

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

**Professor Kay's Speech**

**Call for Evidence Launch**

**National Association of Pension Funds (NAPF)**

**15 September 2011**

I am very grateful to the NAPF for hosting this occasion today. My own association with the NAPF goes back almost thirty years. Then, as Director of the Institute for Fiscal Studies, I concluded that pensions were one of the most inadequately understood and inadequately studied areas of fiscal policy. Since then, the area has been far more extensively studied: I am not sure that it is more adequately understood. Nor am I sure that the results of increased attention have been wholly beneficial. That lesson is one we shall have in our minds in conducting the present review.

But during these years and through the many changes we have experienced, the NAPF has played a central role in facilitating study and improving understanding. Let me express my thanks for the help you gave in that to me, my colleagues and successors at IFS, and for the role you continue to play. Let me also express my thanks to your past Chairman, Chris Hitchen, in agreeing to be part of the advisory board for this inquiry.

What are we trying to achieve in this review of equity markets and long term decision making which Vince Cable announced in June? I am very aware that there is a degree

of 'review fatigue' amongst company directors and the financial community. I hope to avoid adding to that fatigue. If a year from now I find myself spending the autumn addressing audiences of company secretaries and compliance officers, describing a new code, illustrating the boxes that they will be required to tick, I and my colleagues will have failed in our job. The subject of this review is corporate decision making and corporate performance, not corporate governance. We will be concerned with actions and effects. Our interest in process arises only to the extent that we can identify direct links between process and performance.

So we will not just be discussing what new regulation might be imposed on companies and investors, but whether existing regulation may be getting in the way of the goals of a vibrant corporate sector and the achievement of strong investment returns. Is it possible, for example, that successively more onerous reporting requirements imposed on companies encourage managers to focus on 'making the numbers' rather than on developing the underlying competitive strengths of their businesses? Is it possible that the more demanding obligations to which pension trustees are now subject have in practice encouraged them to pursue more passive investment strategies?

Our concern is with the effects of equity markets. Equity markets provide the link between the activities of publicly traded companies and returns to the underlying beneficiaries. Such companies are a principal source of jobs and growth: the returns these companies earn for their shareholders are critical to the achievement of our personal financial aspirations and our comfort in retirement. Equity markets contribute

to our prosperity in our multiple roles – as employees of businesses, as consumers of their products, as savers, as prospective pensioners whose standard of living depends on investment returns. Everything we will do in this review follows from the perspective of how these markets contribute to jobs, growth and financial security.

The core questions we will be asking are therefore how well equity markets perform in

- enabling publicly traded companies to make the right decisions in the development of sustainable, profitable businesses;
- enabling savers and those who act for them to make the right decisions to achieve their underlying investment goals.

If equity markets provide the link between the activities of publicly traded companies and the returns to beneficiaries, it follows that the functions of equity markets are to enhance the capabilities of publicly traded companies, on the one hand, and to achieve the best possible returns for savers, on the other. The performance of equity markets is to be judged by their success in promoting these purposes – enhancing the corporate performance of companies by facilitating investment and supporting better corporate governance, and enabling investors to profit from the development of these capabilities. In the end, the twin objectives of corporate achievement and high returns reduce to a single criterion, because it is only the performance of companies that enables investors to derive sustainable returns from business activities.

That perspective implies that everything that happens in equity markets has to find its rationale in its contribution to one or other of these two objectives. Does it help companies perform better? Does it enable investors to earn more (perhaps after making appropriate allowance for risk)? I emphasise this perspective because it is common to measure the performance of equity markets in terms of intermediate objectives – liquidity, transparency, price discovery – rather than by reference to final goals.

Liquidity, transparency, price discovery may be good things: but they are not unambiguously good things: they may have diminishing returns, and achieving them may entail costs. We will be looking for justification for equity market practices, not by reference to the criteria applied by market intermediaries, but by reference to the benefits offered to the customers of these markets – the companies which list and the savers whose funds are invested in these companies.

This is not to doubt for a moment that the provision of liquidity is central to equity markets. Equity markets allow the time horizons of the companies which use investment funds to differ from the time horizons of the savers who provide these funds. That is why a modern market economy needs an equity market. We do not take seriously the naive argument that if fund managers must review their performance on a quarterly, or monthly, basis, it follows that company managers are similarly forced to review their performance on a quarterly, or monthly, basis. People who think that simply do not understand how equity markets work.

But to say that equity markets allow investors and companies to work to different time horizons does not mean – nor should it mean - that investors and companies can make long term decisions independently of each other. Nor does it mean that companies and savers are not greatly affected by the timescales on which intermediaries in equity markets – such as asset managers – are held accountable. To think that would also be to misunderstand how equity markets work.

To reiterate, the performance of equity markets should be judged by the contribution these markets make to improving the capabilities of companies and to enhancing the returns to investors – and these are the central criteria by which the performance of equity markets is to be judged.

That is the premise from which this review begins. The origins are found in a concern on the part of the Secretary of State, and of some of the respondents to the consultation which he launched in 2010, that equity markets have evolved in ways which are insufficiently supportive of one, or both, of these objectives. Our job is to ask whether there is a basis for these concerns, and, if so, what might be done about it.

The timetable on which we are operating will therefore divide our work into two parts. The consultation I am launching today will be principally concerned with the evidence base – is there a problem, and if so what is its nature – and will run to November 18<sup>th</sup>. We will review that evidence and publish interim findings in February 2012.

I suppose we might conclude at that point that there is no problem, and take ourselves off on a skiing holiday in the Alps. But I doubt it: it is evident from the material which BIS has already received that many people believe there is an issue here. Even if their fears are exaggerated, as in some respects they may be, the perception of such a problem is itself a problem: especially if that perception is maintained by people in the business community. So I doubt if we will have reached the end of our work in February. In the interim report we will make preliminary suggestions of actions that might be taken, providing a further opportunity for consultation which will run until sometime in the spring of next year. We propose to publish a final report in July 2012.

The question of the relationship between perception and reality affects the conduct of the review in other ways. I am anxious that our report should be evidence based. We will receive submissions more enthusiastically if they contain evidence – which might be statistical data or, equally welcome, descriptions of the respondent's own experience – than submissions which are primarily statements of opinion. Of course, statements of opinion are evidence, but they are evidence of what people think, rather than of whether there is a sound evidential basis for what they think.

The scope of the review will principally relate to companies traded on UK markets which have significant operations in the UK. These markets include the Alternative Investment Market (AIM) and the PLUS markets as well as the London Stock Exchange's main market. We will not therefore be concerned with businesses that have UK listings but

are not in other respects UK businesses – mining companies in the former Soviet Union spring to mind. We might, however, be concerned with the effect the presence that such companies in the UK markets has on the behaviour of UK investors and UK based companies. Nor will our concern be with the behaviour of companies operating in the UK which are listed elsewhere – for some reason Kraft springs to mind. But we will be concerned with major UK based and listed companies even if they are multinational in their operations, as so many UK listed companies now are. BP, Glaxo Wellcome, Vodafone are very much part of our brief.

When we start to think of the names of individual companies, we also begin to think of the types of decisions which are relevant to this review. When people talk about short and long-term decision making they are often concerned with decisions about physical investment – the sorts of expenditures which a company like BP must make, and has in the past successfully made, in oil exploration, development, and production around the world: investment which may take a decade or more to come to fruition. But, as the BP example itself illustrates, the issues germane to the long term health of the company do not just involve its physical assets. Successful businesses must maintain their reputation with their customers and within the communities in which they operate. Successful businesses must build and sustain the skills and confidence of their workforce. All these are equally important parts of the long term agenda – and I am fortunate to have Sir John Rose on my advisory board. His former company, Rolls Royce, has an impressive long term record in all three of these areas – tangible investment, corporate reputation and workforce capabilities.

As does Baillie Gifford, the asset management company which has generously lent the services of James Anderson to the Review. Baillie Gifford is itself a partnership: the fact that globally so many of the largest and most successful investors in quoted markets are not themselves quoted companies – Fidelity, Capital, Vanguard, TIAA-CREF - is a paradox to which we might devote a little attention.

Asset managers are, for the purposes of this review, the most important of the intermediaries engaged in the transmission of corporate performance to savers and pensioners. But they are only one of many kinds of intermediary in the investment chain. The days have long gone in which the principal source of equity funding for public companies was the individual buying stock in a business of which he or she had personal knowledge. The central role of the professional intermediary creates scope for stimulating better decision making by both companies and investors, through more skilled and knowledgeable oversight of the activities of businesses and through more sophisticated matching of investment opportunities to the needs of savers.

A fundamental issue for the review, therefore, will be whether the growth of intermediation has achieved this objective. Or has the proliferation of intermediaries added to the costs faced by savers (what I will describe as the 'wedge' between the underlying return earned by the company and that received by the investor). Has it interposed agents with their own objectives which may differ from those of either companies or savers? And, if all these things – more professionalism, higher costs,



multiplication of potential conflicts of interest – are true, have the costs of increased intermediation justified the benefits? That is a core issue on which we shall be seeking evidence, both through submissions and from our own research.

We begin this review with one, and only one, preconception: that the purposes of equity markets in this country are to enhance the performance of British business and to provide good returns to savers and pensioners. Beyond that, everything else is open for evidence and debate. This review is not designed to provide cover or rationale for a set of decisions which have already been made – or if it is, no one has told me what these decisions are. Neither I, nor the Secretary of State, come to the review with an agenda of specific reforms we are seeking to promote.

I am aware that when someone undertakes a task such as this, certain people will trawl through what the individual concerned has said and written in the past. They want to discover ‘where they are coming from’. I am afraid that anyone who undertakes that task in this case has a difficult job, since I have said and written a great deal, and they will find what I have said and written on this issue somewhat contradictory. If they look back twenty years, they will find me sceptical about whether there is indeed a short-termism issue: more recently, I have been more inclined to suspect there is. If I have changed my mind, I think it is partly because the environment has changed, and partly because my interpretation of it has changed: I am more sceptical about market efficiency, and attach more significance to deviations from market efficiency, than I did two decades ago.

‘When the facts change, I change my mind: what do you do sir?’ This remark is often attributed to Keynes, although I know of no evidence that he actually said it, and I doubt if he did say it because it is not a particularly good remark. Of course, any intelligent person changes his mind when the facts change (although many people seem to find even this difficult): The larger challenge is to acknowledge that one is simply wrong: to change one’s mind when new evidence or better analysis of the same facts appears. The intellectually honest answer to ‘where are you coming from?’ is ‘I have not come from anywhere, and I don’t know where I am going to end up, but I do know the steps I am planning to take to get there’. It is in that spirit that I approach this review, and it is these steps that I am describing today.

(2506 words)