BIS | Department for Business Innovation & Skills

KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING

Professor John Kay
Speech at Kay Review Launch

23 JULY 2012

Kay Review of UK Equity Markets and Long-Term Decision Making

On 23rd July 2012, Professor John Kay published the Final Report of his independent Review to examine investment in UK equity markets and its impact on the long-term performance and governance of UK quoted companies.

Terms of Reference for the Review were:

"To examine the mechanisms of corporate control and accountability provided by UK equity markets and their impact on the long term competitive performance of UK businesses, and to make recommendations."

This included the following areas:

- Whether the timescales considered by boards and senior management in evaluating corporate risks and opportunities, and by institutional shareholders and fund managers in making investment and governance decisions, match the time horizons of the underlying beneficiaries
- How to ensure that shareholders and their agents give sufficient emphasis to the underlying competitive strengths of the individual companies in which they invest
- Whether the current functioning of equity markets gives sufficient encouragement to boards to focus on the long term development of their business
- Whether Government policies directly relevant to individual quoted companies (such as regulation and procurement) sufficiently encourage boards to focus on the long term development of their business
- Whether Government policies directly relevant to institutional shareholders and fund managers promote long-term time horizons and effective collective engagement
- Whether the current legal duties and responsibilities of asset owners and fund managers, and the fee and pay structures in the investment chain, are consistent with asset owners' long term objectives
- Whether there is sufficient transparency in the activities of fund managers, clients and their advisors, and companies themselves, and in the relationships between them
- The quality of engagement between institutional investors and fund managers and UK quoted companies, and the importance attached to such engagement, building on the success of the Stewardship Code
- The impact of greater fragmentation and internationalisation of UK share ownership, and other developments in global equity markets, on the quality of engagement between shareholders and quoted companies
- Likely trends in international investment and in the international regulatory framework and their possible long term impact on UK equity markets and UK businesses.

Professor John Kay – Speech at Kay Review Launch – 23 July 2012

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The Kay Review
of
UK Equity Markets
and
Long-term Decision Making

RSA, Monday 23rd July 2012

Professor John Kay

1. I would like to begin by thanking the people, many of whom are in this audience, who have contributed to this Review – the Advisory Board, James Anderson, Chris Hitchen, and John Rose, who are with me on the platform: the BIS team, led by Andrew Busby and Alastair Cowie, who have supported us: my own personal assistant, Jo Charrington, who managed my time, the friends of the Review, who contributed to our thinking in a series of round table discussions: and the many people who made submissions and with whom we had formal and informal consultations. I have learned a lot in the process – and it was more fun than I had anticipated.
2. The final report of the Review which was published this morning is 40,000 words long – I was aiming at half that length – and fairly dense, although I hope it is more readable than the average government report. So I don't expect that many of you will have read it: I hope you will find an opportunity to do so, but tonight I cannot do more than give a brief outline. I want to outline the issues, as we have seen them; describe our diagnosis and approach; and then talk about some principal recommendations.
3. One central theme is the need for trust and confidence in financial intermediation. What financial intermediation is about, essentially, is enabling people to invest their savings with borrowers and businesses about which they may know little or nothing, and to do so with confidence because they have well-founded trust. Another thing is the importance of incentives. To some people incentives mean bonuses but I mean

something wider. People's behaviour typically meets the expectations generated by the environment in which they operate. Incentives aren't an alternative to culture; incentives, appropriate or inappropriate, and trust and confidence, or its absence, are the product of the culture of financial organisations.

4. Our subject is equity markets and long term decision making. The American psychologist Walter Mischel has studied the drivers of short term behaviour. Mischel is famous for the marshmallow test, in which young children are offered the choice of one marshmallow now, or two after a short wait.
5. Mischel conducted follow up studies over 20 years of the children who participated in his experiments. He claimed that the reactions of the children was a good predictor of both scholastic achievement and future behavioural problems.
6. Reactions to the marshmallow test illustrate the two common manifestations of the natural human tendency to short termism. One is excessive discounting of the future in favour of the present. No sophisticated discounted cash flow analysis is needed to demonstrate that the internal rate of return on waiting a few minutes to get two marshmallows instead of one is extremely high. But the test also demonstrates our innate bias to action. It is very difficult for small children to sit, even for a few minutes, without doing something.
7. But do we overcome these biases when we grow up to become corporate executives? And do the institutions of our equity markets aggravate these biases, or help us to resist them? These are the questions which the Secretary of State posed for us a year ago. Today, I am going to answer these questions: yes and yes.
8. I am particularly glad Richard Lambert is here today, because I can jog his memory about another occasion on which we shared a platform: the CBI's annual conference at Harrogate in 1996, when he was still editor of the Financial Times and John Major was still Prime Minister. I began that talk by describing a change in the objectives and aspirations of ICI, for most of the last century Britain's leading industrial company. This was how the ICI of the past described itself.

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9. That company had shifted its direction from its origins in dyestuffs and explosives to fertilisers and petrochemicals as new commercial applications of chemistry and related sciences because available. After the Second World War, the ICI board correctly saw that the application of chemistry with the greatest potential was pharmaceuticals, ICI lost money in the pharma business for two decades but in the process created an organisation that ultimately became the principal profit earner for the group as a whole. Support for ICI's pharma division may have been the best and most important long term decision in the history of British business.
10. In the 1990s, ICI's traditional approach changed. The company adopted a new mission statement.

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ICI 1994

"Our objective is to maximise value for our shareholders by focusing on businesses where we have market leadership, a technological edge and a world competitive cost base".

11. The pharmaceutical business was floated off. The rump company sought to reinvent itself through an programme of acquisitions and disposals. We now know how the story I told in 1996 ended.

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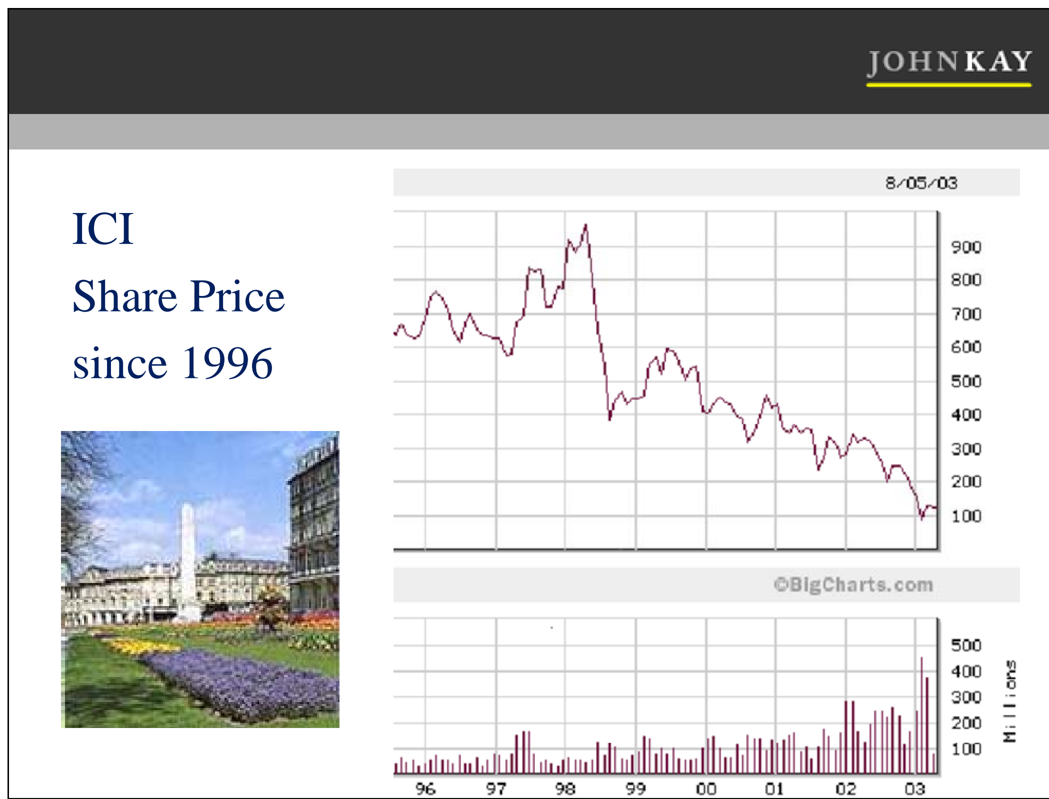

12. The ICI share price, was at a peak at the time of that talk, and went on rising – for two more years. It then began a relentless five year decline. After 2003 the share price stabilised and then recovered somewhat. ICI no longer exists as an independent company: in 2007 it was bought out, at something close to the 1996 price, by the Dutch company, AkzoNobel.

13. At the beginning of the 1990s, Britain's second largest industrial company was GEC. At the time of that Harrogate conference GEC was also experiencing fundamental change, with the retirement of the man who had dominated it for 30 years, Arnold Weinstock. Weinstock had for a time been Britain's most admired industrialist, having cleared up the inefficient bureaucracy which had constituted Britain's electrical engineering industry before GEC acquired AEI and English Electric. But in the later stages of his tenure, Weinstock's emphasis on budgetary control based on short term targets had led the company to concentrate on sales in relatively uncompetitive markets to public sector customers, and to miss opportunities in exciting new applications of electrical engineering skills.

14. But worse was to come – much worse. The new management of GEC determined to rectify the company's weakness in new markets through a series of acquisitions. The purchases made were ludicrously expensive, and when the new economy bubble burst in 2000 the company was left exposed. Within a short time it came close to collapse, was broken up after a debt for equity swap, and like ICI no longer exists as an independent entity.

15. The world's leading chemical and electrical engineering companies today are BASF and Siemens, both German. Britain does again have a major chemical company, although it is legally headquartered in Switzerland: that company is INEOS, and it is

privately owned: in fact it is Britain's largest private owned company. The largest operator of the former ICI activities is the US company, Huntsman, privately owned until 2005 and still controlled by the Huntsman family.

16. These facts direct our attention to the second part of the Secretary of State's question: the role of equity markets. Weinstock's GEC was damaged by short termism, but the blame for this must rest with the company's style of financial control, not the influence of its shareholders: Weinstock was contemptuous of equity markets. But the changes at ICI, and at GEC after 1996, were very directly related to market influences.
17. Once, the senior management of large British companies paid little attention to the company's share price or its investor relations. At ICI this disdain became much harder to maintain after the company cuts its dividend in 1981, in the face of recession and exchange rate appreciation which hit the heavy chemical businesses hard. The following year, the publicity conscious John Harvey Jones was appointed executive chairman. But the decisive event was ten years later, in 1991, when Hanson – the acquisitive conglomerate now itself defunct – built a disclosable stake in ICI; the effect was galvanising to a degree disproportionate to the reality of the takeover threat.
18. The motives behind the transformation at GEC are clearly set out in a series of three articles written in the Financial Times in 2002 by John Mayo, the investment banker turned corporate executive who played a leading role at both ICI and GEC. Mayo sets out a vision of the corporate executive as meta-fund manager, acquiring and disposing of a portfolio of businesses rather as a fund manager might view a portfolio of shares. In his account, what the businesses actually do is a matter which is reported to him, rather than a matter he himself seeks to influence. The world of the meta fund manager, preoccupied with market expectations, is a style of thought very different from that described in that ICI statement of 1987. Or the one still embraced at BASF and Siemens.
19. Many respondents took the view that the key problem for us to address in the Review was the need to increase shareholder engagement. We can only partially agree. At ICI and GEC, shareholder engagement was the problem rather than the solution: if executives had been less interested in the views of the market, they would not have made the decisions they did, and the events that led to the death of these companies were initially strongly supported by shareholders. It is the quality of engagement, not its quantity, that matters.
20. Engagement of quality is based on trust and confidence, and these characteristics are the heart of effective financial intermediation. We have heard a lot recently about the need to restore trust in the financial services sector. A recent poll for ITN showed that only 10% of the population trusted bankers – less even than journalists and politicians. But restoring trust is not something you achieve by lecturing people about how honest you are.
21. Trust and confidence is something that is earned or forfeited by behaviour, and the reason trust has gone is that the objective basis for trust has gone.
22. The central issues for this Review arise from the replacement of a financial services culture based on trust relationships by one based around transactions and trading. We can see that shift in the management preoccupations of ICI and GEC, and in the development of a market place in which hedge funds and high frequency traders account for a majority of turnover on the London exchange even though they hold an insignificant proportion of the stock.

23. In one of the many helpful submissions we received, the IMA invited us to distinguish between investors and traders.

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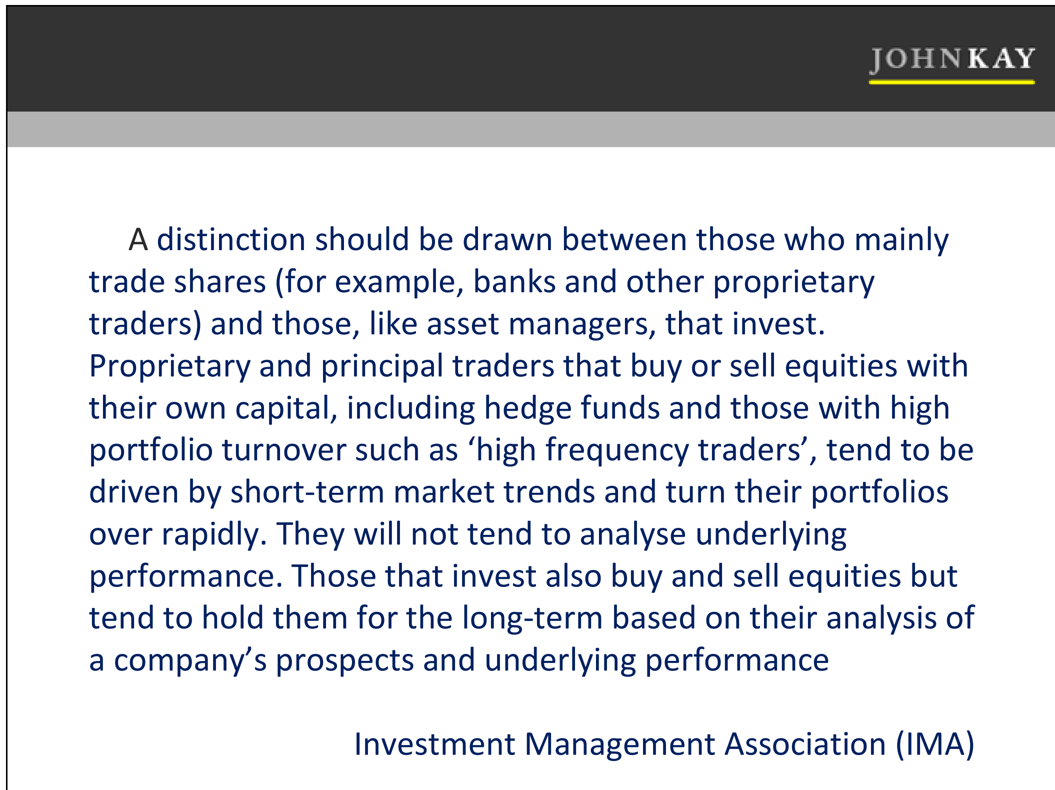

24. This distinction is not clear-cut, and any asset manager's strategy will involve elements of both investment and trading. But the distinction is mirrored in the two fundamental bases of asset valuation.

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Two bases of asset valuation

- The value of an asset is the value of the cash and earnings it will generate over its life

- The value of an asset is what someone else is willing to pay for it.

25. That distinction explains why it makes sent to wait for the second marshmallow – the value to the patient investor is the higher of the two possible bases of valuation.
26. Short termism in decision making in asset management does not, of itself, imply short term decision making by corporate managers. This point was well made to us on many occasions – the essential purpose of equity markets is to allow savers and companies to invest on different time scales.
27. But there is a relationship between the horizons of performance measurement and the horizons of decision makers. Begin with a simple example. An event changes the fundamental value of a company.

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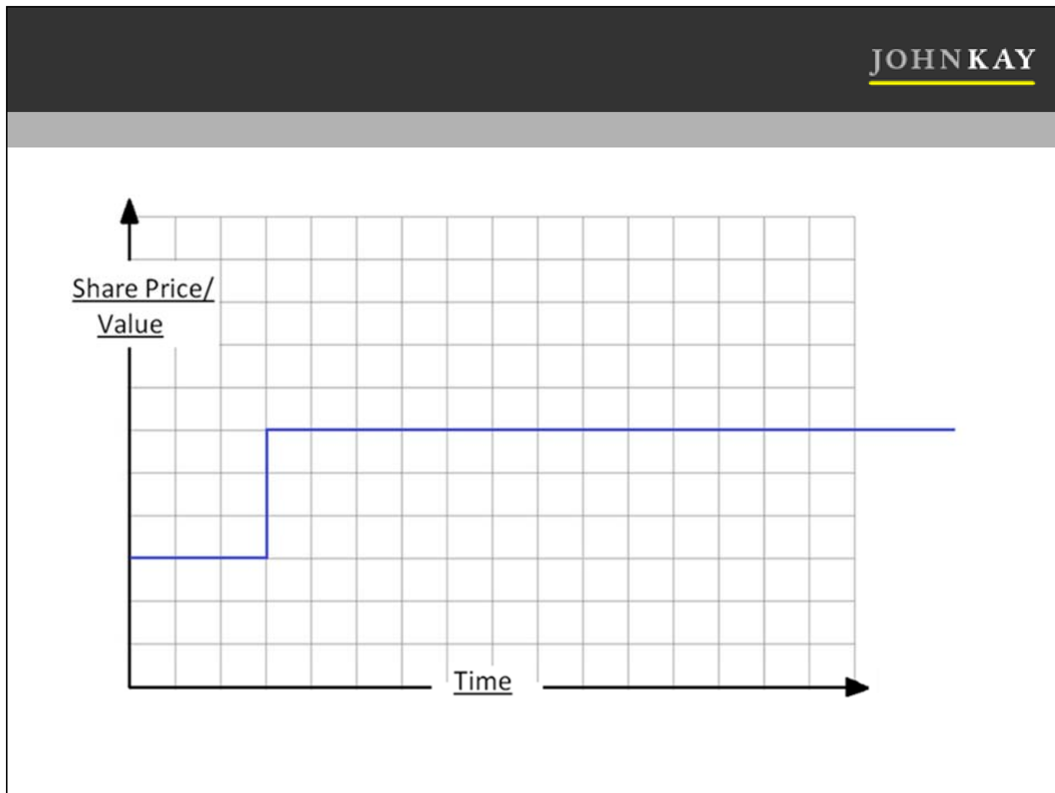

28. But we don't know – nobody knows – exactly what the effect will be. In the case of some large events with complex long term consequences – an acquisition, for example – we may not even be sure of the direction of the effect.

29. So we expect errors and fluctuations in assessment, which will gradually settle down as the future emerges. Call the point at which the effects have become clear the value discovery horizon.

30. Now compare that with the time period over which the asset manager's performance is judged. If the performance horizon is long, then what matters is the ability of the fund manager to understand the impact of the event over the value horizon.

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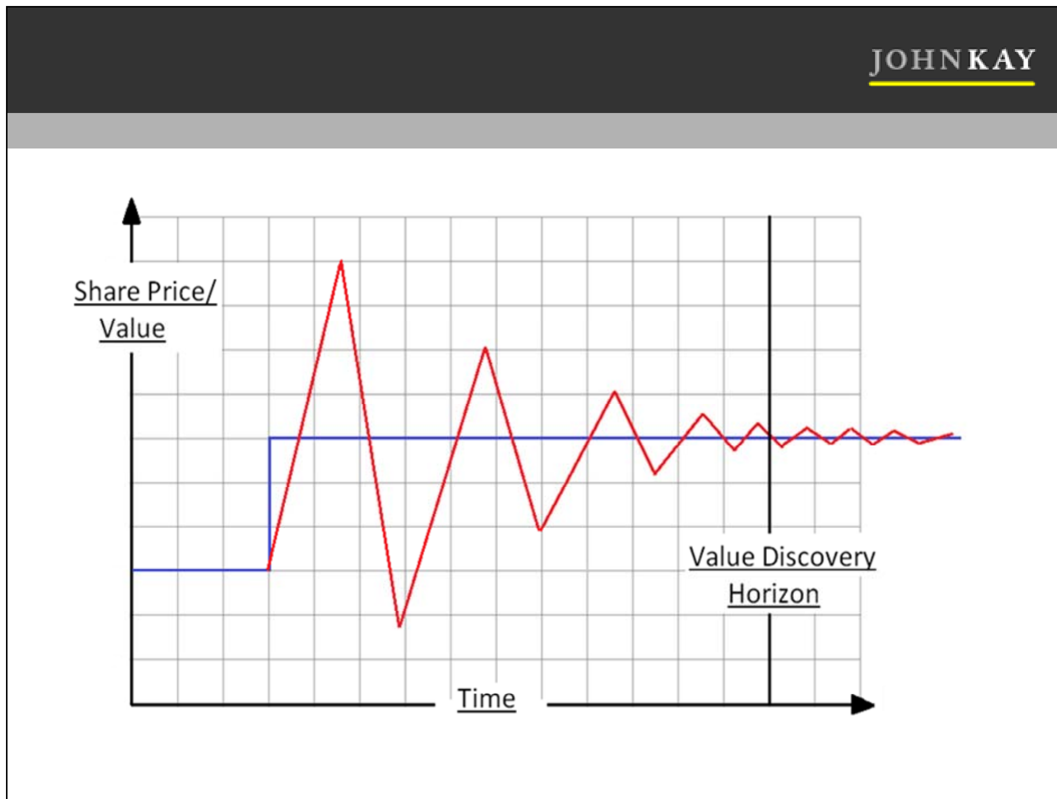

31. But not if the performance horizon is short, what matters then is the market's assessment of the event, not the actual impact of the event.

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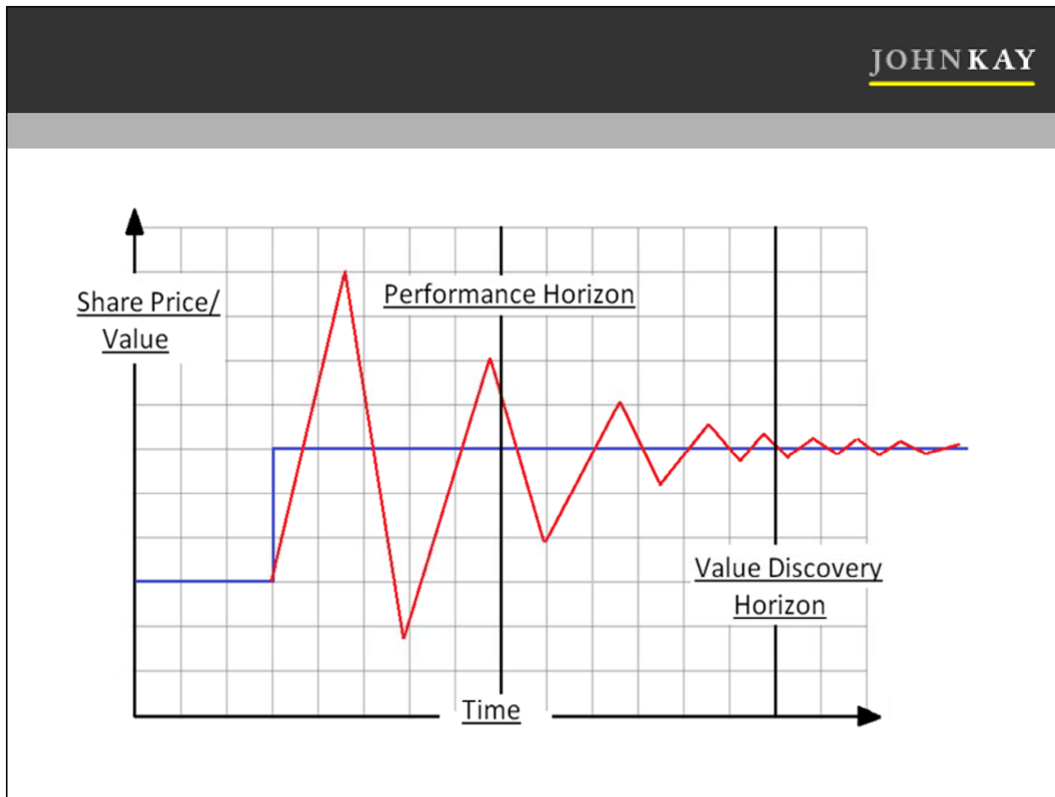

32. On top of that, the asset manager is judged, not just on his short term performance, but on his short term performance relative to other asset managers. He is being judged, by reference to the quality of his guess at other asset managers' assessment of the event. This is, of course, Keynes' famous beauty contest, in which contestants are speculating, not on which face is most beautiful, but on which face other contestants will think other contestants will think is most beautiful. The shorter the performance horizon relative to the value discovery horizon, the more important is the understanding of the psychology of other asset managers, and the less important the understanding of the impact of events on the fundamental value of the company. And that is true for asset managers, for prospective investors and for traders – and for corporate managers who focus on the price of their company's shares, or are incentivised to do so.

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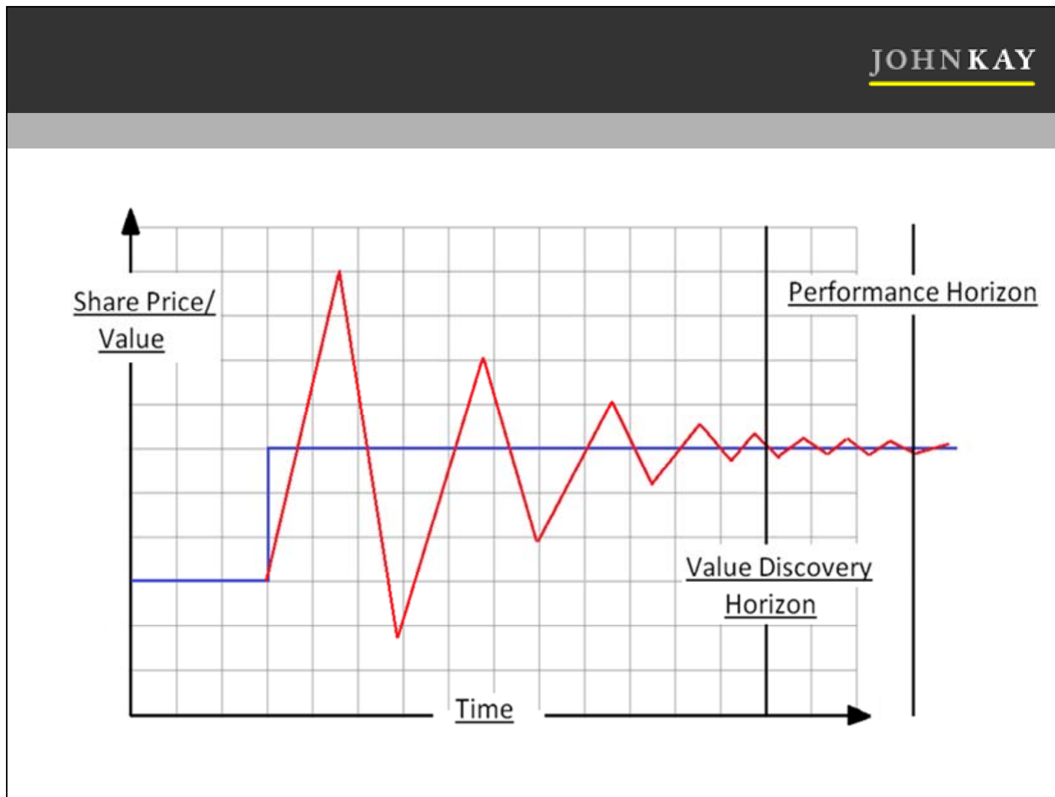

33. What we have seen over the last few decades, therefore, is a process by which the affairs of companies became ever more complex and uncertain – so that the value discovery horizon lengthens – while the assessment of the performance of asset managers, traders, and company managers becomes more rigorous and more frequent – so that the performance horizon shortens. And this shortening of the performance horizon and lengthening of the value discovery horizon becomes self-reinforcing. As asset managers look more and more to each other, and less and less to the competitive strengths of the companies in which they invest, short term price fluctuation becomes more extreme, and the value discovery horizon lengthens.
34. And so we have created a world in which trading and transactions have replaced trust and confidence, in which people look more and more to what each other is doing and less and less to the long term fundamental value of their activities. This isn't – let's emphasise – because people are not trying to do the right thing, as they see it. It is because they are responding to the incentives created by the environment in which they operate.
35. And that leads us to how we approach the question of what we should do about it. I have started with diagnosis, contract to analysis, let's talk about remedies. We need to talk about regulation. Almost everyone I have talked to in the last few months thought both that there was already too much regulation, and also that we would be proposing more of it. That suggests something is going wrong.
36. We have dysfunctional structures that give rise to behaviour that we don't want. We respond to these structures by identifying the undesirable behaviour, and telling

people to stop. We find the same problem emerges, in a slightly different guise. So we construct new rules. And so on. And on. And on.

37. Moreover, as the regulation becomes more and more detailed, fewer and fewer people understand it. We create a regulation industry which has an interest in its own expansion. And because knowledge of this regulatory detail is a requirement for commenting on regulation, the regulators come to see issues through the eyes of the industry they regulate – the phenomenon described as regulatory capture. Of course they see things that way. What else can they talk to? What other source of information do they have? The result is one we all recognise – regulation which is at once extensive and intrusive, and yet largely ineffective in achieving its objectives – promoting the interests of the companies and savers that use financial markets.

38. The approach we favour is one which favours giving people incentives to do the right thing, rather than presenting rules to prevent them doing the wrong thing in a situation where commercial incentives encourage them to do the wrong thing. It is an approach which emphasises structure and incentives, rather than prescriptive rules.

39. And that is why we have not made proposals for new regulations or legislation in our report, with some important areas of exception. The most important of these is that we are clear that those engaged in the equity investment chain should operate to fiduciary standards – that is, that anyone who manages other people's money, or advises on such investment, should avoid conflicts of interest: act in the interests of the client: and should behave as a prudent man would in managing the affairs of someone for whom he felt responsibility. Most people, including many people in the industry, would think it incredible that anyone should think otherwise, and fiduciary standards are an obvious precondition of establishing the relationships of trust and confidence I have described.

40. Two central recommendations in our report are that the principal agents in the equity investment chain – asset managers, asset holders, and company directors – should act in accordance with statements of good practice, and that we should encourage large institutional investors to act collectively and establish a form to facilitate such collective engagement. The chain of intermediation in equity investment – registrars, custodians, nominees, fund managers, fund of fund managers, asset allocators, trustees, investment consultants, platforms, IFAs, and more – is too long: it costs too much, and it creates potential for misalignment of incentives as each group of intermediaries operates its own business model.

41. The central figure in the chain is, and should be, the asset manager. Indeed in my ideal world, the simple chain of intermediation would be one in which the saver places funds with an asset manager in whom he or she has trust and confidence, and the asset manager invested in companies with whom he or she enjoyed a sustained relationship of trust and confidence. I should acknowledge that only a proportion of total equity holdings can, or should, be actively managed in this way – it is likely that passive holdings will constitute a large part of the overall market.

42. This is an ideal, but one which is a long way from where we are now. We identified – I don't have time to develop the argument now, although it is a crucial issue – the misalignment of incentives that arises for the asset manager, whose business model generally depends on short term relative performance, vis-à-vis the saver and the company, whose interests are, or should be, in long term absolute performance. That misalignment is the product of the short term performance horizons I have described, and the focus on relative performance – asset managers seek to achieve α, but aggregate α for the industry is zero. Returns to savers taken as a whole can be

enhanced only by activities which enhance the performance of companies, taken as a whole.

43. Our statements of good practice relate not just to asset managers themselves, but to asset holders, who place funds, and to company directors themselves. Good practice is, we believe, ultimately the product of how people think, not the result of rules which attempt to impose good practice on them. We hope that good practice will lead to an asset management sector with more concentrated portfolios, more differentiated from each other, based on fewer but longer term holdings than is typical today, thus partly addressing the problems of misaligned incentives created by the fragmentation of the asset management industry.

44. We also seek to address this fragmentation by our proposal for an Investors' Forum, a formal vehicle for collective analysis and action in which the major players would be the principal asset managers. If the Arab spring needs to be followed by a stable constitutional government, so should the shareholder spring. It is very easy to think of recent and current examples of where collective action by major shareholders would have been useful.

45. Our approach – emphasising trust and confidence, incentives, and the need for long term decision making – leads us to proposals on the structure of executive remuneration, the central issue in that shareholder spring. We are sceptical altogether of the role of bonuses: measures intended to produce alignment of interests in the equity investment chain have, as these events have illustrated, proved to be a principal source of friction and misalignment. Relationships based on trust and confidence don't typically have bonuses as a central component, as the economist who applied principal agent theory to toilet training discovered. We are particularly sceptical about the role of so called long term incentive plans created by remuneration consultants. We advocate that bonuses should be paid only in shares, and that the vesting period should extend beyond the tenure of the executive.

46. I am not – you will be relieved to hear – going to take you through the 17 recommendations of the report one by one. I would emphasise again the central themes:

    - the need for a simpler, shorter, less costly equity investment chain based on relationships of trust and confidence rather than transactions and trading
    - the importance of aligning incentives at each of these stages with the imperatives of good long term decision making
    - the need for regulation which focuses on structure and incentives rather than the complex rule making, and adopt the perspective of the end users of markets rather than the market participants.

47. What we have tried to do is set out a long term vision and philosophy combined with some initial practical steps towards these goals. I commend the report to you and look forward both to your immediate reactions today and your considered responses when you have had an opportunity to digest the diagnosis, approach and recommendations we have put forward.

This publication consists of Professor Kay's speaking notes and also the slides presented by Prof. Kay, during his speech. The Final Report of the Kay Review is available separately, at: http://www.bis.gov.uk/kayreview

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