-Cola and Motorola have stopped publishing forecasts for these figures and are still sought-after stocks.

4 What information should long-term oriented investors take into consideration when making investment decisions?

Company research for investment purposes is largely based on the traditional models and theories of corporate finance. These surely have their justification, but they typically cover an investment horizon of five years maximum and in actual practice are often broken down into data covering even shorter periods. Between this perspective and the lifetime horizon of savers there is consequently a large discrepancy. Some will argue that constantly adapting investment portfolios to changing market conditions is the best strategy for maximising long-term profits. But the survey cited in the introduction suggests that this approach hampers genuine value creation and thus negatively affects the total growth rate of the economy. Thus, there is a strong case for using different information for corporate valuation or to adjust its weighting. This can take at least three forms:

Thesis 8:

Established valuation and rating models need to be complemented or redesigned in order to capture causal relationships revealing long-term growth potential.

- 1) Employ traditional Discounted Cash-Flow (DCF) models, but feed them with different data that put more emphasis and work into the second or third stage of DCF models, i.e. on sustainable growth rates and margins;
- 2) Pay stronger attention to long-term risks, applying the cost of capital used for the DCF model;
- 3) Use different models altogether, which, for example, are suitable for scenario building. The latter could be inspired by insights from growth theory or resource economics.

There are clear signs that we are entering a phase of economic development that will be marked by increasing pressures and constraints regarding the availability of natural resources and energy. Commodity prices are sky-high, oil prices have been climbing inexorably and emissions reduction markets are taking shape. These trends are going to trigger a whole new cycle of technology development. Intelligent long-term investment should both promote and benefit from the accruing growth possibilities. The data may be of a softer character and more difficult to obtain than those used in traditional financial models, but their availability can be expected to increase due to the continuing advances in information technology, particularly regarding data accessibility and accuracy.

Thesis 9:

Financial institutions should promote intelligent long-term investment that can benefit from the emerging innovation cycles triggered by growing pressures on natural resources and energy.

Yet, it may also be necessary to analyse, and address, the incentive conflict of a portfolio manager who takes a new position in an "exotic" stock, or a stock for which the research department has neither developed a valuation model nor included the effects of unconventional criteria yet. If the price of an "exotic" stock goes up, the portfolio manager will at best get a nice "thank you", at worst nothing. Because in all probability he did not dare to invest more than 1 to 2 per cent of his portfolio, even a doubling in price is hardly felt in his overall performance figures. If the stock crashes, however, everybody will be happy to confirm that this was just what they had always predicted and warned him of...

J. Frank Brown, Dean, INSEAD: The Growing Importance of Institutional Investments



“The first question is really: why do we have such short-term behaviour in the market? And I would lay out as a premise that the overwhelming majority of investment theory is more short-term. I think you have to look at the fact that market behaviour is dependent upon perceived returns, and all around the world we see opportunistic investments which can result in transactions of as short as a nano-second generating enormous returns. So I think, increasingly, the need is for proof that longer-term investment and sustainable enterprises are going to generate superior returns; I do not think that has been proven.

How can institutional investors be influenced to the longer-term view? Simple answer: better returns. But again, we have to prove it. They will only take a longer-term view if they see an advantage. Now, you have to look at the rest of the community. Analysts can be significantly helpful here, by focusing on non-financial metrics, by focusing on issues of sustainability. ... How should a long-term investor look at an investment opportunity? It is very basic – this is something I have spent half my career on: fundamental due diligence. But what are the key questions, what are the key things that investors need to look for? Well, the fundamentals are a given. Beyond that: a) Quality of governance; b) Quality of management; c) Succession plan: how long has the CEO been there? (Is the CEO chair a revolving door and what does that mean? – It is usually an indication of either lousy CEOs or real short-term pressure.); d) Product development pipeline: how much information can you get on that?; e) Employee morale; f) Customer satisfaction; g) Regulatory history. And, in general, what would enable you as an investor to get that information is transparency. What kind of information is the company willing to provide to the market and to potential investors?

What will happen if short-termism persists? Well, my view, to be negative and provocative, is that we will probably have a lot more frauds. I think right now we are in a little bit of a hiatus. We have not really had a major catastrophic fraud in a couple of years that has gotten a lot of headlines. I still think they are out there because of the tremendous pressure put on management for short-term results. And again, this happens around the world. So, if that pressure continues and if the short-term perspective continues, that is what we are going to get. ... If the frauds that I mentioned do happen, we will continue to see more of a regulatory effect. Right now, if you look at the U.S., you will see that some people have started to back away from Sarbanes-Oxley. That will go away as soon as we have any kind of a major event.”

Abby Joseph Cohen, Managing Director & Chief U.S. Investment Strategist, Goldman Sachs: Capital Markets at the Crossroads



“Socially responsible investment and the assets under management in that regard have flattened out in the United States in recent years. This was a typical form of niche investing. However, one of the elements has broken out in a very dramatic form. Here are the assets under management of those investors or sponsors of investors who have raised their hand and said that they want their assets managed in a way that is environmentally aware: in 2003, for example, about 600 billion \$ of assets were put under this banner. Within two years, however, that number grew to more than 2.7 trillion \$ in assets, and that is not an inconsiderable sum. We think it is important to recognise that there has been this growth in assets under management focusing on environmental, social and governance (ESG) criteria, because it has implications for the ultimate returns. ... There are now studies that show that markets around the world have been inefficient as it relates to ESG, that is – as one example – the stock or shares of a company that may not be the best citizen as it relates to environmental matters have not suffered as a consequence. Alternatively, there may be instances where the shares of a company that is a very good citizen and role model in that regard have not benefited from that good behaviour. In an inefficient market those mispricings can persist. One of the key elements in the growth of assets is that as more and more money is focusing on doing the analysis and identifying those pricing anomalies, they should begin to eliminate and reduce, which means that we should now start to see that the better performing companies in this regard indeed generate better returns for their investors. Quite frankly, up until very recently most academic work suggested that there was no benefit to investing in an ESG sensitive way. However, a most recent study published⁵ indicates that there is now an eco-efficiency premium, that is, a premium return can now be achieved in some cases by owning those assets of companies that are doing the right thing.

There are many in the NGO field who have not understood why pension funds, endowment funds and so on have waited for so long to pay attention to this area. ... In the United States and many other countries the professional money managers have fiduciary responsibilities to the owners of that money, and in the case of a pension fund the fiduciary responsibility is to the people who will ultimately be retiring. If it cannot be proven that an ESG aware portfolio can generate better-than-average returns, then the portfolio manager with those fiduciary responsibilities has a very hard time arguing that this is the way the money should be managed. It is now possible that, with the amount of money focusing on this sort of investing, the market has become more efficient, will become more efficient and therefore better returns will go to these strategies. As that is the case, we will see that portfolio managers can combine their fiduciary responsibilities to generate good returns for the owners of that money in combination with their desire to be ESG aware. And so, those two things, the movement of ESG away from being a niche form of investment to mainstream and, secondly, the fiduciary responsibilities coming together with the ability to look at these other desirable goals is very important, indeed.”

⁵ J. Derwall, N. Guenster, R. Bauer and K. Koedijk: “The Economic Value of Corporate Eco-Efficiency”, *Financial Analysts Journal*, vol. 61(2), March/April, 2005.



Session 1: Long-Term Investment: The Beauty and the Beast

Wilfried Hauck: “If I’m not able to generate transparency for long-term success in asset management, I need trust. Trust could be built up, I believe, if we share the risk position.”

Thomas Müller: “We need to work at enlarging the accepted window of performance, and this means accepting volatile returns.”

Heinrich Wiemer: “There is no free lunch. If we want to have a good retirement, we need to have the courage to take risks.”

If long-term investment is considered by many to have clear benefits, why is it so difficult to accomplish in practice? What are the beasts, in other words, that “beset” the beauty? Launching the symposium’s examination of these forces, Wilfried Hauck of Allianz Global Investors underlined that taking a long-term investment perspective makes evident sense for managing the company’s assets, since the maturity of its insurance policies averages 27 years. This requires identifying macro trends such as climate change and analysing whether companies take them into account in their business plans. Taking such a fundamental viewpoint amounts to thinking more like managers, in order to understand how companies really create value in the marketplace. But unless the success of long-term strategies can be adequately measured, Hauck warned, they may actually be the beauty for asset managers but the beast for policy holders. He identified this as one of the principal problems: established measurement methods focus on out-performance over a relatively short period of time, and asset managers’ compensation schemes are directly tied to this.

This “beast” of how to measure and communicate the performance of long-term investments was one of the key topics in the ensuing panel discussion. Taking the viewpoint of an investee company rather than that of an investor, Thomas Müller emphasised that Swiss Life continuously strives to explain its three-year strategy to analysts. The trend to delegate investment decisions to hedge funds and other alternative investment classes that operate with investment horizons of three to eighteen months is making this increasingly difficult, though. On a more general note, Heinrich Wiemer criticised the widespread preference for simple, but not very meaningful figures such as earnings per share. He argued that this results from a profound lack of knowledge of financial markets and identified a strong need to educate the ultimate beneficiaries and their trustees.

The importance of education also surfaced in the context of regulatory requirements. Politicians and regulators were suspected of not understanding, or purposely ignoring, some of the fundamentals of the industry. The higher the minimum guaranteed returns are set, for example, the lower expected real returns will be. The panellists agreed that, consequently, a constructive dialogue between the industry and regulators is badly needed. But whereas Heinrich Wiemer sensed a fundamental mistrust between the different players, Thomas Müller offered a more upbeat view, drawing attention to some recent successes in Switzerland, such as the good cooperation in the context of Solvency II⁶.

In the final round moderator Ernst A. Brugger asked the panellists to single out one thing that would have to change. All three answers revolved around the core concept of risk. Heinrich Wiemer stressed that there is no free lunch to be had and that optimising long-term returns requires taking risks. Thomas Müller supported this view, arguing that the “accepted window of performance” is currently too narrow; extending it would produce more volatility, however. Finally, Wilfried Hauck suggested that the trust necessary for long-term investments could be built up if asset managers were to participate in the same investments and the final returns, thus creating a kind of risk sharing with the investors.

⁶ EU capital adequacy framework for insurers to be introduced between 2008 and 2010.

Session 2: Do Beneficiaries Know What They Want?

Jean-Louis Nakamura: “The issue we’re dealing with is that, unfortunately, pension fund members are not able to define their objectives clearly and to set incentives accordingly.”

Dominique Biedermann: “The separation between the functions of defining investment guidelines, choice of manager, asset management and control is fundamental.”

Travis Engen: “Life is complicated, businesses are complicated, and one needs to look at a lot of things to have a good handle on what’s really going on, on what’s improving and what’s not.”

Stefan Bichsel: “Beneficiaries know what they want, but they don’t know what they need to know to be wanting the right thing.”

The aim of the second panel session was to take a closer look at the role played by the ultimate beneficiaries in long-term investment. Presenting a case study of the Fonds de Réserve pour les Retraites (FRR), Jean-Louis Nakamura argued that the contract between the beneficiaries and the managers of a pension fund is usually very incomplete. The latter need clear guidance on investment horizon, risk appetite, socially responsible investment (SRI) values etc. The former, however, are far from being able to formalise their preferences even when they know them. This creates a very complex situation for pension fund governance bodies in which to devise and implement an investment strategy. For FRR, a nation-wide scheme funded by government receipts that covers almost all private-sector workers in France, this challenge is particularly acute. Its response has been based on a governance structure that a) clearly separates strategic decisions from day-to-day management; b) an internal decision-making process aiming to reduce agency problems; and c) employing external asset managers in a way that minimises conflicts of interests.

In his comment, Dominique Biedermann of Ethos pointed out that Jean-Louis Nakamura’s presentation had raised two issues which are at the very heart of fiduciary capitalism: the basic framework for pension fund governance and the interests of the beneficiaries. He argued that, firstly, strong governance creating trust depends on enforcing the parity principle on the board of trustees, not just in letter but in spirit, which means that employee representatives need to have the freedom to express differing views without fear of retribution. Furthermore, there needs to be a clear separation of functions in the investment process (guidelines, asset management, monitoring). Secondly, correctly aggregating beneficiaries’ preferences rests on two essential steps: acknowledging the very long time horizon in asset allocation and defining the true final objective. While financial expectations clearly play a crucial role, so does the desire to live in intact social and environmental surroundings, Dominique Biedermann stressed. Since pensions are a form of social insurance, this could serve as justification for regulators to require the inclusion of ESG factors in investment decisions and active shareholder engagement.

Travis Engen of Alcan added some thoughts on the implications of this debate for investee companies and brought up the problem of measurement once more. At any given time, companies are pursuing a number of major projects, all with the aim of creating economic value. In Engen’s view, none of the existing accounting conventions or market measures does justice to this, which leads to a “huge disconnection” in the communication between companies and investors. On a positive note, however, Alcan found out that its shareholders are quite prepared to accept more share price volatility as long as they understand what really drives the business.

Stefan Bichsel of Lombard Odier Darier Hentsch delved a little deeper into the session’s theme question. Yes, he said, pension fund beneficiaries do know what they want but perhaps this is no longer the right thing. The stable world of twenty years ago has vanished and the increasing stress on pension systems must be expected to trigger a move towards more personal responsibility and individualisation. Jean-Louis Nakamura and Dominique Biedermann both questioned the benefits of a more personalised system, however: inadequate education regarding financial markets among large parts of the population and the principle of social insurance based on solidarity may well mean that collective approaches produce better overall results, they said.

Workshops I Drivers for (Un)Sustainable Returns

A **Managing the Long-Term in a Short-Term Oriented Environment: The Challenge of Pension Funds**

Workshop Keynote Speaker: Michael Bernegger, Swiss Life
Challenger: Wilfried Hauck, Allianz Global Investors Advisory
Moderator and Reporter: Ivo Menzinger, Swiss Re

Opening this workshop, keynote speaker Michael Bernegger presented some long-term chart data of the main asset classes that show institutional investors to be doing the exact opposite of what they are supposed to do in the true interests of the investors. Wrong incentives for “overpaid asset managers” are part of the explanation, he said, but a closer look at the industry and its environment suggests that most investment behaviour is a direct or indirect response to a bundle of regulatory constraints that forces asset managers to make counter-productive decisions from a long-term perspective. This is because regulatory requirements have evolved addressing individual issues, in the process neglecting the overall picture. Given the pressure exerted on the system by the two large challenges of demographic change and structural shifts in the economy, he warned, it is paramount to reconsider multi-period risk models, legal quota participation schemes and accounting restrictions. In his comment, Wilfried Hauck listed a number of factors distorting investment decisions and urged that asset allocation be based on a clear analysis of current and future liabilities. In the ensuing discussion two key questions from the earlier panel sessions were picked up again: whether government regulation or the industry bears chief responsibility for the flaws in the current system, and whether more choice for the savers might improve the situation.

B **Significant Factors Impacting Capital Markets**

Workshop Keynote Speaker: Craig Metrick, Mercer Investment Consulting
Challenger: J. Frank Brown, INSEAD
Moderator and Reporter: Alexander Barkawi, SAM Indexes

Extending investment horizons requires the availability of information that reliably indicates long-term profit potential. Workshop B examined to what extent environmental, social and governance (ESG) factors may meet this objective. Keynote speaker Craig Metrick pointed out that originally such factors were used for negative screenings of companies or whole industries and later for best-in-class selection. Several recent initiatives in the investment community (Freshfields report, Principles for Responsible Investment) suggest that they increasingly attract interest for mainstreaming purposes, i.e. for integration into standard investment analysis, though. New surveys show that governance is currently seen as the most relevant issue, especially proxy voting and shareholder engagement. Interestingly, however, there is a notable difference of view between institutional investors and investment managers with regard to the overall materiality of ESG factors: while 75 per cent of the former regard such information as material, only 35 per cent of the latter expect an increase in demand for ESG analysis, with attitudes in the US being particularly sceptical. The ensuing discussion centred on some of the barriers that may be at work. Fundamentally, quantitative evidence on the positive link between ESG factors and performance is still rather inconclusive. Only a minority of investors are therefore prepared to pursue proactive strategies, while most wait for further evidence to accrue. This is in marked contrast to

attitudes towards active management styles in general, for which the evidence on performance is just as inconclusive. Overcoming persistent misunderstandings and negative attitudes, participants concluded, may require a concerted marketing campaign with a unified language, involving cases of major institutional investors.

C Risk Appetite of Institutional Investors

Workshop Keynote Speaker: Heinrich Wiemer, Capital Market Strategies

Challenger: Giuseppe Benelli, Vontobel Group

Moderator and Reporter: Sandra Hedinger, Swiss Life

In opening Workshop C, keynote speaker Heinrich Wiemer widened its theme and traced it back to the principal's willingness to provide risk-bearing capital. On average, he claimed, individual savers are risk averse, chiefly as a result of insufficient knowledge of financial markets. Reminding the audience of the large opportunity costs of weakening long-term economic growth, he stressed the need to resolve this conflict. In order to identify key obstacles, he took a brief look at some problematic characteristics of five groups of actors. Accordingly, individual portfolio managers have a strong incentive to safeguard their bonus, which can be seen to favour cautious strategies of following the "herd" over independent, contrarian behaviour. Directly connected to this, asset management houses rarely have controlling, audit and compensation processes in place that create long-term incentives; moreover their cost structures are still overblown. Rating agencies can neither be considered swift or reliable in how they provide information. Regulators have difficulty striking the right balance between over- and under-protection. And lastly, the media all too often go for the easy headlines offered by financial scandals. Responding to these pithy observations, challenger Giuseppe Benelli and the workshop participants put a particular focus on regulation. It was argued that effectively defending the principal's real interests requires a relaxation of rules, for example with regard to the preferred level of risk-taking, as well as a clearer definition of property rights. But a vote advocating the right to sue one's pension fund triggered an interesting debate on the difference between property and consumer rights. If the beneficiary's role as asset owner is taken seriously, Heinrich Wiemer suggested, investors should perhaps not even be allowed to simply exit their investments for opportunistic reasons.

D Making Best Use of the Right Information

Workshop Keynote Speakers: Peter Ohnemus and Dominique Habegger, ASSET4

Challenger: Hans C. Steckling, HCS-Consulting

Moderator and Reporter: Angela de Wolff, Lombard Odier Darier Hentsch

Keynote speakers Peter Ohnemus and Dominique Habegger addressed the question of what information to use in assessing a company's potential for long-term value creation by describing their own framework at ASSET4. Intangible assets reportedly accounting for some 80 per cent of market value today as compared with merely 38 per cent back in 1982, the challenge lies in capturing and structuring relevant extra-financial information. The analysts at ASSET4 do this by looking at 278 indicators (describing value drivers as well as outcomes) and feeding the information into 18 categories within the four pillars of economic, environmental and social performance plus corporate governance. The two speakers presented



some evidence that, if such information is used to make a rough distinction between “above-average” and “below-average” companies, it can indeed reveal differences in performance. They stressed, however, that ESG data indicating long-term value creation vary between countries and sectors and that such approaches should not replace but complement existing valuation models. Responding to the initial workshop input, challenger Hans C. Steckling questioned whether ESG information provided by companies themselves can be regarded as reliable. Instead, he suggested, it might be more worthwhile to analyse the personal values of CEOs and the importance attached to human capital management when judging a company’s long-term prospects. The participants fully agreed on the under-representation of non-financial data in traditional analysts’ assessments. But they also shared some of the doubts over the reliability and relevance of available ESG data, for the simple reason that company budgets for financial reporting remain much larger than those for extra-financial reporting.

E The Multiple Principal-Agent Relation in Institutional Investment

Workshop Keynote Speaker: Brunno Maradei, EIRIS

Challenger: Ivo Knöpfel, onValues Investment Strategies and Research

Moderator and Reporter: Erna Karrer-Rüedi, Care Group

Launching this workshop discussion, Brunno Maradei first took the audience through the chain of ownership in institutional investment and pointed out the multitude of potential conflicts of interest between the ultimate savers, pension fund trustees, investment consultants, fund managers, brokers and company managers. He then proceeded to outline some remedies, in the areas of governance structures and reporting, aligning incentives of company managers, regulation over brokers, advisers and research, fund fee structures, share lock-ups, education of beneficiaries, trustee selection and harmonising the incentives of investment consultants and funds of funds. Turning to the specific goal of encouraging long-term investment, he drew attention to the need for creating demand for corresponding strategies, on an individual and institutional level. Overcoming obstacles such as differing views on sustainability, the short-term horizons of performance measurement and executive compensation schemes, lacking education of beneficiaries and scarce independent research would require a “step change in thinking”, he concluded, though. The discussion revolved around three main topics: regulation, the role of consultants and trustee education. There was wide agreement that a “fixing holes” approach had led to chaotic over-regulation. “Soft” regulation was advocated as a third way between yet more top-down fine-tuning and far-reaching liberalisation, aiming to initiate systemic changes, for example in terms of accountability or research funding. Adopting investment consultants’ strong bias for short-term strategies in line with the duration of their own mandates was judged to be simply a breach of fiduciary duty. Finally, better education of trustees was deemed indispensable, for example through guidance papers issued by the regulators.

Wim Vermeir, Member of the Executive Committee, Dexia Asset Management: New Perspectives for Long-Term Investing



“I think the big advantage of sustainable investing is that you have a longer time perspective and that you have a broader picture of the company because you look at externalities, because you look at stakeholders. I agree with Abby Cohen that we start to see some academic evidence that there is something in corporate responsibility, that there is something in sustainability that could be positive for financial performance in the long run. ... The only challenging result from these studies is the fact that, apparently, the link between ESG factors and accounting-based financial performance is stronger than market performance. And that is interesting because accounting is probably a better measure for underlying economic performance. ... But everything taken together I think there really is a business case to promote, or to defend, integrating sustainability issues for long-term investors.

The way we work at Dexia is that we separate. We have a traditional, financial, fundamental way of analysis and on the other side we make a sustainability analysis, looking at the broader context of the company. And then in the portfolio we will combine the two analyses and we will only invest in companies who have a good score in the traditional financial analysis but also a good score in the more innovative sustainability analysis in order to give our clients the best of both worlds. So they are different but, that said, there are some things that are common for both approaches. If in the financial analysis we examine the value chain, this of course helps our sustainability analysis team to determine the relevance of stakeholder domains and sustainability themes. If the sustainability analysts have data about corporate governance, that of course teaches us something about the risks of the company, and that is something that traditional analysts can integrate in their models by adapting the cost of capital. If we learn something in the sustainability analysis about externalities, about stakeholder relations, that teaches our traditional financial analysts something about risk appraisals, about management quality and about long-term goals.

My impression of what is happening is very positive, because I think that we are a lot of actors in the field, that we are ready to change something, that companies, pension funds, asset managers want to get rid of this short-term obsession. That's the positive side. But as has been said this morning, it is not an easy challenge, because it is much easier to go for the short term, because then you can look at the earnings of each quarter, try to estimate them and try to be a little bit overrated or underrated and being very close to the benchmark. So having a long-term perspective, trying to integrate non-financial information means that you have to develop new methodologies, new tools. That is rather risky and I think it is very positive that a lot of people want to do it. And for me the only possibility that we have is to be very transparent about it, that we share information. ... So for me the title of the conference is not only 'long-term investment: who cares?' but also 'long-term investment: who shares?'”

Iris Bohnet, Associate Professor of Public Policy, Kennedy School of Government, Harvard University: How Much Can You Trust?



“Why is it so hard to focus on the long term? There are two answers to this question – there are probably more, but there are two answers in the disciplines that I am more familiar with, economics and psychology. We have heard a bit about the economic answer today, which is this whole literature on the principal-agent problem and how we can change incentives to align the agents’ interests with the pension fund principal. But secondly – and that is something we have talked very little about today – there may be something psychological going on here. I coin this ‘bounded awareness’.

If your environment – and that could be instructions, could be incentives, could be information, could be its complexity – focus your attention on x, you are more likely to neglect y. And this is particularly problematic in the environment we are interested in, because there is a natural tendency of everyone to focus on the short term. In fact most of our models using discounting underestimate our preference for the short term, our preference for immediate benefits, for the present, for what’s going to happen tomorrow. In contrast we could not care less what is going to happen in five years from now. So there is a natural tendency to focus on the short term anyway and if the environment reinforces that, it is very easy to just forget about the long term. Secondly, there is also a tendency to focus on simple numbers; numbers are easier, simple metrics are easier than the qualitative information that we heard discussed before and if the environment reinforces our attention on the short term and the simple metrics, that is what we will do. I tell you this because, even if we solve the problem of incentives – and I am not saying that we have –, the cognitive boundaries that constrain the way we think will still encourage us to focus on the short term and on simple metrics.

One of the biggest surprises for me when I looked at the literature a bit more closely was that incentive disclosures are severely lacking in the managed funds industry. Many of us, including the press and academics, have been focusing heavily on CEOs, on the managers of investees: how are they compensated, are their incentives aligned with investors’ interests? But there are many intermediaries, and there is relatively little information on incentive structures in the managed funds industry.

Bounded awareness: what do we have to do? We have to shift the focus to long-term value creation, provide more meaningful information and avoid oversimplification. That means that we actually have to make the easily available information less salient. More frequent communication about company strategy and long-term value drivers, but less frequent reporting of simple numbers. Shift from quarterly to annual earnings guidance or eliminate guidance altogether as some companies have done in the past. ... Analysts and asset managers should base their analyses on long-term rather than short-term models, and in addition – there is some recent interesting research on that – provide incentives for analysts to dissent from the consensus.”

Winston H. Hickox, Portfolio Manager Environmental Initiatives, CalPERS: Incentives Promoting Patience in Investment



“Fundamentally, I believe that the homily ‘necessity is the mother of invention’ has never been more appropriate than at this time in history of mankind. ... This is most exemplified by the two mothers of all necessities: climate change and peak oil, or the volatile high-risk commodity pricing world that we live in with regard to energy commodities, whatever term or approach to describe that makes you most comfortable. It is the realisation by the CalPERS trustees and the senior managers in the investment office at CalPERS that their core fiduciary responsibility involves understanding risk, managing risk, mitigating risk and finding opportunities to invest in the face of that risk that has driven us to the initiatives that we have put in place with regard to the environment that I offer you as an example of patience in investing at its ultimate.

It constantly amazes me that there are these two worlds that have relatively little ability to find one another: the two worlds are the government regulatory systems and the investment world. When I attend conferences associated with the regulatory structures like the efforts that led to Assembly Bill 32⁷, it is usually representatives of the business community, government regulators and NGOs. But there is relatively little representation from the investor community. It is almost as though the investor community finds that a black box of immense uncertainty and wants little to do with it. Similarly, when I have had occasions to attend gatherings involving the investment community, you often have this, obviously, along with businesses and to some degree the NGOs or the environment-related interest groups. But you rarely ever see a representative from the government regulatory structures. In fact, I kiddingly offer the thought ‘God forbid these groups find one another.’ And I say that because, again, of my own personal experience and background, having worked in both of these areas and the ability to see the synergisms, and I propose to you that I believe that finding a way for those groups to meet someplace in the middle is a real force in promoting patience in investing.

What we found over time and again, and I am sure that you all in this room are very much aware of this, is that government with all good intentions can at times be very counter-productive. In a recent legislative hearing I had an opportunity to participate on a panel and I did share that I thought the most important thing for government in trying to develop policy to deal with these large-scale, longer-term forces was that we needed to be consistent. Let the marketplace know what our intentions are – the worst thing we can do is create tax incentives or other government support systems to nurture new technologies and then abruptly withdraw them. It creates losers in the marketplace, which causes capital to be very leery about filling in behind.”

⁷ The California Global Warming Solutions Act of 2006 calls for a state-wide cap on greenhouse gas emissions and a 25 per cent reduction by 2020. With this act California will establish emission controls for the largest industrial sectors, including utilities, oil refineries and cement manufacturing, and introduce the use of market mechanisms.

Workshops II **Striving for a Longitudinal Perspective**

F **How Much Corporate Governance Is Needed?**

Workshop Keynote Speaker: Peter Voser, Royal Dutch Shell
Challenger: Thomas Scheiwiller, PricewaterhouseCoopers
Moderator and Reporter: Christina Ulardic, Swiss Re

This workshop on the effects of corporate governance regulations was strongly based on the case of Royal Dutch Shell. Summarising the company's experiences, Peter Voser noted that the proliferation of formal regulations may well place large demands on companies' resources but that they can also have a very beneficial side effect. Globalisation, he stressed, is making business ever more complex, constantly altering key challenges and risks. This is especially true for oil and gas companies, as exploration moves to increasingly sensitive areas after the end of "easy oil". When Shell came to the conclusion that its traditional decentralised governance structure was no longer suitable for dealing with this complex environment, a drive for simplification and standardisation was started. Peter Voser noted that these efforts were greatly helped by Sarbanes-Oxley (SOX) legislation: "SOX is basically nothing more than common sense; it takes you through a stringent process to document all internal controls and it has sharpened our focus on key risks." The real problem, he added, lies in the lacking harmonisation between different national regulations. The discussion then explored some of the limits of recent regulations, i.e. the regulatory approach to corporate governance. While the control side is important, Peter Voser said, so is strategic corporate governance, which aims to inform investors about how internal structures and processes contribute to value creation, for example by applying principles of responsibility and sustainable development to major projects. The ability to address other key issues, such as transparent information and honesty, meanwhile, was said to require a corresponding corporate culture.

G **Enabling and Obstructive Frameworks**

Workshop Keynote Speaker: Winston Hickox, CalPERS
Challenger: Markus Nöthiger, PricewaterhouseCoopers
Moderator and Reporter: Kai-Uwe Schanz, Converium Holding

As in all markets, framework conditions shape individual decisions in the investment industry. Workshop G sought to identify factors currently impeding long-term investment and to offer possible improvements. Keynote speaker Winston Hickox re-emphasised the statement from his plenary speech that both government leadership and business are required to extend investment horizons. In financial markets, one of government's most important tasks is to ensure transparency – making use of the available information in portfolio decisions, however, is the individual player's duty. Unfortunately, Winston Hickox argued again, the financial and the government worlds usually find it hard to establish a constructive dialogue with each other. The workshop discussion led to a number of clear policy recommendations. On a general note, it was stressed that government regulation should always aim to act as a catalyst for market-based solutions. More specifically, attention was drawn to fund managers' compensation schemes: if managers were made to take a share in the underlying risk, this would help to promote a long-term focus. Turning to shareholder activism, the development of collective information platforms was suggested



as a means to lower the high transaction costs faced by individual players. Finally, rating agencies were seen as a potentially effective mechanism to address the principal-agent problem, by providing transparent and clearly structured information.

H Changing Investees' Business Behaviour

Workshop Keynote Speaker: Colin Melvin, Hermes Pensions Management

Challenger: Brian Harrison Spence, economie

Moderator and Reporter: Thomas Streiff, The Sustainability Forum Zürich

In this workshop exploring effective approaches for investors to influence companies, keynote speaker Colin Melvin first highlighted three key issues. Firstly, ownership: because awareness of pension fund clients' large stake in companies is insufficient, the associated implications are neglected. Secondly, there are two basic conflicts: one between shareholders and companies, and the other in connection with financial intermediaries in the chain of ownership. Thirdly, corporate governance is about directors' accountability to shareholders, not about compliance. Addressing these issues through active engagement, he summarised, is the key to successfully increasing companies' performance and, thus, value. Preparing the ground for the group discussion, challenger Brian Harrison Spence argued that the goal of shareholder engagement should be to enforce the principles of social responsibility, not just to improve performance, and that it is quite easy to put companies under pressure, for example by lobbying the media. However, one workshop participant pointed out that the goals and strategies of different shareholders are simply not identical. Colin Melvin agreed and added that reaching a common position before addressing a particular company is all the more important as a result. But he stressed that a large pension fund is a quasi-universal owner in the economy: as such it needs to seek constructive dialogue with under-performing companies, as opposed to a strategy of "naming and shaming". If warranted, this approach may very well include issues of long-term relevance.

I Fiduciary Duty – What Does It Comprise?

Workshop Keynote Speaker: David R. Scott, Scott + Scott, LLC

Challenger: Brunno Maradei, EIRIS

Moderator and Reporter: Alexander Barkawi, SAM Indexes

Fiduciary duty is at the core of the relationship between pension fund beneficiaries and trustees. This workshop examined what the legal definitions of fiduciary duty imply for investment decisions in today's market environment. In his introduction, David R. Scott explained that the basic concept of fiduciary duty is actually very similar in common law (US, UK) and civil law (European countries), centring on the principle, of acting in the sole best interest of the beneficiaries. The practice of applying this principle, however, has evolved over time and has responded to changes in the environment. Two recent reports (Baker & McKenzie, Freshfields) cited by David Scott clearly state that considering ESG factors is permissible as long as it is compatible with the mandate of maximising returns; and since these factors increasingly seem to have an impact on risk/return calculations, trustees have an obligation to at least consider them in the investment process. The discussion group therefore concluded that the situation is rather clear when ESG criteria are material. The

problem, however, lies in determining what ESG criteria are really material and over what time horizon. “Duty of obedience” is a crucial notion in this context: since pension funds have the clear mandate of securing long-term retirement income for their beneficiaries, any investment activity that risks undermining this “purpose of the scheme” may constitute a breach of fiduciary duty. The workshop participants discussed the implications of climate change from this perspective and wondered when the first lawsuit can be expected against a board of trustees for neglecting to take the issue into consideration.

J **Fostering Long-Termism at Business Schools**

Workshop Keynote Speaker: Heiko Spitzeck, oikos International

Challengers: Ivo Knöpfel, onValues Investment Strategies and Research
and Antoinette Hunziker-Ebneter, Forma Futura Invest

Moderator and Reporter: Jacqueline Coté, WBCSD

Launching this workshop on the role of business schools in shaping investment attitudes, Heiko Spitzeck presented an assessment of the status quo. He noted that the subject of sustainability has gained significant ground and is now on the agenda at many schools. He granted, however, that it is usually presented as a separate module within the curriculum; in order to really change attitudes, however, aspects affecting long-term performance would have to be incorporated into the individual disciplines. Drawing from her professional experience in financial institutions, Antoinette Hunziker-Ebneter argued that wealthy clients frequently seem unimpressed by purely financial benchmarking results and instead want financial return on investment combined with return on values. She described such an index including sustainability aspects which she had successfully implemented and urged business schools to do likewise. Other voices were more sceptical, however. Ivo Knoepfel, the second challenger, pointed out that an MBA is chiefly a means to attain a senior management position in an existing organisation, not a course in visionary leadership, while one participant argued that MBA programmes represent the status quo and thus cannot be an engine for the promotion of sustainability. Another participant added that the picture looks even bleaker when one includes the Chartered Financial Accountant (CFA) programme, where sustainability or long-term considerations are virtually non-existent. Under these circumstances it would be up to the companies themselves and the business school alumni to instigate change, the moderator concluded.

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Session 3: Theses – New Aspects – Conclusions

Colin Melvin: “The reality of the chain of ownership between the directors and the beneficial owners is that the intermediaries in the chain are generally able to generate benefits from short-term transactions.”

Peter Voser: “I feel very strongly that management is here to run the business and the owners are actually here to control the management but should not run the business.”

Peter Forstmoser: “I think that as an investor you have the choice between voice and exit, and that you should choose between these two possibilities according to what’s helpful for the beneficiary.”

Peter Ohnemus: “We believe that the quality of information is extremely important and that there is way too much non-quality information out there.”

The final panel session sought to develop conclusions on some of the key issues raised during the symposium, by bringing together four authoritative figures from companies (Peter Forstmoser and Peter Voser), a fund manager (Colin Melvin) and a specialised ESG information provider (Peter Ohnemus). Moderated by Ernst A. Brugger, the discussion centred on three topics: firstly, the relationship between owners and management; secondly, transparency and the quality of information; and thirdly, self-regulation by the industry.

Arguing from the standpoint of a fund manager for very large pension funds, Colin Melvin repeated his arguments made in the previous workshop for maintaining a constructive dialogue between a company’s owners and its management. Because of the sheer amount of money they need to invest, the largest funds are virtually indexed and consequently they cannot just exit under-performing investments. Instead they need to identify the worst performers and engage with them in order to improve their results. Given the chain of ownership in the real world of the investment industry, this amounts to excluding intermediaries focused on making short-term profits and establishing a direct dialogue between pension fund trustees and company directors.

Speaking from his own corporate background, Peter Voser said that in actual practice the nature of dialogue varies among different investors. Many analysts primarily relying on spreadsheet analysis are indeed driven by short-term goals. Investors with a longer-term horizon appreciate strategic information, however, and this kind of dialogue could be further improved. Nevertheless, he cautioned that a clear distinction should be kept between owners and management, so that the latter can run the business effectively. Peter Forstmoser took up Colin Melvin’s plea for active engagement strategies and offered a somewhat different view: while he accepted that this may make sense for particular investors such as very large pension funds, he stressed that in principle it is vital to be able to choose freely between exit and voice strategies, depending on what is in the genuine interest of the ultimate beneficiary.

Meaningful dialogue for long-term investment presupposes the availability of reliable and relevant information. Peter Forstmoser called this a big issue because it would allow companies to get fairer valuations for their long-term focus. The fact that there is still relatively little interest in extra-financial data among professionals and still no agreed reporting framework was called “scary” by Peter Ohnemus, who added, though, that he was very confident to see major improvements in the next few years. At the same time, he agreed with Colin Melvin that there may also be too much information and that transparency needs to go hand in hand with accelerated efforts to identify genuinely material criteria.

The third topic ran across these two issues: should necessary changes be initiated by the industry itself or by the regulators? The answer did not seem to be clear-cut. On the one hand, the panellists made a case more than once for engaging with the regulators. On the other, they expressed a preference for self-regulation. They agreed, however, on the need for a framework providing some sort of censure or “teeth”, as Peter Forstmoser called it. If companies’ compliance (or non-compliance) with the agreed principles and rules is not made visible in some way and there is no pressure by the market or the public, self-regulation will not be effective.

Robeco

SRI in the genes

Robeco's experience of investing in equities goes back to 1929, the founding year of Robeco. Set up as a cooperative structure, Robeco was owned by its clients. Providing long term service to our clients is in our genes, as we say.

Robeco has experience with SRI since 1998. In that year, we won our first discretionary SRI mandate from a Swiss pension fund. It is a strong argument that this client is still a client today. A year later, in February 1999, we launched the SRI mutual fund, Robeco DuurzaamAandelen, as the first Dutch sustainable fund from the bigger, commercial asset managers. As to this day, Robeco still considers SRI as a very good area for business growth. Next to the equity funds, Robeco is also very active in sustainable private equity. In 2004, Robeco Sustainable Private Equity I was launched, and at the moment Robeco Clean Tech Private Equity II is in focus.

Moving towards integration of sustainability

Besides providing our clients with specific SRI products, Robeco is working towards integration: being a responsible and involved shareholder. In 2003, Robeco announced active use of its voting rights worldwide for all its mutual funds. Full voting details are available through our websites. Furthermore, Robeco is offering an engagement product to its institutional clients and as of 1 January 2007 we will engage on behalf of our retail funds as well. Robeco's overall size gives it direct access to company management. Because Robeco feels the obligation to use this opportunity in a responsible way, in these contacts governance and sustainability issues are raised as well. The starting point of our engagement initiatives always lies in external, broadly accepted international codes of conduct such as the UN Global Compact. All these codes are subscribed by Rabobank, of which Robeco is a wholly owned subsidiary.

Robeco believes doing business responsibly is of the essence to fulfill our role in the financial world. Robeco sees that this contributes, in the long run, to better investment products, higher returns and satisfied employees. We continuously need to work in order to keep up with the expectations of society. In our view, this subject needs to be addressed by every asset manager, eventually.

About Robeco

Robeco provides discretionary asset management products and services, as well as a complete range of mutual funds to a large number of institutional and retail clients worldwide. Robeco's product range encompasses fixed income and equity investments, balanced accounts, money-market funds and alternative investments. Robeco is the centre for asset management within the Rabobank Group and has full operational independence. The combination of the highest credit ratings from the major international rating agencies and the highest Sustainability Cluster Score within the banking sector reflects the high added value Rabobank has always offered its investors, members, clients and employees.

Dexia Asset Management

From short- to long term: who cares?

For Dexia AM, long-term investing means sustainable investing. Indeed, sustainable investing is not exclusively a question of ethics, but resolutely a matter of a responsible long-term strategy in line with the principles of sustainable development. According to this approach, in order to achieve lasting or sustainable economic growth, a company must take account of the interests of its stakeholders. From this perspective, sustainable management, the objective of which is clearly the return on long-term investment, includes an additional level of analysis (called sustainability analysis) alongside the financial analysis, so as to identify the long-term risks and opportunities, early indicators of financial profitability.

Sustainability analysis adds a complementary dimension since it considers information of a different nature with a 3 to 7 years' time horizon, often based on more intangible and qualitative aspects of companies. Over the last couple of years, some of these elements have gradually been factored into traditional financial analysis, as for instance corporate governance or, very recently, CO₂ emissions. To date, the degree to which sustainable analysis translates into cash flow forecasts depends on the maturity of the sustainability-related issue and varies sector by sector. However, sustainability analysis will continue to generate a large number of new and unexplored opportunities and prevent long-term risks. In that sense, "sustainable investing" is a way of filling in the sometimes weakly defined concept of long-term investing.

Nowadays, sustainable investing is gradually everyone's business. Companies' management increasingly integrates sustainable development principles. More and more asset managers change their investment philosophy and processes accordingly; institutional investors develop specialist mandates and/or overlays and some of them are ready to change their evaluation horizons, in order to avoid giving up long-term performance for short-term certainty. A key role will be played by end investors and trustees, who need convincing and who also require objective information on the sustainable investment case.

The driver for long-term orientation will be surely a matter of "who cares", but also a matter of "who shares" information, as transparency is a true driving force behind the development of sustainable investing.

About Dexia AM

Dexia Asset Management (Dexia AM) has developed a comprehensive method of sustainability analysis integrated into the well-established and high-performance SRI investment process.

Dexia AM is the asset management arm of the Dexia group, currently managing over €100 billion of assets for institutional as well as retail clients. Dexia AM is not only a leader in the European asset management market, providing a complete range of investment solutions in all asset classes, but it has also pioneered the socially responsible investment (SRI) market by launching its sustainable management process and funds in 1996. Today, SRI assets under management represent € 14 billion altogether at Dexia AM, reflecting the long-lasting commitment to sustainable development principles and values of Dexia group.

At present, a team of nine sustainability analysts works jointly with the traditional financial analysis teams and the eight managers dedicated to SRI.

In October 2006, Dexia AM was elected "Sustainable Asset Manager of the Decade" at the BANCO d'Or 2006 trophée event in Switzerland.

The Sustainability Forum Zürich

The Sustainability Forum Zürich (TSF) is an independent, non-profit, non-partisan association, founded by leading representatives from business, science and public authorities from Zürich and increasingly joined by financial market players from throughout Europe. It has the purpose of organising and realising the annual International Sustainability Leadership Symposium and other dialogue events as well as connected research and promotion of projects, in particular as pertaining to the sustainability topic relevant to the financial market.

Rapid globalisation produces great economic and public upheaval; it essentially changes the playing field and in some measure the rules of the game for business pursuits. On the one hand, the private sector benefits from a significant expansion of its entrepreneurial scope. On the other hand, new challenges emerge: e.g. demographic change, increasing international mobility, shortage of resources, climate change and pandemics. For business, globalisation therefore means greater opportunities as well as risks, greater freedom as well as extended responsibility.

Because of their service and hinge function between the “real economy”, the capital market and society, the players in the financial market – independent of their size and their sphere of influence – deal with these challenges early on. Only in this manner can they maintain their competitive capacity and thereby ensure their existence in the medium to long term.

The following questions are thus posed:

- What are the sustainability issues and related challenges the financial market players will be exposed to in future?
- How does the financial market react to the expected new framework conditions and incentives in order to remain competitive, i.e. to be able to utilise the evolving “sustainability opportunities” and to avoid and manage risks.
- How is entrepreneurial and societal responsibility changing and evolving, in the financial industry in particular and in the private sector in general - and how will the inter-linkages work and where are its limits?

Living up to a transdisciplinary approach is a crucial principle which will be achieved by building up and maintaining strong relations with science and other competent and credible sustainability organisations.

Objectives

TSF provides its members and partners with a dialogue platform that enables the exchange of the most cutting-edge knowledge, experiences and opinions on challenges relevant to the financial market. Companies, experts and scientists, other financial market players, asset owners and capital market regulators are invited to

- “Get fit”: Getting the main players fit through early recognition of financial market relevant, social and geopolitical issues and trends;
- “Challenge mind-sets” of both, the decision makers of the financial sector with respect to their social responsibility, the resulting challenges and of the financial market players with respect to their innovation and communication capacity;
- “Promote options for actions” of the financial market players. The ambition is to improve the efficiency and effectiveness of market practices and instruments and to simultaneously create societal added-value.

TSF’s symposia to date:

2000: Sustainability – Driver to Economic Success?

2001: Financial Services – Drivers to Sustainability?

2002: Governance for Sustainability: Making Corporate Responsibility Work

2003: Towards a More Sustainable Retirement System: The Quest for New Governance and Asset Management Strategies for Pension Funds

2004: Business Investment in Development: Experiences and Perspectives

2005: The Market Value of Reputation

2006: From Short- to Long-Term: Who Cares?

Vision

TSF seeks to contribute to sustainable business in the dynamics of globalisation by promoting forecast, reflection and action in and through financial markets and its key players.

Mission

TSF aims to take up topics relevant to the future, by way of an action-oriented dialogue with internationally recognised topic leaders and decision makers, enabling the integration of entrepreneurially relevant sustainability principles in the financial market.

Conclusions

The topic of the 7th International Sustainability Leadership Symposium clearly hit a raw nerve. As TSF Chairman Prof. Peter Forstmoser pointed out in his welcome address, a number of scandals in the run-up to the event had brought the problems besetting institutional investment to everyone's attention. There was a certain air of urgency about the event therefore, and many participants from mainstream financial services took the lively discussions as a welcome opportunity to identify key shortcomings and propose some specific remedies.

The principal-agent conflicts encountered along the chain of ownership in institutional investment were undisputed. As one speaker put it succinctly, the issues connected to this lie at "the very heart of fiduciary capitalism". In an abstract sense, the ultimate beneficiaries know exactly what they want in the long term: a secure pension that allows them to maintain their standard of living in an intact environment. However, the large majority of savers were said to be incapable of translating these expectations into clear investment preferences, which leads to a very incomplete contract with the pension fund trustees and managers. Addressing this dilemma requires pension funds to create a strict and transparent governance structure aimed at expressing the beneficiaries' real but abstract preferences and reducing conflicts of interest through a clear separation of functions in the investment process.

Financial intermediaries such as fund managers and investment consultants evidently play a crucial role in the investment process: they link capital supply with demand. Intriguingly, though, the way they operate seems to be something of a black box for most non-specialists. Publicly disclosed information on the incentives governing decisions in the managed funds industry was said to be surprisingly scarce, quite in contrast to the spotlight recently put on the compensation of company CEOs.

Methods to measure fund managers' performance and determine their compensation were thus key topics for many participants. Their verdict was clear: currently there is a strong focus on out-performance of a specific benchmark over a very short period of time. This in turn leads many fund managers to over-emphasise quarterly or half-yearly earnings figures, thus creating strong short-term pressures for investee companies. Likewise, investment consultants have a vested interest to match measurement horizons with the length of their own mandates.

Measuring performance over a longer time period therefore emerged as a highly desirable goal. Several speakers warned of the difficulties involved in this, however. Determining and compiling relevant information that reliably indicates long-term success potential has so far proved difficult, so extending the horizon of performance measurement was said to carry risks, especially for the ultimate savers. Incomplete processing of information ("bounded awareness"), the audience was reminded, is one of the reasons why people have a natural tendency to focus on the short term.

It was no surprise, then, that the concept of risk and the search for information with long-term relevance both featured strongly in the discussions. Acceptance of risk is a fundamental precondition for generating long-term economic growth. Investors need to be made aware of this connection and learn to accept the higher volatility associated with it. Anecdotal evidence presented at the symposium suggests that investors are willing to overcome their prevailing risk aversion, provided they understand what causes swings in a particular business. But there is also a need to better align risk-sharing with financial intermediaries who do not at present bear a direct share of the risks generated by their investment strategies. Building trust for long-term investments, it was argued more than once, requires that fund/asset managers are made to take a stake in their investments and financial results.

With regard to the availability and use of meaningful information, the symposium revealed a somewhat contradictory situation. Relatively simple metrics that can be fed into spreadsheets still play a dominant role in analysts' work. At the same time some recent studies cited at the symposium provide evidence that environmental, social and governance (ESG) criteria are positively correlated to financial performance. This means that their inclusion in investment decisions does not violate the fiduciary principle, which requires the maximisation of returns unless another purpose is specified. As a result, there have been signs that the use of ESG factors has started to spread from the "niche" market of socially responsible investment (SRI) to main-stream investment.

Yet, it also became apparent that there is still a lot of scepticism about the relative relevance of individual ESG factors as well as their overall reliability. This led to calls for accelerating efforts to determine their materiality, increasing transparency and improving communication with the investment industry.

In the case of underperforming investments investors have traditionally responded with "exit" strategies, that is, by simply selling their shares. Strategies of "engagement", efforts to seek a constructive dialogue with such investee companies, have shown to have a positive impact on long-term performance, however. When the relative merits of these two approaches were debated at the symposium, the varying needs of different investors emerged as a key argument. On the one hand, it was stressed that it should at all times be possible to freely choose between engagement and exit, depending on what is in the true interest of the ultimate beneficiaries. On the other hand, attention was drawn to the fact that exit strategies may be impractical for very large pension funds because frequently these are virtually indexed. Direct engagement with individual companies then becomes the only option to improve performance, which means that intermediaries with short-term goals need to be cut out of the chain of ownership.

The wide range of inputs discussed at the symposium and the sophistication of debate were in themselves reminders of the complexity of the topic. The ability to assume direct responsibility and express preferences in this complex environment requires a good grasp of the fundamentals of investment. Not surprisingly, therefore, the need to improve education in financial and economic matters was emphasised throughout the event. This applies not only to the individual savers but also to pension fund trustees.

The significance of education was directly tied to the question of individual choice. In this context two distinct positions became apparent: Supporters argued that increasing pressure caused by demographic change as well as structural shifts in the economy would make a change of system towards personal responsibility inevitable. Critics replied that, because of the large educational gaps currently existing, collective approaches based on the solidarity principle of social security are likely to produce better overall results.

Finally, a number of speakers and participants argued that many of the problems besetting institutional investment have been caused, or at least aggravated, by regulatory frameworks. An approach focused on "fixing holes", it was felt, had led to unsystematic overregulation, in the process creating wrong incentives for players in the industry. Part of the blame for this failure was put on the lack of dialogue between regulators and financial sector representatives. A shared effort to overcome this apparent wariness emerged as one of the key priorities from the symposium – which is fully in line with the mission of The Sustainability Forum Zürich.

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